

**School of Accounting**

**Audit Committee Expectations on the Effectiveness of the Internal  
Audit Function: A Malaysian Perspective**

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**This thesis is presented for the Degree of  
Doctor of Philosophy  
of  
Curtin University**

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# DECLARATION

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To the best of my knowledge and belief this thesis contains no material previously published by any other person except where due acknowledgement has been made. This thesis contains no material which has been accepted for the award of any other degree or diploma in any university.

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# ABSTRACT

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Following the Enron and Worldcom debacles, policymakers worldwide have demanded that the audit committee ('AC') intensify their oversight responsibilities over financial reporting, risk management and governance of organisations. Internal audit is seen as a reliable support to the AC. Acknowledging the significant role of internal audit in governance, Malaysia is one among the few countries worldwide that has required its listed issuers to establish an internal audit function ('IAF') and for them to report directly to the AC.

Prior studies tend to conceptualise the effectiveness of an IAF based on internal auditors' attributes, which are narrowly prescribed within the external audit standards, for example, AICPA (1990). The concept of internal auditing derives from the Western model normally fails to take into account the influence of the economic and political differences in emerging markets such as Malaysia. Rarely have prior studies explored the key contextual and environmental factors that could impact on internal audit practices, particularly from the perspectives of the key IAF stakeholders or service users such as the AC. This thesis aims to address this expectation gap.

This study adopts a qualitative research approach. A two-phase research design is employed. First, a conceptual framework of IAF effectiveness is developed after a critical review of the research literature, professional guidance and regulations. It is followed by a series of semi-structured, in-depth interviews with the AC members of Main Market listed issuers in Malaysia, whose views are used to confirm/negate or refine the conceptual framework.

The refined framework (incorporating the ACs' views) encompasses three core components. The first two components are respectively the external and internal enabling factors that could impact on internal audit practices in Malaysia. For external enabling factors, the rules and regulations, the role of the Institute of Internal Audit ('IIA') and the readiness of the internal audit industry in meeting market expectation are considered. For internal enabling factors, the influence and support of the AC, the organisational support

and the adequacy of internal audit resources are considered. The third component depicts the internal audit practises in Malaysia and the AC's expectation of them.

Drawing from a multi-theoretical lens, which includes agency, stakeholders and institutional theory, the findings (based on the ACs' views) reveal that although the regulations require listed issuers to establish an IAF, many have decoupled by ceremonially conforming to the coercive pressure (regulations) to stay legitimate. Top management's scepticism over the true contribution of an IAF has also relegated their significance in corporate governance. The IIA Malaysia's less proactive engagement with market participants has also negated its professional influence and presence. Generally, the ACs do not perceive the need for the IAF to fully comply with the 'theoretical role' (as defined in *Definition of Internal Auditing* (IIA 1999)) to be considered 'effective'.

This thesis makes an original contribution to the corporate governance literature (internal audit) in Malaysia. As it is the first to identify a broader array of key conceptual and environmental factors that could impact on IAF effectiveness from the lens of the AC. This study also provides a richer base of reference for future IAF-related research, not only for Malaysia but also for emerging markets with a similar economic and political background.

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## LIST OF FIGURES

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Figure 2.1: The internal governance structure .....	12
Figure 2.2: The Malaysian corporate governance framework .....	17
Figure 4.1: Two-phase research design.....	42
Figure 4.2: Phase II: qualitative fieldwork procedures .....	44
Figure 4.3: Interview protocol and procedures .....	55
Figure 4.4: A summary of Guba and Lincoln (1994a)'s three paradigms and their corresponding evaluation .....	62
Figure 5.1: Conceptual IAF Effectiveness Framework (basic).....	70
Figure 5.2: Conceptual IAF Effectiveness Framework (first component - external enabling factors) .....	76
Figure 5.3: Conceptual IAF Effectiveness Framework (second component - internal enabling factors) .....	<b>102</b>
Figure 5.4: Conceptual IAF Effectiveness Framework (3rd component - internal audit practices) .....	<b>114</b>
Figure 5.5: Conceptual IAF Effectiveness Framework .....	<b>117</b>
Figure 6.1: Conceptual IAF effectiveness framework (first component – external enabling factors) .....	119
Figure 6.2: Refined external enabling factors (first component) .....	135
Figure 6.3: Conceptual IAF effectiveness framework (second component – internal enabling factors).....	136
Figure 6.4: AC participants and IAF sourcing arrangement of listed issuers .....	157
Figure 6.5: Refined internal enabling factors (second component) .....	177
Figure 6.6: Conceptual IAF effectiveness framework (third component – internal audit practices) .....	178
Figure 6.7: Refined internal audit practices (third component) .....	204
Figure 6.8: Refined IAF effectiveness framework.....	206

## LIST OF TABLES

---

Table 4.1: Core differences between positivism and constructivism.....	37
Table 4.2: Demographics of AC participants.....	49
Table 4.3: AC participants' and their associated number of listed issuers by industry sectors .....	50
Table 6 1: Summary findings for external enabling factors (first component).....	132
Table 6.2: Key comments on AC attributes and influences/support (under second component).....	147
Table 6.3: Key comments on organisational support (under second component) .....	155
Table 6.4: Key comments on IAF resources (under second component) .....	170
Table 6 5: Summary of findings of internal enabling factors (second component).....	173
Table 6 6: Summary findings on internal audit practices .....	200
Table 7.1: Influence of enabling factors over the stages of operationalisation of the IAF: institutional theory perspectives.....	227
Table 8.1: The key interview findings .....	231

## ABBREVIATIONS

Abbreviations	Definition
AC/ACs	Audit committee/Audit committees
AICPA	American Institute of Certified Public Accountants
ARMC	Audit and risk management committee
BRC	Blue Ribbon Committee
Bursa Malaysia	The stock exchange of the Malaysia and also the market regulator of listed issuers in Malaysia (formerly known as the Kuala Lumpur Stock Exchange)
CAE	Chief audit executive
CEO	Chief executive officer
CFO	Chief financial officer
CG Code	The Malaysian Code of Corporate Governance
CIA	Certified Internal Auditor
COSO	Committee of Sponsoring Organizations of the Treadway Commission
ERM	Enterprise-wide risk management
ERMC	Executive risk management committee
IAF	Internal audit function
CAANZ	Chartered Accountants Australia and New Zealand
ICAEW	Institute of Chartered Accountants in England and Wales
IIA	Institute of Internal Audit
IIAM	Institute of Internal Audit, Malaysia
IPPF	International Professional Practices Framework
Listing Requirements	Bursa Malaysia Listing Requirements
MIA	Malaysian Institute of Accountants
MICPA	The Malaysian Institute of Certified Public Accountants
NASDAQ	NASDAQ Stock Market LLC
NYSE	New York Stock Exchange
PCAOB	Public Companies Audit Oversight Board
QAIP	Quality Assurance and Improvement Program
RMC	Risk management committee
SOX	<i>Sarbanes-Oxley Act 2002 (US)</i>
SGX	Singapore Stock Exchange
UK	United Kingdom
US	United States of America



## **RESEARCH OUTCOME FROM THE THESIS**

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Some sections of this thesis had been published in a research colloquium:

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# Table of Contents

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<b>DECLARATION</b> .....	<b>i</b>
<b>ABSTRACT</b> .....	<b>ii</b>
<b>ACKNOWLEDGEMENTS</b> .....	<b>iv</b>
<b>LIST OF FIGURES</b> .....	<b>v</b>
<b>LIST OF TABLES</b> .....	<b>vi</b>
<b>ABBREVIATIONS</b> .....	<b>vii</b>
<b>RESEARCH OUTCOME FROM THE THESIS</b> .....	<b>viii</b>
<b>CHAPTER 1: INTRODUCTION</b> .....	<b>1</b>
1.0    Introduction.....	1
1.1    Motivation of the Study .....	3
1.2    Research Objectives and Questions .....	4
1.3    Research Methodology .....	5
1.4    Contribution of the Study .....	6
1.4.1    Contribution to theory.....	6
1.4.2    Contribution to policy .....	7
1.4.3    Contribution to practice .....	8
1.5    Organisation of the Thesis .....	8
1.6    Chapter Summary .....	10
<b>CHAPTER 2: THE GOVERNANCE AND REGULATORY FRAMEWORK</b> .....	<b>11</b>
2.0    Introduction.....	11
2.1    Internal Governance Structure .....	11
2.1.1    The IAF with senior management .....	12
2.1.2    The IAF with external auditors .....	13
2.1.3    Interdependency of the IAF and the AC .....	13
2.2    Concept of IAF Effectiveness .....	14
2.3    Corporate Governance: The Malaysian Context .....	16
2.3.1    Background and development .....	16
2.3.2    Regulatory framework .....	17
2.4    Chapter Summary .....	22

## **CHAPTER 3: MULTI-THEORETICAL PERSPECTIVES AND LITERATURE**

<b>REVIEW .....</b>	<b>23</b>
3.0 Introduction.....	23
3.1 The Need to Adopt a Multi-Theoretical Perspective .....	23
3.2 Corporate Governance: Multi-Theoretical Perspectives.....	24
3.2.1 Agency theory: the traditional approach.....	24
3.2.2 Stakeholder theory .....	26
3.2.3 Institutional theory .....	28
3.3 Extant Research on Alternative Corporate Governance Theories .....	30
3.4 Review of Extant Literature and Research Gap.....	32
3.5 Chapter Summary .....	35
<b>CHAPTER 4: RESEARCH METHODOLOGY .....</b>	<b>36</b>
4.0 Introduction.....	36
4.1 Selection and Justification of the Research Methodology .....	36
4.1.1 Overview of the research paradigm .....	36
4.1.2 Justification of the research paradigm .....	38
4.1.3 Justification of a qualitative approach .....	38
4.2 The Research Design: Two-Phase Research Design .....	41
4.2.1 Phase I: development of a conceptual IAF effectiveness framework.....	42
4.2.2 Phase II: qualitative field study .....	43
4.3 Sampling Methods .....	45
4.3.1 Sampling strategies .....	45
4.3.2 Sample size .....	48
4.3.3 Sample: AC participants .....	49
4.4 Data Collection .....	50
4.4.1 Semi-structured, in-depth interviews.....	50
4.4.2 Interview instrument .....	51
4.4.3 Interview protocols and procedures.....	53
4.4.4 Data sources .....	55
4.4.5 Data preparation: interview transcripts.....	56
4.5 Data Analysis.....	57

4.5.1	Coding.....	58
4.6	Quality Evaluation in Qualitative Inquiry .....	60
4.6.1	Choice of evaluation procedures.....	60
4.6.2	Quality evaluation of this study .....	63
4.7	Ethical Considerations .....	66
4.8	Chapter Summary .....	67
<b>CHAPTER 5: DEVELOPMENT OF CONCEPTUAL IAF EFFECTIVENESS</b>		
	<b>FRAMEWORK .....</b>	<b>68</b>
5.0	Introduction.....	68
5.1	The Need for an IAF Effectiveness Framework .....	68
5.2	External Enabling Factors (First Component) .....	71
5.2.1	Rules and legislations .....	71
5.2.2	The role of the IIAM.....	74
5.3	Internal Enabling Factors (Second Component).....	76
5.3.1	AC support: attributes and influence .....	77
5.3.2	Organisational support.....	87
5.3.3	IAF resources .....	94
5.4	Internal Audit Practices (Third Component) .....	103
5.4.1	Planning: audit planning .....	103
5.4.2	Implementation: nature of internal audit activities .....	105
5.4.3	Evaluation: performance evaluation .....	111
5.5	Overview and the Conceptual IAF Effectiveness Framework .....	114
5.6	Chapter Summary .....	116
<b>CHAPTER 6: REFINEMENT OF CONCEPTUAL IAF EFFECTIVENESS</b>		
	<b>FRAMEWORK .....</b>	<b>118</b>
6.0	Introduction.....	118
6.1	External Enabling Factors (First Component) .....	118
6.1.1	Rules and legislation .....	119
6.1.2	The role of the IIAM.....	124
6.1.3	Internal audit industry readiness (a new emerging theme) .....	128
6.1.4	Summary .....	132

6.2	Internal Enabling Factors (Second Component).....	135
6.2.1	AC support: attributes and influences.....	136
6.2.2	Organisational support.....	149
6.2.3	Internal audit resources (in-house IAF).....	156
6.2.4	Out-sourced IAF.....	165
6.2.5	Summary.....	173
6.3	Internal Audit Practices (Third Component).....	178
6.3.1	Planning: internal audit planning.....	178
6.3.2	Implementation: nature of internal audit activities.....	182
6.3.3	Evaluation: performance evaluation.....	195
6.3.4	Summary.....	200
6.4	Refined IAF Effectiveness Framework.....	204
6.5	Chapter Summary.....	205
<b>CHAPTER 7: DISCUSSION.....</b>		<b>207</b>
7.0	Introduction.....	207
7.1	Importance of Each of the Components Identified Under the Refined IAF Effectiveness Framework.....	207
7.1.1	External enabling factors (first component).....	208
7.1.2	Internal enabling factors (second component).....	212
7.1.3	Internal audit practices (third component).....	220
7.2	Implication of the Findings.....	225
7.2.1	Influence of the enabling factors on different stages of operationalisation of the IAF: institutional theory perspective.....	226
7.2.2	AC participants' expectation of IAF effectiveness in Malaysia.....	227
7.3	Efficacy of the Refined IAF Effectiveness Framework.....	228
7.4	Chapter Summary.....	229
<b>CHAPTER 8: CONCLUSION.....</b>		<b>230</b>
8.0	Introduction.....	230
8.1	Summary of Key Findings.....	230
8.2	Contribution of this Thesis.....	234
8.2.1	Contribution to theory.....	234

8.2.2	Contribution to policy .....	235
8.2.3	Contribution to practice .....	236
8.3	Limitations .....	236
8.4	Future Research Opportunities .....	238
8.5	Chapter Summary .....	239
<b>REFERENCES .....</b>		<b>240</b>
<b>Appendix 1 .....</b>		<b>259</b>
<b>Appendix 2 .....</b>		<b>262</b>
<b>Appendix 3 .....</b>		<b>263</b>
<b>Appendix 4 .....</b>		<b>268</b>
<b>Appendix 5 .....</b>		<b>272</b>
<b>Appendix 6 .....</b>		<b>274</b>

# CHAPTER 1: INTRODUCTION

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## 1.0 Introduction

In the aftermath of a series of high-profile corporate scandals, including Enron and WorldCom, there is a heightened expectation for greater accountability from the key corporate governance stakeholders such as the audit committee ('AC'), senior management, and external and internal auditors (Gramling, Maletta, Schneider, & Church, 2004). The AC in particular are under tremendous pressure to intensify their oversight responsibilities over financial reporting, risk management and governance systems of organisations. However, due to their non-executive role, the AC are often confronted with an information asymmetry problem (Raghunandan, Read and Rama 2001), particularly on company-specific information. On the other hand, internal auditors, whose expertise is in risk management, controls and governance, are said to have acquired extensive company-specific knowledge through their daily involvement in the organisation. Hence, the internal audit function ('IAF') could play a support role to the AC in overcoming their limitations (Sarens, De Beelde and Everaert 2009). However, the AC will only rely on the IAF if they perceive the latter to be effective (Sarens, De Beelde and Everaert 2009; Abbott, Parker, Peters, & Rama 2007; Bailey 2007b).

Internal audit as a key component of an organisations' governance mechanism has gained prominence over the past two decades. This is evidenced in the heightened demand by regulators worldwide for internal auditors to assume a more significant governance role and a growing research interest in IAF-related studies (see Anderson, Christ, Johnstone, & Rittenberg, 2012; Brown, Beekes and Verhoeven 2011; Prawitt, Sharp and Wood 2011; Barua, Rama and Sharma 2010; Arena and Azzone 2009; Hoitash, Hoitash and Bedard 2009; Abbott, Parker, Peters, & Rama, 2007). In Malaysia, the Bursa Malaysia, (formerly the Kuala Lumpur Stock Exchange) requires all listed issuers to establish an IAF reporting directly to the AC (Listing Requirements 2011). While the Malaysian regulator has mandated the establishment of an IAF in listed issuers, it is not explicit in the practices of the IAF. This has accorded the listed issuers flexibility in terms of the structural and

functional makeup of the IAF. This has raised concerns over whether the IAF could truly contribute to corporate governance and support the AC in meeting their governance obligations.

Prior literature tends to conceptualise IAF effectiveness based on internal audit attributes as narrowly prescribed within the external audit standards (ISA 2013, AICPA 1990)<sup>1</sup> or the *Attributes Standards* (IIA 2013a) and concepts derived from a Western model of internal auditing without taking into account the influence of cultural and political differences in developing nations (Al-Twaijry, Brierley and Gwilliam 2004). Prior literature relies either on the self-assessment of the IAF or chief audit executive ('CAE') (see Fazli Aghghaleh, Muhammaddun Mohamed and Ahmad 2014; Abdolmohammadi 2012; Stewart and Subramaniam 2010; Christopher, Sarens and Leung 2009; Goodwin 2004; Goodwin and Yeo 2001) or the reliance of external auditors on IAF work or financial measurements (e.g. earnings management) to proxy or infer IAF effectiveness (see Prawitt, Smith and Wood 2009; Davidson, Goodwin-Stewart and Kent 2005).

Accordingly, this thesis aims to adopt a more comprehensive approach in identifying a broader dimension of key enabling factors<sup>2</sup> that could impact on the IAF effectiveness in an emerging market such as Malaysia. Also, instead of relying on the IAF or CAEs' self-assessment (which could be subject to respondents' bias) or inferences from indirect sources (e.g. the reliance of external auditors on IAF or financial measurements to proxy IAF effectiveness), this thesis adopts a stakeholder's perspective by investigating IAF effectiveness from the lens of the AC, the key IAF stakeholders or key IAF service users.<sup>3</sup>

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<sup>1</sup> International Standard on Auditing (ISA) 610, *Using the Work of Internal Auditors* has been revised and published in 2013. This standard focuses on whether the external auditor can use the work of the internal audit function for purposes of the audit. This revised version of the standard also clarifies whether the internal auditors can be used to provide direct assistance to the external auditor. A similar provision also provided in America Institute of Certified Public Accountants (AICPA) Standard no. 65, *Using the work of Internal Auditors*.

<sup>2</sup> In this thesis, the term 'enabling factors' is used to describe the contextual and environmental factors that would impact on the effective practice of IAF in Malaysia.

<sup>3</sup> The Malaysian regulators has entrusted the AC a direct oversight role over the IAF (see Paragraph 15.27, Listing requirement (2011))



## 1.1 Motivation of the Study

This study is motivated to consider anew the topic of IAF effectiveness. There is a heightened recognition that the IAF is an integral control mechanism and is one of the four corporate governance cornerstones together with senior management, AC and external auditors (Gramling, Maletta, Schneider, & Church, 2004). However, despite heightened pressure from regulators requiring listed issuers to establish an IAF and ensuring the IAF has a closer working relationships with the board (predominantly the AC), market participants are still sceptical of the true value of the IAFs contribution to corporate governance (see Archambeault, DeZoort and Holt 2008; Chambers 2008; Gramling, Maletta, Schneider, & Church, 2004).

Surveys conducted by the Big Four audit firms and prior literature reveal considerable uncertainties over the IAF's contribution and performance. It is reported that the IAF has overly focused on operational and control risks (PwC 2009; Ernst & Young 2008) at the expense of strategic and business risks (PwC 2009). Also, PwC (2010) recommends that the IAF focus on critical risk areas and align their value proposition to meet stakeholders' expectations. Lenz and Sarens (2012) posit that stakeholders' dissatisfaction is due primarily to the failure of internal auditors to deliver their own commitment as proclaimed by the IIA. This view is consistent with Chambers (2008), who asserts that the expanded role of the IAF (as depicted in *Definition of Internal Auditing* (IIA 1999)) is too grandeur for the internal audit profession to deliver. Ambiguity in respect of who is the real 'master' or 'boss' of the IAF (i.e. senior management or the AC) is another concern believed to have caused the IAF's poor performance (Lenz and Sarens 2012; Abbott, Parker and Peters 2010). Apart from that, conflict arising from unclear job scope and role within an organisation have also impeded their effectiveness (Lenz and Sarens 2012; Cooper, Leung, Dellaportas, Ahmad, & Taylor, 2009). Much of this is because the IAF is not mandatory in most countries, thus providing considerable flexibility in its structural and functional make-up (Christopher, Sarens and Leung 2009).

Despite the IAF's growing significance in recent years, virtually no prior academic or professional literature has clearly outlined or provided a comprehensive view on what are

the key contextual and environmental factors that could encourage or inhibit the effective practice of the IAF. Hence, the first motivation of this thesis is to address this research gap. This thesis aims to develop a comprehensive framework that considers the key enabling factors (internal and external to organisations) that appear to encourage and/or inhibit internal audit practices in Malaysia and the consequent impact on its effectiveness through the lens of the AC.

Although there is a growing number of IAF-related studies that examine IAF and its contribution to corporate governance, these studies are predominantly based on the dataset of developed countries (e.g. the United States and United Kingdom). These Anglo-Saxon-based findings may not represent what constitutes an effective IAF in emerging markets with cultural and political differences (Al-Twaijry, Brierley and Gwilliam 2004). In this thesis, Malaysia is selected as the focus of study as it is a good proxy representing the emerging markets in the South-East Asia region. These countries share common cultural, historical and political background that is different from their Western counterparts. In addition, Malaysia is the first emerging market in this region that requires its listed issuers to establish an IAF and for them to report directly to the AC. Accordingly, a study of this nature vis-à-vis their Western counterparts is significant. Furthermore, the findings of this thesis are expected to contribute to the growing corporate governance literature that focuses on the emerging markets in the South-East Asia region. This forms the second motivation of this study. The corresponding research objectives and research questions are outlined in the following section.

## **1.2 Research Objectives and Questions**

In recent years, although regulators and policymakers in Malaysia have demanded the establishment of an IAF in listed issuers, the internal audit industry itself is not regulated. The regulators and policymakers provide no clear guidance on how to operationalise the IAF effectively. Also, the monitoring of IAF performance is lacking. This is in stark contrast to regulatory requirements placed on other key governance stakeholders, such as the board of directors, AC and external auditors. Prior literature suggests that an effective IAF can contribute effectively to an organisation's internal control, risk management and

governance system as well as play an effective supporting role for the AC (Abbott, Parker and Peters 2010; Arena and Azzone 2009; Sarens, De Beelde and Everaert 2009).

Accordingly, the overarching question in this thesis is ‘What constitutes an effective IAF from the lens of the AC?’.

The research objectives of this thesis are:

*RO1: To develop an IAF effectiveness framework that will support the ACs in their role of enhancing governance.*

*RO2: To refine the IAF effectiveness framework as it applies in the Malaysian context.*

*RO3: To determine to what extent the IAF effectiveness framework is being applied in the IAFs of Malaysian public listed companies.*

The consequential research questions are:

*RQ1: What constitutes an IAF effectiveness framework taking into account the key contextual factors that appear to inhibit and/or encourage the internal audit practices of the Main Market listed issuers in Malaysia?*

*RQ2: To what extent does the IAF effectiveness framework meet the AC’s expectation in fulfilling their governance obligations?*

*RQ3: To what extent is the IAF effectiveness framework practised by the IAFs of the Main Market listed issuers in Malaysia?*

The research approach to be employed in addressing the research objectives and questions are presented in the following section.

### **1.3 Research Methodology**

This study is exploratory and investigative in nature and is undertaken through a two-phase research design. Phase I involves developing a conceptual framework that outlines

the internal audit practices and identifies the key enabling factors (internal and external to organisations) that may encourage and/or inhibit IAF effectiveness. This is achieved through a critical review of prior literature (i.e. academic and professional), professional guidance (standards, guidelines and pronouncements issued by accounting and auditing professional bodies etc.) and rules and regulations (corporate governance codes, listing rules etc.) of Malaysia and other major markets.

Phase II of the two-phase research design involves a qualitative component comprising a series of semi-structured, in-depth interviews with a sample of AC chairs or AC members of Main Market listed issuers of the Bursa Malaysia. The objective of Phase II is to seek insightful views of the AC participants on what constitutes an IAF effectiveness framework. The findings from the AC interviews will be used to confirm/negate or refine the key enabling factors (internal and external to the organisations) that could encourage or inhibit the effectiveness of IAF of the Main Market listed issuers in Malaysia.

## **1.4 Contribution of the Study**

### **1.4.1 Contribution to theory**

This thesis is envisaged to make several distinct contributions to theory. To begin with, this is the first research that specifically focuses on the various contextual and environmental factors that are envisaged would impact on effective practice of IAF. This approach is intended to extend the horizon of prior literature, which examines IAF effectiveness based on the narrowly prescribed IAF attributes within the external audit standards (ISA 2013; AICPA 1990). Henceforth, the results of this research will contribute to the theory by revealing new dimensions that could encourage or inhibit effective practice of IAF as one of the control mechanisms within the corporate governance structure.

Second, a significant contribution of this study is the development of a framework that entails key enabling factors (internal and external to organisations) that could impact on the effective practice of IAF in listed issuers. In doing so, a conceptual framework is first developed after a critical review of prior literature (i.e. academic and professional),

professional guidance (professional body standards and pronouncements) and the relevant rulings and regulations. The conceptual framework is refined after taking into account the AC participants' views. Hence, this thesis extends the literature by covering the gap between theory and practice and develops a comprehensive practice-informed framework.

Third, this study employs an inductive inquiry approach through a series of semi-structured, in-depth interviews to explore the views of the AC participants, the key IAF stakeholders or service users. This reliance on the AC's perspective has rarely been considered in prior IAF-related studies and, in the best knowledge of the researcher, not before in Malaysia. In addition, as Malaysia is one among the few countries that requires the establishment of an IAF for listed issuers and for the IAF to report directly to the AC, it is crucial in a study of this nature to consider the views of the AC. Consequently, the findings are expected to provide a richer base of reference for future IAF effectiveness research not only in Malaysia but emerging markets with similar economic and political backgrounds.

#### **1.4.2 Contribution to policy**

Although the regulators mandate the establishment of an IAF in listed issuers, the actual practice of IAF in listed issuers is little known to outside stakeholders or other market participants as internal audit activities are generally not well documented in published documents such as annual reports. Most of the IAF-related disclosures in annual reports are standard and boilerplate (Bursa Malaysia 2014) and prepared to conform to the Bursa Malaysia Listing Requirements (Johl, Johl, Subramaniam and Cooper 2013; Haron, Daing Nasir Ibrahim, Jeyaraman and Hock Chye 2010). The findings in this thesis aim to apprise the policymakers of some of the practical issues surrounding the implementation of the IAF ruling in Malaysia. This will enable the policymakers to consider ways to better support the key governance stakeholders, by removing or mitigating obstacles that hinder the IAF in value-add to organisations' control and governance systems and to support the AC in discharging their governance obligations.

### **1.4.3 Contribution to practice**

First, from the professional level, this study provides insights into the AC's expectations of IAF in supporting the organisation's governance mechanism as well as the AC in meeting their governance obligations. A clear understanding of the expectation of the AC as the key IAF stakeholder or service user will minimise the expectation gap between IAF service users and service providers. The AC's perspective on how certain enabling factors could impact on IAF effectiveness will help organisations to structure their governance mechanisms more effectively. This understanding could also alleviate the tension between the AC and senior management who often have competing demands over IAF resources (Abbott, Parker and Peters 2010).

Second, at the professional body level, this study aims to provide insights into the AC's perception of the Institute of Internal Audit, Malaysia ('IIAM'), the Malaysian chapter of IIA Global, the sole global professional body of the internal audit profession. This study also provides insights into the AC's expectation of how a professional body (such as the IIAM) could support its members (individual or corporate), other corporate governance stakeholders (e.g. the AC) and regulators in enhancing the effectiveness of IAF.

## **1.5 Organisation of the Thesis**

This thesis is organised in the following manner. Chapter 2 is in two parts. The first part presents the internal corporate governance structure of organisations and the role of the IAF and its nexus with other corporate governance stakeholders. The second part outlines the corporate governance framework in Malaysia with specific emphasis on the role of the IAF and its nexus with the AC.

Chapter 3 discusses the multiple theories informing this study, including agency, stakeholder and institutional theory. This is followed by a review of the extant literature that informs the research gap and consequently the development of research objectives and questions for this study.

Chapter 4 discusses the research methodology and approach for this study. A two-phase research design is employed to address the research questions. Phase I involves development of a conceptual framework drawing from a critical review of extant literature, professional standards and relevant listing rules and regulations. Phase II entails a series of semi-structured, in-depth interviews with the AC participants.

Chapter 5 executes Phase I of the two-phase research design. This chapter seeks to develop a conceptual framework outlining the internal audit practices (the ‘theoretical role’ of the IAF)<sup>4</sup> and the key contextual or enabling factors (internal or external to organisations) that could impact on the effective practice of the IAF.

Chapter 6 addresses Phase II of the two-phase research design by conducting a series of semi-structured, in-depth interviews with the AC participants. The findings from the AC interviews will be used to confirm/negate or refine the constructs identified in the conceptual framework developed in Chapter 5.

Chapter 7 discusses the importance of each key contextual or enabling factors identified in the refined conceptual framework (as presented in Chapter 6). This chapter also highlights internal audit in practice vis-a-vis its ‘theoretical role’ (as depicted in the *Definition of Internal Auditing* (IIA 1999)) through the lens of the AC participants. The findings are linked to the multiple theories with particular emphasis on how the three isomorphism processes (under institutional theory) have influenced the effective practice of the IAF in Malaysia.

The final chapter, Chapter 8, presents a summary of the main findings, implications, limitations of the study and avenues for future research.

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<sup>4</sup> As defined in the Definition of Internal Auditing (1999) and the IIA’s International Professional Practice Framework (‘IPPF’)

## **1.6 Chapter Summary**

This chapter provided an overview of this study by highlighting the research objectives and questions as well as the research methodology and approach employed to address the research objectives and questions. Also, it underscored the significance of this study to the field of internal audit, particularly to emerging markets with a similar economic and political background to Malaysia. This chapter also outlined the envisaged contribution to the various stakeholders.

Chapter 2 provides a background to the internal corporate governance structure in an organisation and the IAF's nexus with other corporate governance stakeholders. It also outlines the corporate governance framework in Malaysia with specific emphasis on the IAF's role and its nexus with the AC.



## **CHAPTER 2: THE GOVERNANCE AND REGULATORY FRAMEWORK**

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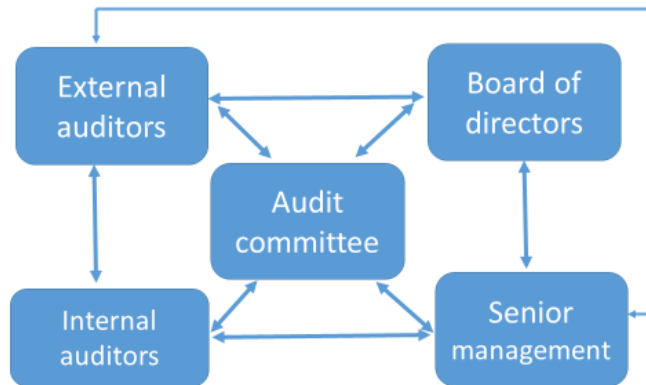
### **2.0 Introduction**

This chapter seeks to present the governance and regulatory framework supporting the development of the research objectives and research questions of this thesis. The first part of this chapter provides an overview of the IAF within the corporate governance framework with a specific focus on its interdependency with the AC, the key IAF stakeholder. The second part of this chapter highlights the interdisciplinary review of related disciplines conceptualising the ‘effectiveness’ of IAF using ‘goal-orientated’ and ‘stakeholder-oriented’ perspectives. The final part of this chapter outlines the background and development of corporate governance in Malaysia and highlights the corporate governance regulatory framework in the Malaysian context.

### **2.1 Internal Governance Structure**

The IAF is an integral component of corporate governance (Bame-Aldred, Brandon, Messier, Rittenberg, & Stefaniak, 2013; Anderson, Christ, Johnstone, & Rittenberg, 2012). Gramling, Maletta, Schneider, & Church (2004) identify four cornerstones of corporate governance, namely, the AC, senior management, external auditors and the IAF. Cohen, Krishnamoorthy and Wright (2004) add a fifth component by including the board of directors in their internal governance ecosystem. The IIA (2013a) postulates that the four corporate governance cornerstones are the IAF, external auditors, senior management and board of directors (represented by the AC). This thesis relies on the Cohen, Krishnamoorthy and Wright (2004) model to illustrate the relationship and interactions among the five internal governance stakeholders. The IAF has a direct relationship with the AC, external auditors and senior management. However, its relationship with the board of directors is indirect, that is, through the AC as a sub-committee of the board. The relationship of the IAF with other key internal governance stakeholders is depicted in Figure 2.1.

**Figure 2.1: The internal governance structure**



*(Adapted from Cohen et al (2004, p.89))*

Effective corporate governance is subject to active and collaborative interactions among its internal governance stakeholders. Due to their expertise in controls, risk management and governance process of organisations, the IAF can provide strong support to the other governance stakeholders. The relationship between the IAF and other governance stakeholders is presented in the following sections.

### **2.1.1 The IAF with senior management**

With the growing complexities and size of today's businesses, it is virtually impossible for senior management to provide direct oversight of their business operations. Senior management requires a reliable internal party who can act as their 'ears and eyes' and report to them on the operations and other affairs of the organisation. It is appropriate for the IAF to assume such a role. The IAF can provide the senior management with assurance over the effectiveness of internal controls, risk management and operational processes (Abbott, Parker and Peters 2010; Sarens and De Beelde 2006a; Gramling, Maletta, Schneider, & Church, 2004). The IAF can also serve to provide consulting services to facilitate improvement of the organisation's controls, operations and processes (Arena and Azzone 2009; Rittenberg and Anderson 2006). It is contended that the IAF could help senior management in generating cost savings and in achieving their operational goals (Abbott, Parker and Peters 2010).

### **2.1.2 The IAF with external auditors**

The IAF can support external auditors in two ways: by providing direct assistance to the external auditors or by performing tasks upon which the external auditor can rely. External auditing standards such as ISA 610<sup>5</sup> allow external auditors to rely on the work of the IAF in performing financial statement audits if the IAF are competent, objective and able to perform work relevant to the external audit. It is suggested that reliance on the IAF may enhance efficiency and effectiveness of the external audit work. Efficiency is said to increase if external audit work is reduced correspondingly and is reflected in an apparent reduction in the audit fee, through lower substantive testings (Abbott, Parker and Peters 2012a; Cohen, Krishnamoorthy and Wright 2010) or audit delays (Pizzini, Lin and Ziegenfuss 2014). Audit effectiveness can be attained if the IAF can provide a higher level of assurance on the integrity of financial statements and act as a deterrent to financial reporting irregularities or aggressive accounting behaviour (Ege 2015; Lin, Pizzini, Vargus, & Bardhan, 2011; Prawitt, Smith and Wood 2009).

### **2.1.3 Interdependency of the IAF and the AC**

A corporate scandal often results in finger-pointing at the board of directors, specifically the AC, for their failure to exert oversight control over the audit function and senior management. However, the AC in discharging their governance mandate may be confronted with an information asymmetry problem (Gendron and Bédard 2006; Raghunandan, Read and Rama 2001). This could be mainly due to their independent and non-executive role within an organisation. This lack of information on the status of company-specific matters has resulted in a level of uncertainty in the AC's ability to fulfil their oversight role (Sarens, De Beelde and Everaert 2009). It is suggested that the IAF is an important internal party that can act as a bridge between the AC and the operational staff (Sarens, De Beelde, & Everaert, 2009; Turley and Zaman 2007) and thus help to

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<sup>5</sup> International Standard on Auditing (ISA) 610, *Using the Work of Internal Auditors* has been revised and published in 2013. This standard focuses on whether the external auditor can use the work of the internal audit function for purposes of the audit. This revised version of the standard also clarifies whether the internal auditors can be used to provide direct assistance to the external auditor.

reduce the AC's information asymmetry predicament (Gendron and Bédard 2006). The IAF is in a position to support the AC due to their daily involvement in the organisation (Sarens, De Beelde and Everaert 2009). In summary, the IAF can provide assurance to the AC in areas such as internal control, compliance, governance, financial reporting integrity and detection of fraud (Ege 2015; Abbott, Parker and Peters 2010; Beasley, Carcello, Hermanson, & Neal, 2009). In return, an effective AC with a strong relationship with the IAF can enhance the IAF's organisational independence (Bailey 2007; Goodwin and Yeo 2001) and consequently boost its effectiveness. In this way the AC and IAF are interdependent regarding their effectiveness.

In fact, regulators and policymakers have also advocated for a closer working relationship between the AC and IAF. For instance, The Blue Ribbon Committee ('BRC') (1999) emphasises the importance of having a strong working relationship between the AC and the IAF to enhance governance; in the United States ('US') the *Sarbanes-Oxley Act 2002* ('SOX') provides the AC with oversight of internal controls over financial reporting, and in the United Kingdom ('UK') the revised corporate governance code requires the AC to monitor and review the effectiveness of corporations IAF (FRC 2010). In Malaysia, the policymakers require the establishment of an IAF in all listed issuers, with the IAF reporting directly to the AC (Listing Requirements 2011).

In summary, although the three internal governance stakeholders' demand for IAF resources is overlapping, there are certain demands specific to their respective needs. In this thesis, the research focus is on the AC-IAF nexus, as the AC is entrusted with the direct supervision role by the Malaysian regulators over the IAF.

## **2.2 Concept of IAF Effectiveness**

Effectiveness is defined as 'the degree to which objectives are achieved and the extent to which targeted problems are solved. In contrast to efficiency, effectiveness is determined

without reference to costs'.<sup>6</sup> Efficiency means 'doing the things right' while effectiveness means 'doing the right things' (Drucker 1995).

The mere presence of an AC in an organisation does not automatically guarantee the effective operation of IAF. Only an effective AC can augment IAF effectiveness (Alzeban 2015; Barua, Rama and Sharma 2010). Similarly, ACs need an effective IAF to support them in fulfilling their governance obligations. The IIA suggests that the IAF can 'help an organisation accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control, and governance processes' (*Definition of Internal Auditing* (IIA 1999)). However, the IIA does not provide a direct definition on what constitutes an effective IAF. Instead, the meaning of 'effectiveness' can be inferred through the IIA's Practice Guide *Internal Audit Effectiveness and Efficiency* (IIA 2010). The Practice Guide suggests that effectiveness is 'the degree (including quality) to which established objectives are achieved' (IIA 2010, p. 2). This 'goal-orientated' perspective of effectiveness is consistent with the 'goal model' as conjectured in management literature such as Cameron (1983).

Besides the 'goal-orientated' perspective of IAF effectiveness, the IIA also emphasises the importance of the stakeholders' perspective. This is reflected in the following provision in the same Practice Guide, 'the first step is to identify key performance measures for activities that stakeholders believe add value and improve the organisation's operations' (IIA 2010, Executive Summary). This perspective is consistent with Albrecht, Howe, Schueler, & Stocks (1988) and Cameron (1983) in that effectiveness is a construct grounded in the values and preferences of evaluators or service users; in this instance, the stakeholders. Thus, the 'stakeholders-oriented' perspective.

Consequently, 'IAF effectiveness' in this thesis aims to seek the AC's perspectives on what are the expected internal audit practices that would help meet their governance

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<sup>6</sup> <http://www.businessdictionary.com/definition/effectiveness.html>.

objectives and what enabling factors (internal or external to organisations) could drive or support the effective practice of the IAF in Malaysia.

## **2.3 Corporate Governance: The Malaysian Context**

### **2.3.1 Background and development**

In Malaysia, the concept of corporate governance was first mooted in the late 1990s in the aftermath of the Asian Financial Crisis. It is believed that the Asian Financial Crisis started with speculative attacks on the Thai baht leading to its initial devaluation in July 1997. The devaluation of Thai baht set off a domino effect and brought about a regional crisis of unprecedented speed and magnitude. During that crisis, the Malaysian Ringgit lost more than 40 per cent of its value against major currencies and interest rates hiked above 12 per cent. The Kuala Lumpur Stock Exchange Composite Index plunged 80 per cent from the pre-crisis high of 1,300 points in February 1997 to 260 points in September 1998. The Malaysian corporate sector suffered a ‘triple whammy’ of high interest rates, sharply devalued currency and a significant plunge in domestic demand (Low 2002). However, it was widely acknowledged that poor corporate governance (i.e. lack of transparency, disclosure and accountability) and weak financial management and financial position (e.g. over-leverage) before the crisis were responsible for the vulnerability of the Malaysian corporate sector (Low 2002).

It was against this backdrop that the Finance Committee on Corporate Governance (‘Finance Committee’) was established in March 1998 by the Malaysian Minister of Finance. The Finance Committee was tasked with assessing and making recommendations to the policymakers the necessary corporate governance standards to restore investors’ confidence in the capital market. The first Malaysian Code of Corporate Governance (‘CG Code’) was made public to the capital market in October 2000. The CG Code was subsequently revised in 2007 and 2012.

### 2.3.2 Regulatory framework

In Malaysia, the corporate governance regulatory framework adopts a hybrid approach towards compliance of the regulations (i.e. both voluntary and mandatory). The corporate governance framework is governed by law, including regulatory requirements instituted by the regulators, stock exchange and statutory bodies. The framework is illustrated in Figure 2.2.

**Figure 2.2: The Malaysian corporate governance framework**



(Source: [www.sc.com.my](http://www.sc.com.my))

Whilst the corporate governance regulatory framework is working towards the enhancement of corporate governance and investors' protection in Malaysia, the specific rulings on the role and responsibilities of the AC and IAF are stipulated in the Listing Requirements and the CG Code.

In the aftermath of the Asian Financial Crisis, there was a major overhaul of the laws and regulations relating to the conduct of Malaysian corporations. The old listing rules were revamped to incorporate higher standards of business conduct and investors' protection. The revamped Listing Requirements were announced by the Bursa Malaysia in 2001 (Listing Requirements 2001). The Listing Requirements were subsequently revised in 2007 and 2011 to further raise the corporate governance standards amongst its listed issuers.

The CG Code, issued by the Securities Commission of Malaysia in October 2000, charted another key milestone after the Asian Financial Crisis. It was the first of its kind in the

entire region (Low 2002). It provides the framework of corporate governance for the Malaysian public companies. The CG Code (2000) has undergone two subsequent revisions: the CG Code (2007) strengthened the roles and responsibilities of the board of directors, the AC and the IAF; and the CG Code (2012) lists eight principles focusing on strengthening the board structure and composition, recognising the role of directors as active and responsible fiduciaries and as effective stewards and guardians of the company. Under the CG Code (2012), the board of directors are not only involved in strategy setting and overseeing the conduct of business but also in ensuring compliance with laws and ethical values, maintaining an effective governance structure, upholding the integrity of financial reporting and ensuring the appropriate management of risks and level of internal controls.

Both the Securities Commission of Malaysia and Bursa Malaysia are standard-setters and regulators of the capital and bond markets activities in Malaysia. While the Bursa Malaysia's oversight focus is on the registrants listed on the exchanges, the Securities Commission of Malaysia has a bigger oversight role over the market exchanges, clearing houses and central depositories and other market intermediaries (e.g. stockbroking firms). Besides a monitoring role, the Securities Commission of Malaysia is also responsible for licensing market intermediaries and approving and regulating bonds, unit trust and capital transactions involving public companies.<sup>7</sup> The ultimate responsibility of both the Securities Commission of Malaysia and the Bursa Malaysia is to protect the investing public.

Although both the Securities Commission of Malaysia and Bursa Malaysia are independent bodies, they work together to develop standards and rulings so as not to confuse the market participants. Usually the Listing Requirements will reflect the recommendations and guidance in the CG Code or other pronouncements by the Securities Commission of Malaysia. While the adoption of recommendations in the CG Code (2012)

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<sup>7</sup> Public companies refer to companies listed under the Companies Act, 1965 with more than 50 shareholders which may or may not be a listed vehicle.



by listed issuers is voluntary,<sup>8</sup> the adoption of provisions in the Listing Requirements is mandatory.<sup>9</sup> This legislative power of the CG Code and Listing Requirements is best illustrated in Figure 2.2 above.

In Malaysia, the requirement to establish an IAF in listed issuers was first introduced in October 2007 as a best practice (CG Code (revised) 2007). The provision is as follows:

*The Board should establish an internal audit function and identify a head of internal audit who reports directly to the audit committee. The head of internal audit will be responsible for the regular review and /or appraisal of the effectiveness of the risk management, internal control and governance process within the company. (CG Code 2007)<sup>10</sup>*

Although it is proposed as a best practice in the CG Code (2007), the listed issuers are, however, required by the Bursa Malaysia to establish an IAF that is independent of the activities it audits and reports directly to the AC.<sup>11</sup> The significance of the IAF is further evidenced when the Securities Commission of Malaysia includes the IAF establishment provisions as one of the eight ‘principle’ practices in the recent CG Code (2012). The CG Code (2012)<sup>12</sup> stipulates that:

*The board should establish an internal audit function which reports directly to the audit committee.*

In the commentary section of Principle 6 of the CG Code (2012), the board of directors are to engage a head of the IAF with relevant qualifications and that head of the IAF will be responsible for providing assurance to the board that the internal controls are operating

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<sup>8</sup> The CG Codes are voluntary documents and serve as best practice for the listed issuers. Therefore, non-observance of the CG Code merely requires disclosure with reasonable reason(s) in the annual reports by the listed issuers (i.e. ‘comply or explain’ approach).

<sup>9</sup> That is, failing to adhere to the provisions of the Listing Requirements will subject the listed issuers to sanction or reprimands from the Bursa Malaysia, the capital market regulator.

<sup>10</sup> Best Practices - Part BB: Accountability and Audit, Paragraph VII, CG Code (Revised) (2007)

<sup>11</sup> See paragraph 15.28 of the revised Listing Requirements (2001)

<sup>12</sup> Principle 6, Recommendation 6.2 of CG Code (2012). Similar provision has also been reflected verbatim in paragraph 15.27, Listing Requirements (2011)

effectively. The IAF should also conduct regular reviews and appraisals based on standards set by recognised professional bodies on the effectiveness of the governance, risk management and internal controls processes within the company.

Based on the CG Code (2012) and Listing Requirements (2011), it is apparent that the AC has been entrusted with the direct monitoring role over the IAF. The Listing Requirements (2011) requires the AC to ensure ‘the adequacy of the scope, function, competency and resource of the IA and that it has the necessary authority to carry out its work’<sup>13</sup> and that ‘the internal audit programme, processes, the results of the internal auditor programme, processes or investigation undertaken and whether or not appropriate action is taken on the recommendation of the IAF’.<sup>14</sup>

Bursa Malaysia is one of the few stock exchanges worldwide that requires the establishment of an IAF in their listed issuers. The Malaysian policymakers have gone a step further by requiring the IAF to report directly to the AC. This clearly infers their determination to mitigate the role ambiguity of the IAF and confusion over ‘who is the master’ (see Abbott, Parker and Peters 2010; Lenz and Sarens 2012) and to accord the IAF with greater organisational independence from the senior management. Hence, it will be interesting to explore and investigate whether the mandatory rulings have indeed provided support for better corporate governance and enhanced IAF effectiveness.

To heighten the demand for greater accountabilities on control and risk management environment of listed issuers, Principle 6 of CG Code (2012) stipulates that:

*The board should establish a sound risk management framework and internal control systems.*

Recommendation 6.1 of the CG Code requires that:

*The board should establish a sound framework to manage risks.*

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<sup>13</sup> Paragraph 15.12(1)(e), Bursa Malaysia Listing Requirement (Main Markets)

<sup>14</sup> Paragraph 15.12 (1)(f), Bursa Malaysia Listing Requirement (Main Markets)

Together, Recommendation 6.1 and the commentary stipulate that:

- The board should determine the company's level of risk tolerance and actively identify, assess and monitor key business risks to safeguard shareholders' investments and the company's assets.
- Internal controls are important for risk management and the board should be committed to articulating, implementing and reviewing the company's internal control system.
- Periodic testing of the effectiveness and efficiency of the internal controls procedures and processes must be conducted to ensure that the system is viable and robust.
- The board should disclose in the annual report the main features of the company's risk management framework and internal control system.

The board's disclosure of the main features of the company's risk management framework and internal control system is also reflected in Listing Requirement (2011).<sup>15</sup> To enable the board of directors to make such disclosure, the Bursa Malaysia has required the senior management (e.g. CEO, CFO or MD) to provide a back-to-back assurance to the board that the risk management and internal control systems of the listed issuers are operating effectively. The external auditors are also required to comment on the board's disclosure. The key corporate governance stakeholders can seek further guidance from the *Statement of Risk Management and Internal Control – Guidelines for Directors of Listed Issuers* introduced on 31 December 2012.<sup>16</sup>

Although the board is entrusted to oversee the risk management framework and internal control system of listed issuers, this oversight role is normally reassigned to the AC or another sub-committee of the board. Since the IIA has positioned the IAF as the internal control domain knowledge expert and reinforces the importance of IAF as a third line of

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<sup>15</sup> See Paragraph 15.26 (b), Listing Requirements (2011).

<sup>16</sup> The Statement of Risk Management and Internal Control - Guidelines for Directors of Listed Issuers repealed the Statement of Internal Control –Guidelines for Directors of Listed Issuers which has been in practice since December 2000

defence against risks, it will be interesting to explore the actual practice of IAF and their nexus with the AC in Malaysia.

## **2.4 Chapter Summary**

This chapter presented the governance and regulatory framework that supports the development of the research objectives and research questions of this thesis. The following chapter discusses the multiple theories that support this study, including agency, stakeholders and institutional theory. It also provides a review of extant literature that informs the research gap identified in Chapter 1, leading to the development of the research objectives and research questions for this thesis.

## **CHAPTER 3: MULTI-THEORETICAL PERSPECTIVES AND LITERATURE REVIEW**

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### **3.0 Introduction**

Following a discussion of the governance and regulatory framework in Chapter 2, this chapter discusses the multiple theories that underlie this study as well as the extant literature that leads to the development of the research objectives and research questions for this thesis. The first section of this chapter deliberates on the need to adopt a multi-theoretical perspective to inform this study. It is followed by a synthesis of multiple corporate governance theories (namely agency, stakeholders and institutional theory) that help explain the enabling factors (internal and external to organisations) that could encourage or inhibit the effective practice of the IAF in Malaysia. The third section of this chapter presents the alternative corporate governance theories being adopted in this field of study. The final section of this chapter critically reviews the extant literature that informs the research gap leading to the development of research questions of this thesis.

### **3.1 The Need to Adopt a Multi-Theoretical Perspective**

Historically, corporate governance research in accounting and finance has focused on deductively testing the theoretical hypothesis based on the positivist agency theory (e.g. Zattoni and Van Ees 2012; Dalton, Hitt, Certo, & Dalton, 2007; Daily, Dalton and Cannella 2003). In other words, they rely on the agency framework to provide significant insights into problems associated with companies in discharging their accountability to the dominant stakeholder group, that is, the shareholders ('shareholder-centric'). This shareholder-centric perspective is still solidly rooted in corporate governance policies and code of practices of many major capital markets. They instigate corporate governance reform from the perspective of protecting and enhancing shareholders' wealth. However, whilst the large majority of corporate governance research continues to adopt agency theory as its underpinning theory, empirical evidence provided by these studies is mixed and has revealed that agency-based perspectives generally have equivocal impacts on

governance behaviours and performance outcomes (Dalton, Hitt, Certo, & Dalton, 2007; Rhoades, Rechner and Sundaramurthy 2000; Dalton, Daily, Ellstrand, & Johnson, 1998). Recently corporate governance literature has suggested the need to look beyond agency theory. In response to that, there are a growing number of studies adopting a multi-theoretical lens in their governance studies. Some researchers purport that while agency theory has a place in corporate governance research, it should not be relied on as the solitary underpinning theory (Bansal 2013; Zattoni, Douglas and Judge 2013) as this may result in researchers losing sight of the underlying governance problem.

The majority of recent IAF-related studies are founded on an agency perspective (see Abbott, Parker and Peters 2010; Sarens and Abdolmohammadi 2010; Sarens, De Beelde and Everaert 2009; Goodwin-Stewart and Kent 2006b). However, research evidence on the extent of IAF's contribution in mitigating the agency problem (e.g. monitoring) is less than convincing as it does not take into consideration contextual issues such as the environmental and organisational influences (Aguilera, Filatotchev, Gospel, & Jackson, 2008; Davis, Schoorman and Donaldson 1997). Thus, it suggests the need to address this thesis from a multi-theoretical perspective.

## **3.2 Corporate Governance: Multi-Theoretical Perspectives**

### **3.2.1 Agency theory: the traditional approach**

Traditionally, research into corporate governance (i.e. how companies are controlled and directed) is founded on the agency framework, focusing exclusively on resolving conflict of interests (agency problem) between corporate managers and the shareholders (Eisenhardt 1989a; Fama and Jensen 1983; Jensen and Meckling 1976). The central tenet of agency theory is that when the interests of principals (i.e. shareholders or owners) and agents (i.e. senior management) diverge, agents tend to maximise their personal wealth at the expense of principals. It is alleged that there exists a nexus of contracts between the principals, who own the economic resources, and the agents, who are entrusted with using and controlling the principals' resources (Jensen and Meckling 1976). This gives rise to the first assumption of agency theory: 'separation of ownership and control'. The second

assumption is ‘information asymmetry’. This is based on the premise that due to their daily involvement in the organisation, agents tend to acquire more information about the organisation than the principals. This lack of full information of the organisation (information asymmetry) has adversely affected the principals’ ability to assess whether the agents are acting in the best interest of the principals. The third assumption of agency theory is ‘managerial opportunism’. It is alleged that agents have self-seeking motives and will capitalise on the principals’ information asymmetry and maximise on their personal wealth; a cost to the principals known as agency costs (Jensen and Meckling 1976). The accentuation of agency theory is to align the interest of agents (i.e. senior management) with those of the principals (i.e. owners or shareholders) and reduce agency costs.

In reducing agency cost (i.e. conflict of interest between principals and agents), Eisenhardt (1989a) suggests two propositions for the control mechanisms: outcome-based contracts (e.g. commission, stock options, market governance) and behaviour-based contracts (e.g. hierarchical governance). Under the outcome-based contract, it is argued that by awarding senior management with stock options, the organisation effectively aligns the interest of agents with that of the principals, thus reducing the conflicts of self-interests between principal and agents (Jensen and Meckling 1976). Under the behaviour-based contract, it is purported that the corporate director (specifically, the independent directors such as the AC) could help to control the managerial opportunism of the senior management through incorporating an appropriate control or monitoring mechanism such as internal and external audit (Fama and Jensen 1983). This is akin to an ‘agent watching over agent’ approach.

The IAF’s role is significant to an organisation as it fills the void that emerges in the corporate governance mosaic (Cohen, Krishnamoorthy and Wright 2004). Although the IAF does not have a direct relationship with the shareholders (i.e. principal), it plays a significant supporting role to the AC, another agent of the principal.

Agency theory is adopted in this thesis as it informs the broader governance and monitoring processes of organisations in general. The two other theories pertinent to inform this thesis are stakeholder theory and institutional theory. Stakeholder theory is adopted as it addresses how IAF could support the other corporate governance

stakeholders (i.e. senior management, AC and external auditors), who in turn owe their fiduciary duty not only to the shareholders but also to a wider group of stakeholders. Institutional theory is appropriate as it addresses the political and cultural differences unique to the Malaysian corporate governance environment.

### **3.2.2 Stakeholder theory**

In the past, the board of directors owed its duty of care solely to shareholders (shareholder-centric). However, recent studies have recognised that organisations are impacted by wider environmental and organisational factors generating a wider range of stakeholders and contractual obligations (Aguilera, Filatotchev, Gospel, & Jackson, 2008; Young and Thyil 2008; Aguilera and Jackson 2003; Freeman 1983). Accordingly, such fiduciary duty of care of corporate directors to shareholders has now extended to include the non-shareholders groups (Marens and Wicks 1999; Boatright 1994). This change of emphasis away from the traditional ‘shareholder-centric’ approach towards a ‘stakeholder-oriented’ approach to corporate governance is a recent phenomenon that gains momentum after the series of corporate scandals that started more than two decades ago.

Freeman (1983) defines stakeholders as ‘any group or individual who can affect or is affected by the achievement of an organisation’s objectives’ (p. 6). In other words, stakeholders are parties who have ‘a stake’ in an organisation and who have something ‘at risk’. Different researchers give a different taxonomy of stakeholders. Carroll (1989) categorises stakeholders into primary (or contractual) and secondary (or diffuse) stakeholders. Primary stakeholders are those who have a direct and contractual relationship with the firms (shareholders, lenders, suppliers, tax office etc.). Whereby, secondary stakeholders are at the peripheral of the organisations but may be impacted by actions or non-actions of the organisations (environmental activists, minority watchdog group etc.).

Sachs, Post and Preston (2002) posit that the stakeholder model is not a zero-sum-game but a positive-sum game that can lead to benefits for all or most critical stakeholders over a long run. In other words, proponents who support stakeholder theory are of the view that to meet only the shareholders’ needs (e.g. maximisation of profit for the organisation) is



short-term thinking. To ensure long-term sustainability and growth of an organisation, it is vital for top management (i.e. comprising owner-managers<sup>17</sup> and professional managers) to be able to identify and reconcile the diverse stakeholders' interests by recognising organisational obligations to wider and more ethically concerned constituencies (Simmons 2004). This view is consistent with Carroll and Buchholtz (2014) who posit that to be a responsible corporate citizen, organisations must pursue both profit and social responsibilities.

Donaldson and Preston (1995) posit that the underlying principle of stakeholder theory is that all persons or groups with legitimate interests in an organisation should be treated equally (i.e. with no prima facie priority over another). However, their view is dissented by Wang and Dewhirst (1992) and Gray, Dey, Owen, Evans, & Zadek (1997) who suggest that organisations need to prioritise stakeholders and be explicit about prioritisation given the limited resources confronting organisations. Conflict resolution is therefore needed between these varied groups of stakeholders. Mitchell, Agle and Wood (1997) allege that stakeholders' significance is determined by their possession of three attributes: their power to influence the firm; the legitimacy of their relationship with the firm; and the urgency of their claim on the firm.

Accordingly, corporate directors (particularly independent directors) are required not only to fulfil their obligations to monitor agents and protect principals, but they are also expected to manage the diverse needs of varied stakeholders to ensure the long-term sustainability of organisations. It is paramount for independent directors to ensure that when directing the organisation's limited resources, no single stakeholder group can benefit at the expense of others. The IAF is expected to support the AC in meeting this governance obligation.

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<sup>17</sup> 'Owner-managers' refers to controlling shareholders who also assume executive management role in listed issuers

The IIA posits that for IAF to be effective, the IAF must have the ability to ‘add value’ to not only the organisations’ control, risk management and governance processes but also to add value to its ‘stakeholders’ (IIA 2013a, Glossary on ‘add value’). The key IAF stakeholders as identified in the IIA are consistent with Gramling, Maletta, Schneider, & Church (2004): the external auditors, AC and senior management. Accordingly, besides supporting the AC in managing the diverse needs of the organisations’ varied stakeholders, the IAF is also expected to meet the expectation of its own key stakeholders (i.e. the senior management, external auditors and AC). In this study, the AC is chosen as the target participants because the Malaysian policymakers have made the IAF directly accountable to the AC.

### **3.2.3 Institutional theory**

This theory is drawn from the sociology of organisations and organisational behaviour disciplines. DiMaggio and Powell (1983) posit that organisations tends to conform with regulations out of expedience (to avoid punishment). However, when faced with uncertainty, for example, due to institutional pressure, they tend to organise themselves in a manner that is similar to other organisations in the same environment to exhibit conformity (DiMaggio and Powell 1983); a process called isomorphism. This isomorphism process could happen by virtue of being legally sanctioned (coercive or legislative pressure), morally authorised (normative pressure) or culturally supported (mimetic or cultural-cognitive pressure) (Scott 2008, 2001; DiMaggio and Powell 1983).

#### **3.2.3.1 Coercive isomorphism**

In the context of IAF, coercive or regulatory isomorphism comprises of those elements (e.g. law, legislation and authority) that could exert pressure on the establishment of an IAF and its practices. DiMaggio and Powell (1983) allege that the central pillars of coercive isomorphism are fear, expedience and force. Coercion could compel organisations to establish an IAF and to maintain a sound system of internal control and risk management framework as well as to review the economy, effectiveness and efficiency of the organisation’s activities to ensure the integrity of financial reporting and organisational performance. An example of coercive isomorphism is the Malaysian

regulators' mandatory requirement for all listed issuers to establish an IAF and for the IAF to report directly to the AC. To stay legitimate, all listed issuers must maintain an IAF either in-house or out-sourced.

### **3.2.3.2 Mimetic isomorphism**

Mimetic or cultural-cognitive isomorphism is founded on the assumption of 'follow the leader' regardless of whether the leader is proven to be effective. Mimetic (cultural-cognitive) isomorphism pressure may not be as visible or as powerful as coercive (regulatory) isomorphism. However, the institutional setting such as corruption, transparency, political connections and business networks could pose isomorphism similar to formal institutions (Gaur, Delios and Singh 2007). These societal values and beliefs systems that mirror the culture of the country may also impact on the governance practices of companies. In the context of internal audit practices, if organisations perceive that the particular structural or functional make-up of an IAF improves the control environment and operational performance of the organisation, then a growing number of organisations will adopt such structural or functional make-up. If organisations perceive that out-sourcing their IAF to third-party IAF service providers will allow them better control over their IAF budget and relieve them from staffing issue, then organisations may mimic others to out-source their IAF.

### **3.2.3.3 Normative isomorphism**

Normative isomorphism suggests convergence through socialisation. Scott (2001) contends that societal norms explicitly specify the means through which socially accepted ends could be achieved. Although not empirically supported, extant literature nonetheless suggests that social class, kinship, religions and other institutions (e.g. universities and research institutions, professional bodies and business associations) could be the source of the collective beliefs and values transmitted to organisations or individuals in society (Dowling and Pfeffer 1975) . In this context, the IIAM could, among others, collaborate with regulators to educate the key corporate governance stakeholders on the value of the IAF, provide training programs to the internal audit practitioners, and encourage more internal audit practitioners to pursue Certified Internal Audit qualifications etc. This effort

will inevitably increase the profile of the internal audit profession and raise the professionalism of the internal audit service providers. Consequently, this will encourage greater diffusion of higher quality internal audit practices into organisations and enhance IAF effectiveness in Malaysia.

In summary, organisations tend to conform to regulations to remain legitimate. However, sometimes when compelled to adopt certain structural changes they may respond to the institutional demand by ‘ceremonial conformity’ (Meyer and Rowan 1977). The organisations ‘decouple’ by exhibiting to the external environment compliance with the ‘requirements’, but internally they are not. For instance, AC processes may become more similar over time as organisations are coerced to become similar through regulations, by following ‘best practices’ or by mimicking other organisations to enhance their legitimacy. Under a circumstance of uncertainty and ambiguity, the board and the AC may embrace ceremonial or symbolic roles (Cohen, Holder-Webb, Sharp, & Pant, 2007). In the Malaysian context, while the regulators have mandated the establishment of IAF, they are not explicit on the practice of IAF. This has accorded flexibility to listed issuers in respect of the functional and structural make-up of IAF. Accordingly, it would be interesting to investigate how these three isomorphism processes inform the internal audit practices in Malaysia.

### **3.3 Extant Research on Alternative Corporate Governance Theories**

The majority of the corporate governance research has been based on the agency framework (Carcello, Hermanson and Zhongxia 2011). However, the current trend suggests that some corporate governance researchers are moving towards adopting alternate corporate governance theories along with agency theory in informing behaviours and processes related to corporate governance. For instance, Nicholson and Kiel (2007) employ agency theory, stewardship theory and resource dependence theory to explain the link between board demography and firm performance. Cohen, Krishnamoorthy and Wright (2008) reveal that in contrast to agency and resource dependence perspectives, which offer a functional view of governance, the managerial hegemony perspective views the board and its sub-committees (such as, the AC) as being under the control of

management and hence could be potentially viewed as dysfunctional from a stakeholder viewpoint. In the same study, they employ institutional theory to explain how the different corporate governance stakeholders' symbolic gestures and activities maintain their form with other relevant parties. Trotman and Trotman (2015) adopts agency, institutional and resource dependency theories to explore the role of internal auditors in greenhouse gas emissions reporting, identifies factors explaining internal audit's role and the future role of internal audit in GHG reporting.

Cohen, Krishnamoorthy and Wright (2010) reveal that while external auditors consider that the AC play an important governance role, the AC are often passive in resolving disagreements between external auditors with the management and they do not have authority over hiring and firing of the external auditors. This may infer that the AC play a ceremonial role and reaffirm the institutional perspective in the AC's governance role. Christopher (2010) postulates that there are three levels of governance (controls) informed by stakeholder theory: resource dependency theory, stewardship theory and agency theory. In his multi-theoretical perspective framework, he informs that the first level of control is control over the management of the diverse needs of the various stakeholders (based on stakeholder theory). The second level is control over the quality of board members and is informed by resource dependency theory. The third level is control over the operational unit within the organisation, and he suggests the application of stewardship theory, which focuses on trust and empowering the stewards (employees) as the monitoring effort.

This thesis relies on the rubric of corporate governance theories discussed in earlier sections, namely agency, stakeholder and institutional theory to inform its findings. It does not attempt to align a particular theory with certain contextual or environmental factors in explaining the IAF effectiveness in Malaysia because the theories simultaneously explain the influence of the key contextual or environmental factors on the internal audit practices.

### 3.4 Review of Extant Literature and Research Gap

Based on the accounting literature, there are two main approaches to the concept and evaluation of IAF effectiveness. The first approach is based on the fit between IAF and universal standards extrapolated from the attributes of the IAF (the ‘IAF attributes fit’ approach). Early studies relied on Sawyer (1988)’s five standards<sup>18</sup> established for the IAF, but recent studies benchmark IAF effectiveness against the standards issued by international professional bodies such as the International Professional Practices Framework (‘IPPF’) and the Committee of Sponsoring Organizations of the Treadway Commission (‘COSO’)<sup>19</sup> as well as ISA 610.

The second approach is premised on the notion of Albrecht, Howe, Schueler, & Stocks (1988) that the effectiveness of the IAF is not a computable reality, but rather is determined by subjective evaluations assigned by the task assignor or key stakeholder (the ‘key stakeholder’s approach’). This is consistent with Cameron (1983)’s view discussed earlier. In other words, the effectiveness of the IAF is measured, either qualitatively or quantitatively, against the expectation of the relevant stakeholders. A majority of recent studies have relied on the IAF attributes fit approach to examine IAF effectiveness. For instance, it is postulated that effectiveness of the IAF is in its independence and objectivity (see Stewart and Subramaniam 2010; Christopher, Sarens and Leung 2009), competencies of the IAF team (see Ege 2015; Arena and Azzone 2009) and close rapport with the AC (see Arena and Azzone 2009; Krishnan 2005). It is also conjectured that IAF effectiveness is influenced by the size of IAF team (see Anderson, Christ, Johnstone and Rittenberg 2012; Arena and Azzone 2009). These studies associate specific attributes of IAF to their effectiveness by relying on the IAF or CAE self-assessment of their own effectiveness.

Another congregation of research on IAF effectiveness is premised on the external auditors’ dependence on IAF, either direct assistance from the IAF or reliance on IAF

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<sup>18</sup> Sawyer (1988)’s five standards include: professional proficiency, interdependence, the scope of IAF work, the performance of IAF and management of the IA department.

<sup>19</sup> <http://www.coso.org/ic.htm>

work. IAF quality or effectiveness is inferred when external auditors rely on the IAF. External auditors will only rely on IAF if they believe that the IAF meets the quality criteria as stipulated in the professional standards (e.g. ISA 610). Recent studies that rely on this approach are Pizzini, Lin and Ziegenfuss (2014), Desai, Gerard and Tripathy (2011), Lin, Pizzini, Vargus, & Bardhan (2011), Desai and Desai (2010), Mishiel Said and Qasim (2010), Munro and Stewart (2010) and Krishnamoorthy (2002).

Interestingly, prior research rarely attempts to garner perspectives of other key IAF stakeholders' (e.g. AC and senior management) in IAF-related or IAF effectiveness studies.

Traditionally, IAF focuses predominantly on financial audits and compliance. However, the IIA claims that its members can provide assurance and consultancy services on control, risk management and governance processes of organisations (IIA 1999). Accordingly, the IAF are envisaged to be able to perform compliance as well as consultancy roles to the board of directors and management on a regular basis (Christopher 2012; Fraser and Henry 2007; Beasley, Clune and Hermanson 2005; Page and Spira 2004). They are also alleged to be able to assist managers in understanding enterprise-wide risks and manage them so as to achieve their expected targets.

Contrary to the IIA's claim, the CBOK 2010 study reveals that only 45% of the IAF activities involve corporate governance review while 57% include enterprise-wide risk management ('ERM') processes (IIARF 2010a). The CBOK 2006 study found that only one-third of the IAF has no role in risk management (IIARF 2007), which may be due to internal auditors overly focusing on operational and controls risks (PwC 2009; Ernst & Young 2008) at the expense of strategic and business risk (PwC 2009). PwC (2010) recommends that the IAF should focus on critical risks issues and re-align its value proposition with that of the stakeholders' expectations. The findings by CBOK reveal the existence of a theory-practice gap in the IAF in discharging their duties, in contrast to what is professed in the IIA's International Professional Practice Framework.

A stakeholders' survey conducted by Deloitte and the IIA UK and Ireland (2008) reveals that two-thirds of the IAFs do not value-add, implying they may not know what is

expected of them by the key users, namely the Board (including the AC) and executive management. A survey conducted by IIA Australia (2013) reveals the existence of a mismatch between the expectations of the AC chair and the skills the CAEs believe they need to enhance their function. Consequently, there is increasing pressure from key stakeholders (e.g. AC and senior management) and the accounting profession for the IAF to re-align its focus. To ensure this, the IIA has issued several practice guides and standards, such as Standard 1300 (Quality Assurance and Improvement Programme) and Standard 1310 (internal and external assessment of IAF quality). It is suggested that focusing on improving the internal audit process is an important activity that will improve the perception of key users over the IAF's performance (Elliott, Dawson and Edwards 2007).

A review of the prior literature reveals that the majority of the studies that focus on the theory-practice gap are undertaken by accounting firms or professional bodies. Except for Abbott, Parker, & Peters (2010) very few academic researchers have attempted to investigate the operational aspect of IAF and whether the IAF meets the expectations of the AC or other key IAF stakeholders (e.g. senior management). This thesis attempts to fill these research gaps by addressing the following research objectives:

*RO1: To develop an IAF effectiveness framework that will support the ACs in their role of enhancing governance.*

*RO2: To refine the IAF effectiveness framework as it applies in the Malaysian context.*

*RO3: To determine to what extent the IAF effectiveness framework is being applied in the IAFs of Malaysian public listed companies.*

The consequential research questions are:

*RQ1: What constitutes an IAF effectiveness framework taking into account the key contextual factors that appear to inhibit and/or encourage the internal audit practices of the Main Market listed issuers in Malaysia?*



*RQ2: To what extent does the IAF effectiveness framework meet the AC's expectation in fulfilling their governance obligations?*

*RQ3: To what extent is the IAF effectiveness framework practised by the IAFs of the Main Market listed issuers in Malaysia?*

### **3.5 Chapter Summary**

This chapter discussed the multiple governance theories underlying this study, including agency, stakeholder and institutional theory. This was followed by a review of extant literature that informs the research gap and consequently the development of research objectives and research questions for this study. The following chapter, Chapter 4 seeks to justify the adoption of an inductive inquiry (qualitative) approach to addressing the research questions. A two-phase research design, which entails the development of a conceptual framework (Phase I) and a qualitative field study (i.e. semi-structured, in-depth interviews) with AC participants (Phase II), will be deliberated. Also, the sample selection, data collection and data analysis will be discussed in the following chapter.

## CHAPTER 4: RESEARCH METHODOLOGY

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### 4.0 Introduction

Research scholars have established that research objectives and research questions determine the selection of the research methodology and design (Saunders, Lewis, & Thornhill, 2011; Sekaran 2006; Patton 2005; Eisenhardt 1989b). Accordingly, this chapter provides the justification for the choice of a qualitative field study for this thesis. The first section of this chapter outlines the research paradigm and methodology as it relates to the research objectives and questions of this study and is followed by a justification for the investigative approach of a qualitative field study within an interpretivist paradigm. This is followed by a description of the research design and processes such as the sample selection, data collection methods, data analysis and ethical considerations.

### 4.1 Selection and Justification of the Research Methodology

#### 4.1.1 Overview of the research paradigm

A research paradigm is an important and crucial part of the research process due to its contribution to the understanding of the development of knowledge. Saunders, Lewis, & Thornhill (2011) posit that the basic assumptions about the way the researchers view the world is contained in the research paradigm they adopt. A *paradigm* is defined as the underlying assumptions and intellectual structure upon which research and development in a field of inquiry are based (Kuhn 1962). Guba and Lincoln (1994) further inform that paradigm is an interpretative framework guided by a set of beliefs and feelings about the world and how it should be understood and studied. These beliefs are broadly categorised as ‘nature of organisational phenomena (*ontology*), the nature of knowledge about those phenomena (*epistemology*) and the nature of ways of studying those phenomena (*methodology*)’ (Gioia and Pitre 1990, p.585). Therefore, to clarify the structure of inquiry and methodological choices, an exploration of the paradigm adopted for this study is necessary.

The four typologies of research paradigms are positivism, realism, interpretivism/constructivism and pragmatism (Creswell and Clark 2007). However, the two main paradigms or worldviews that dominate business and management research are *positivism* and *interpretivism/constructivism* (Saunders, Lewis, & Thornhill, 2011; Tashakkori and Teddlie 2010; Creswell and Clark 2007). While the positivist paradigm underlines quantitative methods, the constructivists paradigm underlies qualitative methods (Guba and Lincoln 1994). Some of the core differences are summarised in Table 4.1.

**Table 4.1: Core differences between positivism and constructivism**

	<b>Positivism</b>	<b>Interpretivism/Constructivism</b>
Ontology	There is a single reality – tangible and fragmented	There are multiple realities – holistic and constructed
Epistemology	The knower and the known are independent	The knower and the known are inseparable
Axiology	Inquiry is value free	Inquiry is value-bound
Generalisation	Possible	Impossible
Casual linkages	There are real causes, temporally precedent or simultaneous with that effects	It is impossible to distinguish causes from effects
Logic	Deductive	Inductive

*(Adapted from Lincoln and Guba 1985b, p.37)*

In brief, the positivists believe in a single reality, and the only reality/truth can be discovered by an objective and value-free inquiry. Conversely, the interpretivists/constructivists believe that there is no such thing as a single objective reality or truth; and a subjective and value-bound inquiry is necessary (Creswell and Clark 2007). It is acknowledged that positivism is a research paradigm that reflects the study of social reality within the tradition of natural scientists. Conversely, interpretivism/constructivism is a research paradigm that reflects the study of social reality propelled by the way human make sense (or interpret) the social settings around them (Grafton, Lillis and Mahama 2011). Positivist research methodologies emphasise theory testing while interpretivism/constructivism methodologies seek to ‘build’ theory (Creswell 2003; Carson, Gilmore, Perry, & Gronhaug, 2001). Under interpretivism/constructivism methodologies, although prior theory may be used as a foundation and may be introduced

at appropriate stages throughout the research study or may guide or loosely frame the research, the research is not about testing this prior theory; instead it is about seeking an actual reality in a specific situation (Carson, Gilmore, Perry, & Gronhaug, 2001).

Saunders, Lewis, & Thornhill (2011) suggest business and management researchers commit to their research paradigm through the research approaches and strategies they employ, due to its relevance to the research problem being investigated. Due to the explorative and investigative nature of this thesis, an inductive inquiry (qualitative approach) within the interpretivist paradigm has been chosen. Justifications of the adoption of a qualitative methodology is found in Section 4.1.2.

#### **4.1.2 Justification of the research paradigm**

It is suggested that research objectives and research questions form the basis for which the research paradigm and methodology are chosen (Patton 1990; Eisenhardt 1989b). They also drive the choice of a research method and design (Creswell 2003; Patton 1990).

In this study, the research objectives and questions are motivated by the apparent lack of a comprehensive IAF effectiveness framework that could support the AC in their role of enhancing governance. Hence, the research objectives and questions are designed to gather a contextual understanding of how the AC perceive IAF effectiveness and also to explore and investigate the enabling factors (internal and external to organisations) that could encourage and/or inhibit the effective practice of the IAF in Malaysia.

To this end, this study needs to employ an interpretivist paradigm due to the explorative and investigative nature of the research questions to be addressed. In addition, this paradigm also acknowledges the context and provides detailed understanding of the social reality to be studied. The adoption of the interpretivist paradigm has led to the choice of an inductive (qualitative) inquiry approach in this thesis.

#### **4.1.3 Justification of a qualitative approach**

A qualitative inquiry within the interpretivist paradigm has been chosen as the most appropriate approach for this study as this approach allows the researcher to gain

insightful perspectives and to understand issues or complex phenomena that are not well defined or structured (Birnberg, Shields and Young 1990) or unable to be obtained through archival methods (Lillis 1999).

Under the qualitative inquiry, a semi-structured, in-depth interview approach is chosen since under this interview approach ‘the interviewer does not keep a tight rein on the interview but instead allows the interviewee, through the use of open-ended questions, to explore the subject in as much depth and from as many angles as they please’ (Longhurst 2009). Furthermore, in-depth interviews accord flexibilities (Patton 2005; Huberman and Miles 1994; Miles and Huberman 1994; Silverman 1993) to researchers that enables them to elicit highly detailed information such as insights on participants’ experience (Cohen, Krishnamoorthy and Wright 2002) and actual work experiences (Cohen, Krishnamoorthy and Wright 2008). The justification for the selection of semi-structured, in-depth interviews is deliberated in the following paragraphs.

Broadly, there are three types of interview method: structured, semi-structured and unstructured (Patton 1990). Structured interviews are a more controlled process, whereby the participants are asked a specific set of questions in a pre-determined order with a limited number of response categories (Denzin and Lincoln 2008). It is employed predominantly by positivistic researchers in the quantitative inquiry (Silverman 2001). However, the limitation of this interview method is its rigidity in that it does not accord the opportunity for researchers to garner in-depth views of the interviewees. Conversely, the unstructured interview is employed predominantly in qualitative inquiry. It is a useful method to develop an understanding of a not fully known culture, experience or setting. This method is commonly employed in ethnographic research, which has its roots in the discipline of anthropology (Marvasti 2010). A potential limitation of this interview method is that since the interview questions are open-ended, it may result in the interviewer having little control over interviewees’ responses and may require the interviewer to speak with interviewees on multiple occasions (Silverman 2001).

Semi-structured interviews sit somewhere in the middle of this continuum and enjoy benefits the other two methods lack (Longhurst 2009). A semi-structured interview method is often used in exploratory or investigative research where the phenomenon or

issues are less well-defined or structured (Miles and Huberman 1994). One of the strengths of semi-structured interviews is that the interviewers are allowed to use open-ended questions to delve into complex behaviours, experiences and opinions (Longhurst 2009). It also provides the flexibility and opportunity for the interviewers to inquire further if a new theme emerges during the interviews (Miles and Huberman 1994). Unlike unstructured interviews, interviewers will not lose control over the interview process as they follow an ‘interview guide’<sup>20</sup> (Lillis 1999). Bernard (1988) suggests that a semi-structured interview is the most appropriate approach if the researchers are accorded only one chance to question the interviewees.

Premised on the preceding discussions, the adoption of a semi-structured interview approach in this study is justifiable. Furthermore, a semi-structured interviews method is widely employed in auditing and accounting field of research (see Tremblay and Gendron 2011; Cohen, Krishnamoorthy and Wright 2010; Trompeter and Wright 2010; Cohen, Krishnamoorthy and Wright 2008; Gendron and Bédard 2006; Cohen, Krishnamoorthy and Wright 2002).

However, one drawback of a semi-structured interview method is that it may be subject to interviewer bias, which could present during both interviewing and the data analysis process. Lillis (1999) suggested two research design features to overcome this: the interview guide and analysis protocol. Both are employed in this thesis.

This study has selected an in-depth interview as opposed to the other data collection methods (e.g. focus groups and ethnography interviews). Ethnography interviews were not considered in this study as it has its root in the discipline of anthropology (Marvasti 2010). Focus group interviews are more relevant to studies that aim to generate information on ‘collective views’ of the participants’ experience or beliefs (Morgan 1997). It is conducted in a group meeting setting and moderated by a researcher, or ‘facilitator’ (Kitzinger 1994). Data collection through focus group interviews are therefore not

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<sup>20</sup> That is a list of key questions and topics that need to be covered during the interview.

appropriate in this study due to the status of the targeted participants (i.e. AC members or AC chair of the Main Market listed issuers).

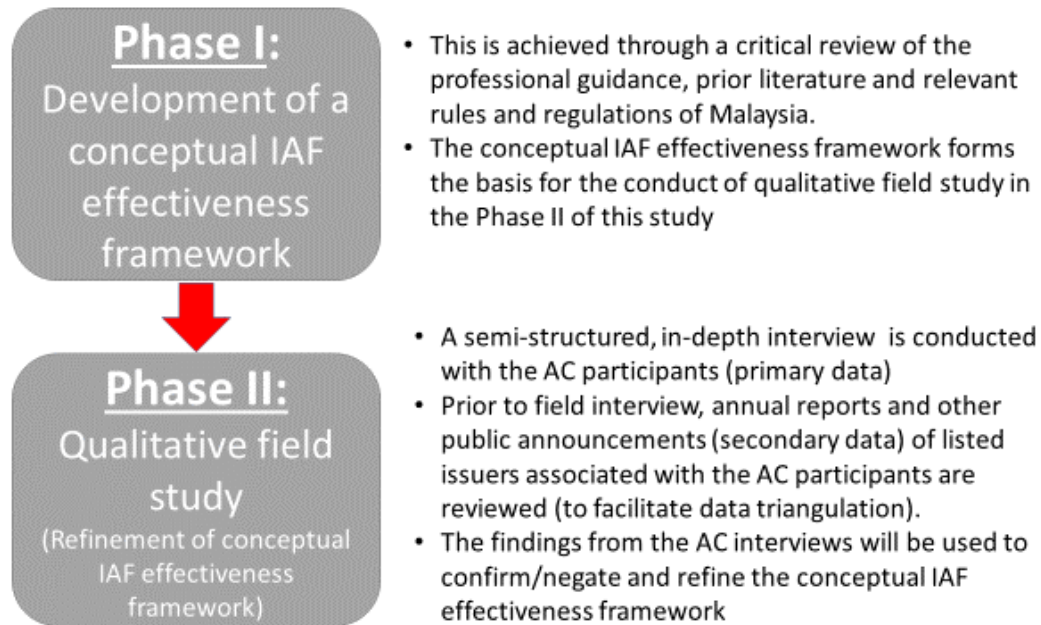
Being members of the board of directors, the AC are deemed the ‘top echelons of the firm’, and are considered the ‘corporate elites’ (Giddens 1972). To get access to the AC is challenging due to their busy work schedule and social status. It is even more challenging to organise a group meeting for the AC at a specific venue and time (an attribute of the focus group). Furthermore, the AC may also not wish to share their views openly in a group discussion on some sensitive issues. These challenges have rendered focus group interviews inappropriate for this study. Interviewing the corporate elite has never been as easy as interviewing the non-elite due to ‘the established barriers that set them apart from the rest of the society’ (Hertz and Imber 1993, p. 3).

Based on the preceding discussions, a semi-structured, in-depth interview method was employed in this study. However, there are two-pronged negativities associated with semi-structured, in-depth interviews. First, the researcher is confronted with practical issues such as the associated costs, time and availability of participants (Longhurst 2009). Second, the generalisability of findings may be limited by its small sample size (Patton 1990). Considering these two limitations, the researcher has to be mindful of getting the right sample size of AC participants to meet the purpose of this study and not overstretch the limited research resources (i.e. manpower and financial).

## **4.2 The Research Design: Two-Phase Research Design**

In this study, a sequential two-phase research design is adopted to address the research objectives and questions. The two-phase research design is presented in Figure 4.1.

**Figure 4.1: Two-phase research design**



#### **4.2.1 Phase I: development of a conceptual IAF effectiveness framework**

Phase I of the research design entails the development of a conceptual IAF effectiveness framework. The following research processes are undertaken to develop the conceptual framework:

- (i) A critical review of the IIA’s professional standards, guidelines and pronouncements (collectively referred to as the ‘professional guidance’) and legislations, code and regulations (collectively referred to as the ‘rules and regulations’) as enacted in Malaysia and other developed capital markets (Chapter 2).
- (ii) A critical review and analysis of the underpinning governance theories and literature (Chapter 3).
- (iii) Identification of constructs within the developed conceptual IAF effectiveness framework (Chapter 5) that are subject to confirmation or refinement through a qualitative inquiry process in Phase II of this two-phase research design. Considering the fact that the contextual and environmental factors that could impact on internal audit practices are under-researched, the literature review



has extended to all journals of Australian Business Dean Council list (published between January 2000 to August 2014) to develop the key enabling factors. Professional literature has also been relied on since the IAF effectiveness framework is to be practice-informed.

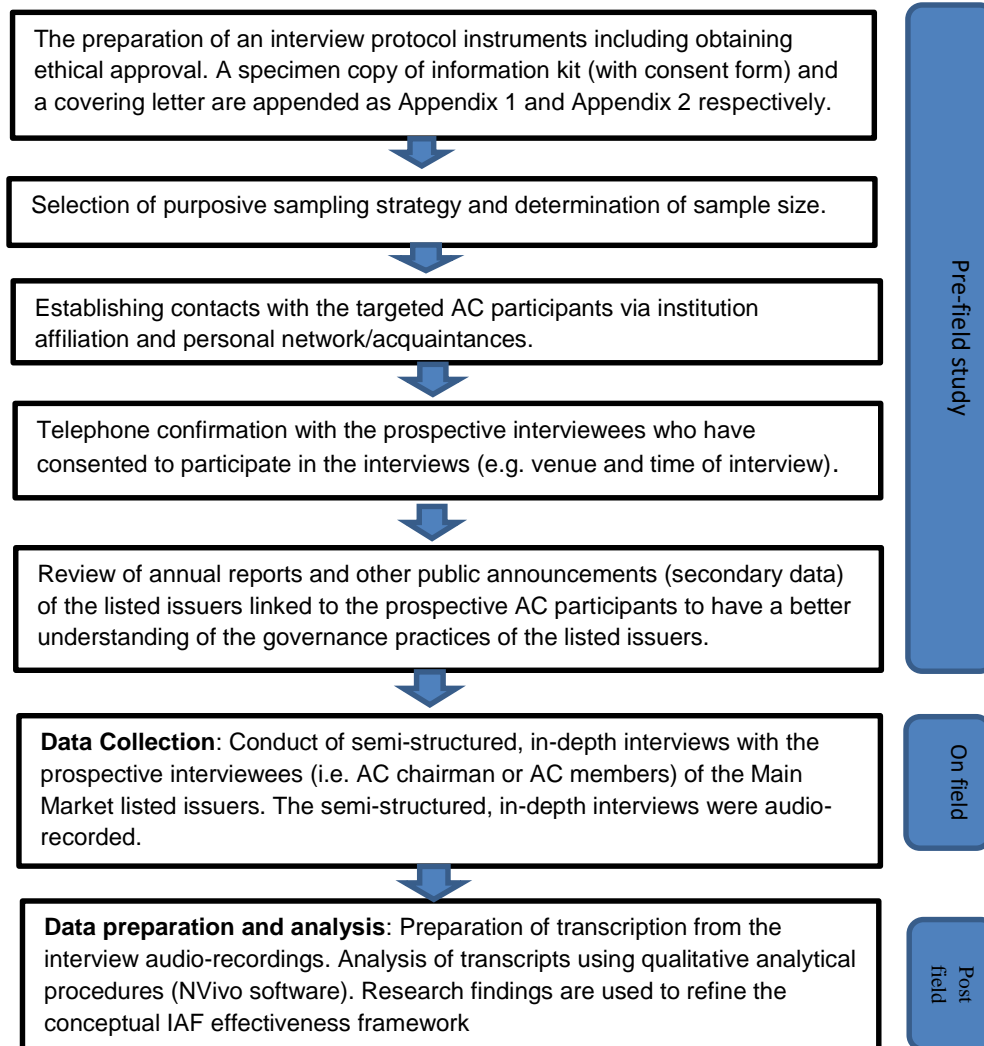
In summary, the outcome of Phase I of the research design is achieved through a process of critical review of extant governance literature and multiple governance theories, the professional guidance and the Malaysian listing rules and regulations. The developed conceptual framework and its constructs from Phase I of this two-phase research process forms the basis of Phase II of this research.

#### **4.2.2 Phase II: qualitative field study**

This phase aims to confirm/negate or refine the conceptual framework and its constructs through a series of semi-structured, in-depth interviews with AC participants of the Main Market listed issuers. This process is necessary as no previous studies have been conducted to identify an IAF effectiveness framework that provides a comprehensive view by considering enabling factors (internal or external to organisations) that will support effective practice of IAF in Malaysia. Most prior studies that rely on the Malaysian dataset tend to conceptualise IAF effectiveness based on the internal audit attributes narrowly prescribed within the external audit standards (see Fazli Aghghaleh, Muhammaddun Mohamed and Ahmad 2014; Cooper, Leung, Dellaportas, Ahmad, & Taylor, 2009) or relied on a specific contextual factor (e.g. board quality) (see Johl, Johl, Subramaniam, & Cooper, 2013). Also, to the best knowledge of the researcher, this is the first IAF-related study to rely on the AC's (the key IAF stakeholder) perspective in Malaysia.

Before the field interviews, the researcher reviewed the secondary data (e.g. annual reports and public announcements) of listed issuers associated with the AC participants. The purpose of this procedure was to facilitate data triangulation and to help achieve convergence, i.e. bringing together two different sources of information to support a common finding (Miles and Huberman 1994). The research procedures of Phase II are presented in Figure 4.2.

**Figure 4.2: Phase II: qualitative fieldwork procedures**



These research procedures are further discussed in the following sections.

## 4.3 Sampling Methods

### 4.3.1 Sampling strategies

In qualitative research, the aim is not to generalise<sup>21</sup> the research findings, but to select ‘an information-rich case for study in-depth with a specific purpose’ (Patton 1990, p.169). There is a wide range of sampling approaches, for instance, convenience, purposeful (purposive), maximum variation, homogenous, critical case, extreme or deviant case, criterion and snowballing (see Saunders, Lewis, & Thornhill, 2011; Sekaran 2006; Miles and Huberman 1994; Patton 1990). Patton (1990) broadly categorised them into: convenience sampling and purposeful sampling.

Convenience sampling is a sampling method where the researcher selects the research sample based on ease and proximity to the researchers (e.g. in shopping mall). The advantage of this method is that data can be collected within a short timeframe with minimal costs. However, it lacks credibility as it is highly vulnerable to selection bias and has a high level of sampling error (Saunders, Lewis, & Thornhill, 2011). Conversely, the purposeful (purposive) sampling method is where researchers select their case (or prospective participant) with a particular purpose in mind (Miles and Huberman 1994; Patton 1990). Purposive sampling is credible and is widely adopted as an evaluation criterion for trustworthiness in qualitative research (Barbour 2001).

In this study, the prospective participants have been identified as an AC member or AC chair of Main Market listed issuers of the Bursa Malaysia. Hence, purposeful (purposive) sampling method relying on ‘criterion’ strategy has been employed in this study.

In determining the selection criteria for the AC participants, the researcher has relied on the relevant provisions in the Listing Requirements (2011). The Listing Requirements (2011) specify that the AC of listed issuers to comprise of at least three members. All of them must be non-executive with the majority being independent directors. Also, at least

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<sup>21</sup> Generalisation is the objective of quantitative research hence they require a larger sample selected randomly (Saunders, Lewis, & Thornhill, 2011; Patton 1990)

one of the AC member must qualify as a ‘financial literate’.<sup>22</sup> The purpose of this study is to seek the AC’s views on the internal audit practices in Malaysia and enabling factors (internal and external to organisations) that could impact on the IAF effectiveness. According to Patton (1990), ‘information-rich cases are those from which one can learn a great deal about issues of central importance to the purpose of the research’ (p. 169). Hence, the AC participants selected need to have in-depth knowledge of corporate governance practices and control mechanisms of listed issuers in Malaysia. AC members who were professionally trained (accountants, lawyers, bankers etc.) are expected to be more proficient than the non-professionally trained. Hence, professional affiliation has been considered as one of the selection criteria. Also, only an ‘independent’ member of the AC will be considered in the sample selection process since they are expected to be more candid and impartial in sharing their views about corporate governance practices in Malaysia compared to their non-independent counterparts.

Accordingly, in this study the three selection criteria for the AC participants are that they must be an ‘independent’ director; affiliated to a professional body (e.g. accounting, banking, legal practice); and a member/chair of the AC of Main Market listed issuers (excluding financial institutions) of the Bursa Malaysia. In this study, the researcher has excluded the financial institutions (e.g. banking and insurance) as they are subject to more stringent monitoring regulations under the *Banking and Financial Institution Act 1989* (Malaysia). This sampling selection procedure is consistent with prior studies (Bliss, Gul and Majid 2011).

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<sup>22</sup> Paragraph 15.09(1)(c) of the Listing Requirements (2011) requires at least one of the AC member to be a ‘financial literate’. To qualify as a ‘financial literate’, the AC must be a member of the Malaysian Institute of Accountants; or if he/she is not a member of the Malaysian Institute of Accountants, he/she must have at least 3 years’ working experience; and (a) he/she must have passed the examinations specified in Part I of the First Schedule of the Accountants Act 1967; or (b) he/she must be a member of one of the associations of accountants specified in Part II of the First Schedule of the Accountants Act 1967; or (c) fulfils such other requirements as prescribed or approved by the Bursa Malaysia.

To access to the AC participants (deemed ‘corporate elites’), this study has employed the strategies proposed by Welch, Marschan-Piekkari, Penttinen, & Tahvanainen (2002). The study highlights the four challenges confronting elite interviewing as:

- obtaining access to elites
- managing the power asymmetry between interviewer and interviewee
- assessing the openness of the elites
- providing feedback.

Several strategies have been proposed to overcome these challenges including tapping into the institution affiliation of the prospective participants, utilising personal connections and seeking support from an influential ‘sponsor’ (Welch, Marschan-Piekkari, Penttinen, & Tahvanainen, 2002).

To gain access to these corporate elites, the researcher employed the ‘institution affiliation of the AC participants’ strategy by tapping into the Malaysian Institute of Certified Public Accountants (‘MICPA’)<sup>23</sup> membership database. The researcher is a Fellow member of MICPA and has been active in supporting MICPA’s training and certification programs for the past two decades. Accordingly, MICPA is supportive of this doctoral study. At the start of the data collection stage, MICPA provided a list of ten prospective AC participants who were also past and present council members of MICPA. Two months prior to the commencement of the field work, the researcher made numerous overseas telephone notifications to seek participation by the prospective AC participants. Among the prospective AC participants referred by MICPA, eight accepted the invitations to participate. One prospective AC participant declined as the data collection period coincided with an overseas business trip. Another had to cancel the interview just before

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<sup>23</sup> The MICPA is a professional body which supports the profession in Malaysia. Amongst other, it trains and conducts professional examinations for graduates who intend to pursue a CPA professional qualification. It supports the policymakers and standards setters in matters about accounting and auditing. It monitors the quality of its member (public accounting) firms. It has a professionally affiliated with the Institute of Chartered Accountants Australia. [www.micpa.com.my](http://www.micpa.com.my)

the pre-scheduled meeting to attend to an urgent personal matter. Six AC participants were arranged through the researcher's personal acquaintances/network.

### 4.3.2 Sample size

In this study, semi-structured, in-depth interviews were conducted with fourteen AC participants (comprising AC chair and AC members) of the Main Market listed issuers. In addressing the sample size issue, Patton (2002) indicates 'there are no rules for sample size in qualitative inquiry' (p. 244) and that 'the validity, meaningfulness, and insights generated from qualitative inquiry have more to do with the information richness of the cases selected and the observational or analytical capabilities of the researcher rather than with sample size' (p. 245). Several extant literatures recommend to continue interview until data saturation is reached, i.e. until the additional data collected provides few or no new insights (Saunders, Lewis, & Thornhill, 2011). Frustrated with the equivocal views from past literature, Guest, Bunce and Johnson (2006) allege that if the study aims to understand commonalities within a fairly homogeneous group of participants, twelve semi-structured, in-depth interviews should suffice.

During the earlier rounds of the semi-structured, in-depth interview, several AC participants were very senior and experienced. They were retired partners of audit firms<sup>24</sup> or retired executive directors of other Main Market listed issuers. Currently, they are a professional AC chair or member of several Main Market listed issuers. They shared many insights into matters about corporate governance practices in Malaysia, AC support and influences, organisational supports and internal audit practices in Malaysia. Their candid responses contributed significantly to the study. Accordingly, there were virtually no new insights generated after meeting the twelfth AC participant. Therefore, the semi-structured, in-depth interview process stopped at the fourteenth AC participant.

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<sup>24</sup> They all had more than ten years of professional AC experience. Two are AC chairs. Both are the ex-audit partners of Big-4 audit firms and sit on several FTBM100 listed issuers (i.e. top 100 largest listed issuers in Bursa Malaysia).

### 4.3.3 Sample: AC participants

The demographics of the fourteen AC participants and the characteristics of the listed issuers associated with them are presented respectively in Table 4.2 and Table 4.3.

**Table 4.2: Demographics of AC participants**

Audit committee (n=14)		n	Per cent (%)	
Qualification	Academic /professional	Professional accounting qualifications <sup>25</sup>	7	50
		Bachelor with professional accounting qualifications <sup>26</sup>	4	29
		Bachelor with other professional qualification <sup>27</sup>	1	7
		Bachelor with Barrister-at-law	1	7
		Masters with professional accounting qualification (CIMA)	1	7
		Experience	Audit committee experience	> 3 years but <5 years 5–10 years > 10 years
	External audit experience	Ex-audit partner Current audit partner None	4 7 3	29 50 21
	Internal audit experience		0	0

<sup>25</sup> Among others includes, MICPA, CAANZ, ICAEW, ASCPA, CIMA etc. Some of the AC participants have more than one accounting professional qualifications.

<sup>26</sup> The accounting professional qualifications are similar to note 25 above.

<sup>27</sup> The other professional qualifications include fellow member of the Institute of Bankers Malaysia

**Table 4.3: AC participants' and their associated number of listed issuers by industry sectors**

Industry sector <sup>28</sup>	AC participants' representation (n=24)
Consumers	8
Industrial products	5
Technology	2
Trading/services	2
Construction	2
Properties	2
Plantation	1
Finance	2
No. of listed issuers represented by the AC participants	24 <sup>29</sup>

## 4.4 Data Collection

### 4.4.1 Semi-structured, in-depth interviews

In this study, the semi-structured, in-depth interview approach is adopted since it allows the interview process to be guided by the identified themes in a systematic and consistent manner while having the flexibility to elicit new themes to be raised spontaneously by the AC participants. Simultaneously, it also keeps the researcher focus on the pre-determined interview questions and research objectives of the study (Creswell 2003; Patton 2002). The benefits of semi-structured, in-depth interviews approach have been well documented in the accounting literature (see Trotman & Trotman, 2015; Gendron 2009; Radcliffe 2010; M. S. Beasley, Carcello, Hermanson, & Neal, 2009; Lillis 2006).

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<sup>28</sup> Main Market of the Bursa Malaysia categorises its listed issuers into eight (8) sectors. In this thesis, the researcher has explicitly excluded financial services companies (e.g. banking, insurance) (see explanation in Section 4.3.1 above). Coincidentally, two of our AC participants also sit on the board (as AC chair/member) of two listed companies categorised under 'finance sector' (but none of them is involved in banking or insurance). Nonetheless, as a precaution, all AC participants were reminded at the start of the interview that they are to refrain from sharing their knowledge and experiences on IAF pertaining to financial institutions.

<sup>29</sup> Some AC participants sit on the board of more than one listed issuers. Accordingly, the number of listed issuers being represented by the AC participants is more than the actual number of AC participants.



Semi-structured, in-depth interviews were conducted between September and October 2014 in Kuala Lumpur and the State of Selangor<sup>30</sup> in Malaysia. The majority of the semi-structured, in-depth interviews took place at public venues (e.g. The Royal Lake Club or coffee houses), two were held at the MICPA office and one was at the AC participant's residence. The length of the semi-structured, in-depth interviews ranged from 69 minutes to 101 minutes with an average of 78 minutes. This average length of semi-structured, in-depth interview is in line with other corporate governance and audit studies (see Westermann, Bedard and Earley 2015; Tremblay and Gendron 2011; Cohen, Krishnamoorthy and Wright 2010; Gendron and Bédard 2006).

All the semi-structured, in-depth interviews were conducted in English, face-to-face and audio-taped by the researcher alone. This would ensure consistency in the asking of interview questions and probing of relevant themes. It has been suggested that having only one researcher may lead to interviewer bias due to the perception and predisposition of the researcher (Patton 2002). However, considering the potential risk of distortion to the findings as the result of using several interviewers (instrumentation bias), the researcher considered the adverse impact of consistency issues outweighed that of interviewer's bias. Furthermore, interviewer's bias could be managed through the adoption of a well-structured interview guide.

#### **4.4.2 Interview instrument**

An interview guide aims to keep semi-structured, in-depth interviews situational and conversational (Patton 2002, p.349). The interview guide is an instrument that incorporates a series of broad themes to be covered during the interview to help direct the conversation towards the issues and research questions of the study (Qu and Dumay 2011). It can also minimise interviewer bias resulting from interviewer's intrusion (Lillis 1999) by using non-directional pre-specified questions and probes (Fontana and Frey 2005). The

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<sup>30</sup> Kuala Lumpur is the capital city and financial centre of Malaysia. The State of Selangor is neighbouring state peripheral to Kuala Lumpur. A high majority of Main Market listed issuers have their head office established in these locations.

interview guide (see Appendix 3) is structured around key questions on the AC participants' perception of internal audit practices in Malaysia and the enabling factors (internal or external to organisations) that could impact on IAF effectiveness, with some probing questions to elicit deeper responses. The initial interview guide was developed focusing solely on listed issuers with in-house IAF engagement. During the semi-structured, in-depth interview period, it came to the researcher's attention that out-sourced third-party internal audit firms ('out-sourced IAF') had gained prominence and taken up a big slice of the internal audit service providers' market share. Accordingly, the interview guide was revised during the fieldwork to cater for this new emerging trend.

During the semi-structured, in-depth interviews, a few AC participants were not asked all the pre-specified interview questions due to two reasons. First, the researcher views benefits derived from interesting insights as outweighing that of attempting to complete all pre-specified interview questions within the timeframe (see Hirst and Koonce 1996). Second, several new themes/issues were raised by later AC participants thus the researcher was not able to seek the view of earlier AC participants (see Westermann, Bedard and Earley 2015). Both practices are not uncommon for semi-structured, in-depth interviews and are consistent with prior studies.

The preliminary interview guide was developed based on the conceptual IAF effectiveness framework developed in Phase I of this study. In developing the interview questions, the researcher drew on sources that relied on the typology of questions, such as Kvale (1996, p. 133–5). The interview questions were designed as open-ended as possible to allow participants to articulate their responses without imposing pre-conceived categorisations that might inhibit responses (Fontana and Frey 2005).

The key interview questions were structured around the three core components of the conceptual IAF effectiveness framework and presented as follows:

- the first component – external enabling factors (i.e. rules and legislation, IIA role as a professional body)
- the second component – internal enabling factors (i.e. AC support, organisational support and adequacy of IAF resources)

- the third component – internal audit practices (i.e. planning, nature of internal audit activities and performance evaluation).

Due to the exploratory and investigative nature of this study, the AC participants were not asked to provide a definition of IAF effectiveness as this might derive a stereotypical response from the participants. Instead, they were asked to provide their views on how IAF effectiveness is evaluated or assessed.

The preliminary interview guide was reviewed by two academics in the field of audit and corporate governance for relevance, clarity and completeness (see Cohen, Krishnamoorthy and Wright 2010). Given the difficulties in securing an appointment with the AC participants and in order not to lose any of the valuable information to a pilot study database, the researcher had adapted the ‘interviewing the investigator’<sup>31</sup> strategy as suggested by Chenail (2011). Subsequently, the researcher’s two supervisors provided further feedback on the interview guide and modifications to improve the interview instrument and approach.

During the fieldwork, the interview instrument was reassessed after each interview. The reassessment process led the researcher to add sub-questions or probing questions to address new emerging themes warranting a deeper questioning and insights (Cohen, Krishnamoorthy and Wright 2002; Hirst and Koonce 1996). The reassessment also involved removing some questions that were of less significance to the research questions in order not to overstretch the interview time.

#### **4.4.3 Interview protocols and procedures**

The researcher started off each semi-structured, in-depth interview session by establishing rapport and outlining the objectives of the study as well as reassuring the participants of confidentiality. The ‘ice-breaking’ introduction was necessary to overcome any potential

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<sup>31</sup> That is, the researcher plays the role of both interviewer and interviewee. The researcher then reviewed to see what information was generated via the interview questions and revised it accordingly (Chenail 2011, p258)

reluctance by the interviewees to freely provide information, as suggested in other prior studies (Trotman & Trotman 2015; Gendron and Bédard 2006; Hirst and Koonce 1996). Before the start of each interview, the researcher would seek the participants' signed consent for their participation in the study and for the interviews to be audio-taped. The researcher also reassured the AC participants that complete anonymity would be accorded to them and the listed issuers they represented. No party would have access to the taped interviews and transcribed scripts other than the researcher and the researcher's supervisors. The researcher also highlighted to the AC participants that they have the right to withdraw from the study any time during or after the interview but before any part of the thesis has been made public (i.e. published). Also, the AC participants were also informed that they could request a copy of the transcript to verify the accuracy of the interviews.

Unlike other prior studies that requested for the background profile of their interviewees (see Hirst and Koonce 1996), the researcher did not seek this information as the directors' profile (age, academic or professional qualifications, current and past work experience, current board representation in other listed issuers, relationship with controlling shareholders etc.) is a mandatory disclosure in the annual report for all listed issuers. All information disclosed in annual reports is subject to stringent due diligence by independent professionals (e.g. due diligence lawyer, company secretary). Accordingly, the researcher excluded this in this study.

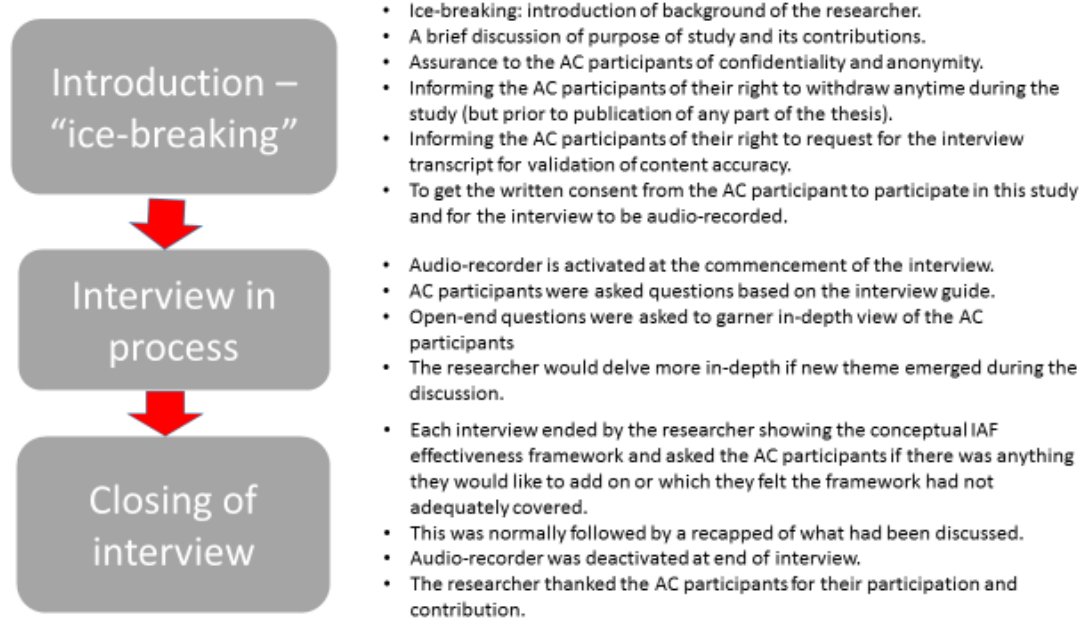
Each AC participants would be asked the key interview questions. However, when participants' responses revealed an emerging theme, this new theme would be pursued before returning to the interview guide. This approach is consistent with other prior studies (Westermann, Bedard and Earley 2015; Cohen, Krishnamoorthy and Wright 2010; Hirst and Koonce 1996). Probing questions were used to seek deeper insights or to clarify certain unclear remarks (Patton 2002).

To encourage candid responses from the AC participants on some potentially sensitive questions (e.g. potential conflicts between senior management and AC over IAF

resources, the commitment of owner-managers<sup>32</sup> to corporate governance), interview questions were phrased to avoid any association with the listed issuers the AC participants represented. The AC participants were asked to provide their view or opinion instead of their personal experience.

Each interview ended with the AC participant being asked if there was anything they would like to add or was not adequately covered. This is often referred to as a closing or clearing question (Patton 2002, p. 379). In many cases, this led to a recap or summary of salient facts highlighted earlier during the interviews. All interviews were conducted in English. The interview protocol and procedures are presented in Figure 4.3.

**Figure 4.3: Interview protocol and procedures**



#### 4.4.4 Data sources

This study relied on both primary and secondary data. The sources of primary data were from the semi-structured, in-depth interviews with the AC participants. The secondary

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<sup>32</sup> 'Owner-managers' refers to controlling shareholders who also assume executive managerial role in listed issuers.

data was used to complement and verify the primary data wherever possible. This approach conforms to the established research design in this study (Phase II) and analyses qualitative information to enhance the validity of the data (Huberman and Miles 1994).

#### **4.4.4.1 Primary data**

The primary data was collected through a series of semi-structured, in-depth interviews with the AC participants. These interviews were recorded and later transcribed. During the interviews, field notes were kept to assist with subsequent data analysis and to enhance validity and reliability of the results (Huberman and Miles 1994). To ensure confidentiality and anonymity, each AC participant was assigned a code to prevent later identification in this thesis or any related publications.

#### **4.4.4.2 Secondary data**

The secondary data are predominantly the mandatory disclosures in annual reports (Corporate Governance Report and Statement of Internal Controls and Risk Management, Chairman's Report, Directors' profile etc.) and public announcements of the listed issuers. The information can be obtained through the website of the respective listed issuers or via the Bursa Malaysia's website. This triangulation process will help achieve convergence, i.e. the bringing together of two different sources of information to support a common finding (Miles and Huberman 1994).

#### **4.4.5 Data preparation: interview transcripts**

Before commencing the data analysis, the standard procedure is to have the semi-structured, in-depth interview recordings transcribed. The transcription of these interviews changes the medium from spoken context to typed transcript. Kvale (1988) warns researchers to 'beware of the transcript'. Issues such as supercoding and decontextualisation, i.e. missing what came before or after the participant's account and missing the point of the larger conversation, are common flaws when moving from one medium to another (Kvale 1988, p. 97). One remedial action suggested is to go back to the recording to check the interpretations based on the transcript (Kvale 1988).

There are no fixed rules on who should perform the transcription of the interview recordings. Flick (2008) suggests that an added advantage of the researcher undertaking the transcribing is that it will give the researcher the opportunity to identify new ideas about the data. In this study, the interview recordings were transcribed verbatim by a professional transcriber. This approach is consistent with other prior audit and corporate governance studies that engaged a third party to perform the transcription (see Westermann, Bedard and Earley 2015; Cohen, Krishnamoorthy and Wright 2010). To ensure validity of the transcript, the researcher checked all the transcripts against the respective recording at least twice, noting only minor errors in the accounting/auditing terminologies and other abbreviations used by AC participants which are unfamiliar to the professional transcriber.

## **4.5 Data Analysis**

Data analysis is a transformation process that starts with collection of data (often voluminous) which is then methodologically ‘processed’ into analytical ideas (Huberman and Miles 1994). This process includes sorting, retrieving, indexing and handling of the qualitative data. Generally, this process can be assisted by the use of software packages such as NVivo.<sup>33</sup> However, while the software can support in the processing of data, it cannot do the thinking. There are no fixed rules in the analysis of qualitative data. It is predominantly a process that includes data handling and interpretation (Flick 2008; Mason 2002; Coffey and Atkinson 1996). Miles and Huberman (1994) have methodologically categorised the process into three simultaneous actions: data reduction, data display, and conclusion (making sense of information) and verification (for validity). Data reduction occurs continuously throughout the entire study, in aspects such as coding, theme identification and cluster building. This process aims to methodologically streamline the data to facilitate data display and drawing a meaningful conclusion. Data display is a process to display information in a manner that allows the researcher to derive certain conclusions. Following data display, the final step is to draw a conclusion from the

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<sup>33</sup> A computer software for data analysis and data management.

information available to the researcher and the information in deriving the conclusion is verified for its validity.

#### **4.5.1 Coding**

Coding is a way of indexing or categorising the transcribed text in order to establish a framework of thematic ideas (Miles and Huberman 1994). Generally, several passages of texts are identified and linked with a name of that idea – the code (Flick 2008). Thus all the texts that exemplify the same thing are categorised to the same code. In this study, a conceptual framework was developed in Phase I of the study (see section 4.2). Hence, in a study of this nature a ‘concept-driven’ coding approach is recommended (Ritchie, Spencer and O’Connor 2003). The researcher builds up a list of key thematic ideas based on the conceptual framework (Ritchie, Spencer and O’Connor 2003). Accordingly, an initial coding scheme was developed at the start of the data collection with the key theme that was structured around the conceptual IAF effectiveness framework. Patton (2002) and Miles and Huberman (1994) contend that coding during fieldwork is an early phase of analysis and provides the opportunity of driving subsequent data collection by highlighting any new emerging themes or areas lacking an in-depth coverage.

The initial coding scheme was used as the basis of open coding. When the coding scheme was perceived to cover both anticipated and unanticipated codes, the code book was developed (see Appendix 4). The code book provided definitions for each code. This ensures consistency in the coding process of the interview transcripts (McCracken, Salterio and Gibbins 2008). Coding is the most subjective stage in the analysis of qualitative research. Hence, it is suggested that the researcher must ensure coding reliability (Abernethy, Horne, Lillis, Malina, & Selto, 2005; Lillis 1999). To enhance coding reliability, Miles and Huberman (1994) suggest the data be coded independently by two researchers.

In this study, the following steps were taken to ensure coding reliability. First, two interview transcripts were coded independently by the researcher and an independent coder using the NVivo software. On completion, the researcher and the coder met to assess



the Cohen's Kappa coefficient<sup>34</sup> (or Kappa coefficient, in short) generated by the NVivo software and discuss the suitability of the codes and the applied definition. If the Kappa coefficient<sup>35</sup> was above 0.75, it signifies excellent coding agreement between the researcher and the coder. Then the remaining transcripts would be coded in accordance to the code book by the researcher. Conversely, if it fell below 0.75, both parties would have to agree on a refined set of codes and incorporate them in the code book. This process would be repeated after coding another two semi-structured, in-depth interview transcripts until the Kappa Coefficient was above 0.75. Any disagreements between the researcher and the coder would be discussed and mutually resolved. If a mutual agreement could not be reached between the researcher and the coder, a third person would be called in to give their view; their decision would be final and would be included in the revised code book.

It is rare to get a perfect agreement (i.e. Kappa coefficient of 1.0). Different people have different interpretations as to what is a good level of agreement. In this study, the researcher has relied on the estimation guide provided by the QSR International, the developer of the NVivo software program. Having said that, the researcher and the coder were allowed to code at any level of detail (sentence, paragraph etc.) and to have dual codes for the same text passage. Minor differences in the boundary of the text passage is not considered disagreement (Abernethy, Horne, Lillis, Malina, & Selto, 2005). Based on the NVivo computation, the researcher and the coder achieved a Kappa coefficient of 0.783 indicating a high level of inter-coder reliability.

Using qualitative data analysis software helps the researcher in searching for 'an accurate and transparent picture of the data while also providing an audit of the data analysis

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<sup>34</sup> It is rare that we get a perfect agreement. Different people have different interpretations as to what is a good level of agreement. The Kappa estimation as presented in Altman DG. Practical Statistics for Medical Research. (1991) (p. 404) London England: Chapman and Hall suggest the following:

Less than 0.20 (poor agreement), 0.20 to 0.40 (fair agreement), 0.40 to 0.60 (moderate agreement), 0.60 to 0.80 (good agreement) and 0.80 to 1.00 (very good agreement)

<sup>35</sup> The Kappa Coefficient formula = [(categories agreed) – (expected agreed)] / [1 - (expected Agreed)] One approximate set of guidelines for interpreting the value of Kappa is as follows: below 0.40 (means poor agreement), 0.40-0.75 (fair to good agreement) and over 0.75 (excellent agreement) [http://helpnv9en.qsrinternational.com/nv9\\_help.htm#procedures/run\\_a\\_coding\\_comparison\\_query.htm](http://helpnv9en.qsrinternational.com/nv9_help.htm#procedures/run_a_coding_comparison_query.htm)

process as a whole' (Welsh 2002). NVivo does not perform data analysis automatically. It is essentially a data management tool. It enables an efficient search of all transcripts for key words or phrases as a means of ensuring completeness of coding. However, the use of qualitative data software reduces reporting bias (Abernethy, Horne, Lillis, Malina, & Selto, 2005) and enhances the rigour and validity of the research. It also provides ease of data comparison and movement between a level of analysis and an audit trail of analysis (Miles and Huberman 1994).

Upon completion of the coding process, the data was compiled using the NVivo software to generate the relevant reports (Coding Summary by Node Report, Node Summary Report etc.) for interpretation of the findings. The Node Summary Report, which presents the node tree (i.e. representing the constructs and sub-constructs of this study) with their respective frequency of code source and references, is presented in Appendix 5.

## **4.6 Quality Evaluation in Qualitative Inquiry**

### **4.6.1 Choice of evaluation procedures**

Evaluating validity (or rigour) in qualitative inquiry has been challenging (Creswell and Miller 2000). This is because 'while quality criteria for quantitative research are well known and widely agreed, that is not the case for qualitative research' (Bryman, Becker and Sempik 2008, p. 262). Certain research scholars reject the application of quantitative procedures (e.g. reliability and validity) in the evaluation of validity (or rigour) in qualitative inquiry as they believe that each research paradigm requires paradigm-specific criteria (Carson, Gilmore, Perry, & Gronhaug, 2001; Miles and Huberman 1994; Lincoln and Guba 1985a). In response to this, Guba and Lincoln (1981) and (Guba 1981) set rigour evaluation criteria for qualitative inquiry as 'credibility, fittingness, audibility and confirmability', later modified to 'credibility, transferability, dependability and confirmability' (Lincoln and Guba 1985a; 1985b). This work was rapidly followed by others resulting in a plethora of terms and criteria introduced for minute variations to evaluate rigour. This led to the development in the 1980s for the post hoc evaluation of

qualitative inquiry (see Morse, Barrett, Mayan, Olson, & Spiers, 2002; Frankel 1999; Lincoln 1995).

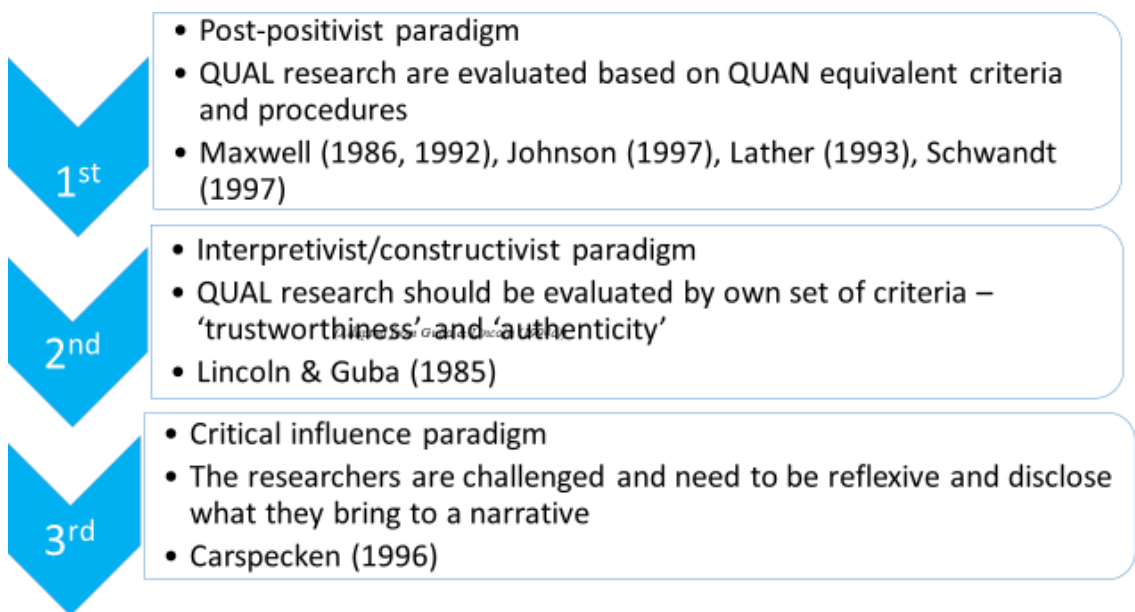
However, the problem surrounding the evaluation procedures of validity (or rigour) for qualitative inquiry persists (see Becker and Sempik 2008; Morse, Barrett, Mayan, Olson, & Spiers, 2002; Barbour 2001; Carson, Gilmore, Perry, & Gronhaug, 2001; Creswell and Miller 2000; Bryman, Huberman and Miles 1994). Notwithstanding that, some researchers still employ quantitative procedures in the evaluation of validity (or rigour) in their qualitative research (Creswell and Miller 2000).

Guba and Lincoln (1994) posit that the choice of evaluation procedure is dependent on the paradigms adopted by the researchers. Three paradigm assumptions have been identified: post-positivist, interpretivist/constructivist and critical influence (Guba and Lincoln 1994). The first paradigm is the post-positivist paradigm. It is posited that the post-positivist researchers assume that qualitative research consists of rigorous methods and a systematic form of inquiry. They support the validity and look for quantitative equivalence of it and actively employ procedures for establishing validity using specific protocols (Creswell and Miller 2000). This philosophical perspective has been employed in social science research since the 1970s (Denzin and Lincoln 1994, as cited by Creswell (2000)). Amongst others, the researchers who embrace post-positivist assumptions towards qualitative validity are Johnson (1997), Schwandt (1997), Lather (1993) and Maxwell (1992).

The second paradigm is interpretivism/constructivism paradigm. It is posited that the interpretivist/constructivist researchers believe in ‘pluralistic, interpretive, open-ended and contextualised perspectives toward reality’ (Creswell and Miller 2000, p.125). Their perspectives of validity procedures are aligned with Lincoln and Guba (1985b)’s trustworthiness (i.e. credibility, transferability, dependability and confirmability) and authenticity (i.e. fairness, stimulates action and empower actions). The interpretivist/constructivist position emerged during the period 1970 to 1987 (Denzin and Lincoln 1994, as cited by Creswell (2000)).

The third paradigm is the critical influence paradigm. In this paradigm ‘validity is called into question, its assumption interrogated and challenged, and the researchers need to be reflexive and disclose what they bring to a narrative.’ (Creswell and Miller 2000). This perspective emerged during the 1980s (Denzin and Lincoln 1994 as cited by Creswell (2000)). It challenges the researchers to uncover the hidden assumptions on how the narrative accounts are constructed, read and interpreted. Guba and Lincoln (1994)’s three paradigms with their corresponding evaluation procedures are summarised in Figure 4.4.

**Figure 4.4: A summary of Guba and Lincoln (1994a)’s three paradigms and their corresponding evaluation**



*(Adapted from Guba & Lincoln (1994a))*

The majority of prior research in accounting and auditing adopts a post-positivist paradigm and evaluates the quality of research based on quantitative equivalent criteria (see Westermann, Bedard and Earley 2015; Tremblay and Gendron 2011; Cohen, Krishnamoorthy and Wright 2010; Cohen, Krishnamoorthy and Wright 2008; Gendron and Bédard 2006; Cohen, Krishnamoorthy and Wright 2002). The researcher adopts a similar paradigm to the prior researchers in the field of accounting and auditing. Accordingly, quantitative equivalent procedures have been adopted in the evaluation of the quality (rigour) of this study.

## 4.6.2 Quality evaluation of this study

Earlier sections discuss the choice of research method, sampling strategies and sample selection, interview protocol and procedures, data collection instrument and data analysis. Within each section, the validity and reliability concerns are addressed. In addition, this study has also adopted some strategies to maximise validity as proposed by Johnson (1997)<sup>36</sup> and presented below.

### 4.6.2.1 Triangulation

Triangulation is a means to ‘cross-check’ information and conclusions through the use of multiple procedures or sources (Johnson 1997). There are four types of triangulation strategies proposed by Johnson (1997):

- data triangulation – the use of different data sources to help understand a phenomenon
- methods triangulation – the use of multiple research methods to study a phenomenon
- investigator triangulation – the use of multiple researchers to collect and interpret the data
- theory triangulation – the use of multiple theories to help interpret and explain the data.

In this study, data triangulation has been employed where the secondary data<sup>37</sup> was reviewed before commencement of any semi-structured, in-depth interviews. This enabled the researcher to gain a greater insight into the listed issuers in order to pursue specific IAF-related questions with the AC participants, for example, IAF scope of work, CAE’s

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<sup>36</sup> Save for the strategies adopted in this study, other strategies proposed by Johnson (1997) are: researcher as ‘detective’, extended fieldwork, participant feedback, negative case sampling, peer review, reflexivity and pattern matching. They were not considered due to their irrelevance to the context of this study.

<sup>37</sup> Comprising disclosures in annual reports of listed issuers (e.g. Corporate Governance Statement, Audit Committee Charter, Statement on Risk Management and Internal Controls, corporate profile of prospective AC participants and reporting structure of CAE) as well as public announcements of the listed issuers on the organisation’s website and the Bursa Malaysia website for listed issuers.

reporting structure within the organisation and other corporate governance mechanisms such as a whistle-blower policy. This triangulation process enhances validity and reliability of the primary data, obtained through the interviews, resulting in a convergence of data sources to facilitate better interpretation of findings. A detailed discussion is presented in section 4.4.4.

In respect of investigator triangulation (multiple researchers), due to cost constraints the researcher did not engage multiple researchers during the data collection stage. Another reason for not engaging multiple researchers was to avoid instrumentation bias (refer to the discussion in section 4.4.1). However, the researcher adopted inter-coding reliability procedures to enhance the validity of data analysis in this study (refer to section 4.5.1).

#### **4.6.2.2 Participant feedback**

Since the targeted participants (i.e. the AC chair and members of Main Market listed issuers) are corporate elite, it would be challenging to arrange for a follow-up meeting<sup>38</sup> or to seek their confirmation of the interview transcripts or narrative of the findings. Hence, the semi-structured, in-depth interviews were audio-recorded as this would give an accurate summary of the interviews, since all responses could be captured during the interviews (Patton 2002, p. 381). Both the attributes of accuracy and completeness would help to enhance the validity of the research (Maxwell 1992). Furthermore, audio-recording can be listened to repeatedly to get clarity of the interviews (Silverman 2010). Audio-recordings capture the tone, pitch of the voice, speed of the speech etc. thus enabling the researcher to recall and reveal the underlying meaning of AC participants' views. The recording also provides the researcher with the opportunity to be more attentive to the participants thus avoiding any interruptions or distraction of note-taking (Patton 2002). This approach is adopted in several audit and corporate governance studies (see Westermann, Bedard and Earley 2015; Cohen, Krishnamoorthy and Wright 2010; Trompeter and Wright 2010; Gendron and Bédard 2006). However, the disadvantage of

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<sup>38</sup> Although all Ac participants have given their written consent for a follow-up meeting (if required).

audio-recording the interviews is that one needs to depend on the equipment and if it fails to function properly then there must be a backup plan. Also, Patton (2002) suggests that some interviewees may be nervous or uncomfortable with recording equipment, which may restrict their conversation and inhibit their candidness in sharing information and contributing their insights.

Considering the advantages outweigh the disadvantages, audio-recording was employed in this study. To overcome any potential equipment failure, two audio-recorders were used in each interviews. None of the AC participants indicated or showed any sign of discomfort over audio-recording the interview. This was evidenced in their candidness in sharing their insights over the interview questions. Furthermore, all AC participants gave written consent for their interviews to be audio-recorded. However, the researcher took notes for one of the interviews. As the interview was conducted in a busy café at the Kuala Lumpur International Airport<sup>39</sup> where the surrounding noise severely impaired the clarity of the audio-recording. Accordingly, the researcher decided to take note for the entire interview. However, to enhance accuracy and completeness of the field-notes, the researcher prepared a full interview script (relying on the field-notes) and emailed it to the AC participant for his confirmation. A signed copy of the interview script (with some minor revisions by the AC participant) was emailed back to the researcher within a week.

#### **4.6.2.3 Low-inference descriptors**

A professional transcriber was engaged to ensure the audio-recordings were transcribed accurately and completely (refer to section 4.5.1). As suggested by Johnson (1997), to ensure low-inference descriptors, the AC participants' views were presented wherever relevant in the narrative account verbatim, i.e. by direct quotation (refer to Chapter 6).

Throughout this study, the researcher strived to ensure maximum validity of this qualitative research by adhering to the strategies proposed in prior research literature (see

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<sup>39</sup> As the AC participant were flying off for a non-prescheduled overseas business trip, rescheduling of the semi-structured, in-depth interview was not possible. In order not to lose this valuable data source, the researcher had no alternative but to conduct the meeting in a busy café before his flight.

Johnson (1997); Guba and Lincoln (1994); Maxwell (1992); Lincoln and Guba (1985a)). However, Barbour (2001) warns that while checklists can be useful in improving qualitative research methods, overzealous and uncritical use can be counterproductive resulting in ‘the tail [i.e. the checklist] wagging the dog [i.e. the qualitative research]’ (p. 1115). The author highlights that in order to comply with research funding and publication requirements, qualitative inquiry researchers have reduced the qualitative research to a list of technical procedures (i.e. purposive sampling, ground theory, multiple coding, triangulation and participant validation), which in the author’s view does not confer any rigor (or ‘trustworthiness’) to the study. Instead, the strength of the qualitative inquiry lies in the systematic and thorough application of the principles of qualitative research. The author’s view is shared by other researchers (see Rolfe 2006; Sandelowski and Barroso 2002).

#### **4.7 Ethical Considerations**

Research ethics has become an important part of contemporary business and management research and the need to ensure appropriate research standards is maintained throughout the study (Myers 2013). Accordingly, this study was conducted in accordance with the procedures and guidelines of the Curtin University Human Ethics Committee. Before commencing the data collection process, the research protocol was approved by the Curtin University Research Ethics Committee (ethical approval number: AC-14-11).

In qualitative field studies, anonymity and confidentiality issues are the primary concerns. This study was conducted in such a manner that the participants did not suffer or experience any loss of privacy, embracement, harm or discomfort. This study ensured the strictest confidentiality to all the study participants and the listed issuers associated with them. The researcher also ensured that before each semi-structured, in-depth interview session, the study participants signed a consent form to indicate their consent to participate and for the interviews to be recorded. A specimen copy of the consent form is at Appendix 1 (see Part II of the Information Kit). Also, all study participants were categorically informed that their participation in this study was voluntary and they have the right to withdraw at any time during or after the interviews (but before publication of any part of



the thesis). They were also accorded the right to request a copy of their interview transcript to ensure it represented their views.

No study participant or listed issuer associated with them is directly or indirectly identified in this thesis. The study participants are all given a code, AC#1, AC#2, AC#3 etc., and the listed issuers mentioned by the study participants during the interviews are given pseudonyms, PLC-A, PLC-B etc.

Furthermore, before the interview commenced, the purpose of the study was discussed with all the participants. More importantly, this study was conducted in accordance with the procedures and guidelines of the Curtin University Human Ethics Committee. The study participants were all given an information sheet outlining the purpose of the study, the nature of information required and how the participants' confidentiality and other ethical concerns would be maintained.

## **4.8 Chapter Summary**

Due to the explorative and investigative nature of the research questions, a qualitative inquiry within the interpretivist paradigm is adopted in this study. A two-phase research design is employed to address the research questions. Phase I involves development of a conceptual IAF effectiveness framework drawing from the critical review of extant literature, professional standards and relevant listing rules and regulations. This is presented in Chapter 5. Phase II entails a series of semi-structured, in-depth interviews with fourteen AC participants. The qualitative findings arising from the implementation of this field study are presented in Chapter 6 and are used to refine the conceptual IAF effectiveness framework.

In summary, this chapter outlined the process of robust methodological development and the application of sound research design to yield the desired research findings.

## **CHAPTER 5: DEVELOPMENT OF CONCEPTUAL IAF EFFECTIVENESS FRAMEWORK**

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### **5.0 Introduction**

This chapter aims to develop a conceptual IAF effectiveness framework as proposed under Phase I of the two-phase research design in Chapter 4. This purpose of this research phase is to address RQ1, ‘What constitutes an IAF effectiveness framework taking into account the key contextual factors that appear to inhibit and/or encourage the internal audit practices of the Main Market listed issuers in Malaysia?’ In developing the conceptual IAF effectiveness framework, the researcher has relied on prior academic<sup>40</sup> and professional literature, the IPPF and other related pronouncements as well as the Malaysian regulations, CG Codes and Listing Requirements with a specific focus on the IAF nexus with the AC. The first section of this chapter considers the need for a conceptual framework. The next two sections highlight the key contextual and environmental factors, drawn from the literature review, and the listing rules and regulations and professional standards that could impact the effective operation of the IAF in Malaysia. The following section depicts the internal audit practices as outlined in the IPPF and its impact on IAF effectiveness. The final section presents an overview of the discussions and development of the conceptual IAF effectiveness framework.

### **5.1 The Need for an IAF Effectiveness Framework**

Corporate governance weakness, such as poor internal control, has been cited as the core reason behind the corporate scandals and the collapse of significant corporations such as Enron and Worldcom in the early 2000s (Verschoor 2002). It is the responsibility of management to establish and maintain a proper monitoring mechanism and to ensure the

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<sup>40</sup> Considering the fact that the contextual and environmental factors that could impact on internal audit practices are under-researched, the literature review has extended to all journals of Australian Business Dean Council list (published between January 2000 and August 2014) in identifying the key enabling factors.

effectiveness of internal control. However, the scepticism as to whether management will work to support the ‘principals’ (i.e. shareholders) in achieving their goals or to capitalise on ‘managerial opportunism’ when their interests diverge with that of the principals (Jensen and Meckling 1976) has been a subject of debate for decades. The scepticism towards management is not unfounded. For instance, the COSO 1998–2007 study reveals that 70% of fraudulent financial reporting in the US involves the very top management such as the Chief Executive Officer of those organisations (Beaseley 2010). To provide a check and balance over the management’s activities, the AC, an independent party, has been entrusted to oversee the monitoring mechanism of organisations (Krishnan 2005).

However, it is difficult for the AC to discharge their governance obligations effectively without the support of other corporate governance stakeholders (e.g. the external and internal auditors) given the ACs’ non-executive role within an organisation. The AC are often confronted with an information asymmetry problem, particularly on company-specific information (Raghunandan, Read and Rama 2001). This is particularly true if the organisation is a diversified group (in terms of geographical locations or businesses) or has a complex group structure. On the other hand, the IAF is alleged to have acquired extensive company-specific knowledge through their daily involvement in an organisation and hence could be a reliable support for the AC (Sarens, De Beelde and Everaert 2009). However, prior research suggests that only an effective IAF can play a significant role in an organisation’s corporate governance system (Anderson, Christ, Johnstone, & Rittenberg, 2012; Prawitt, Smith and Wood 2009).

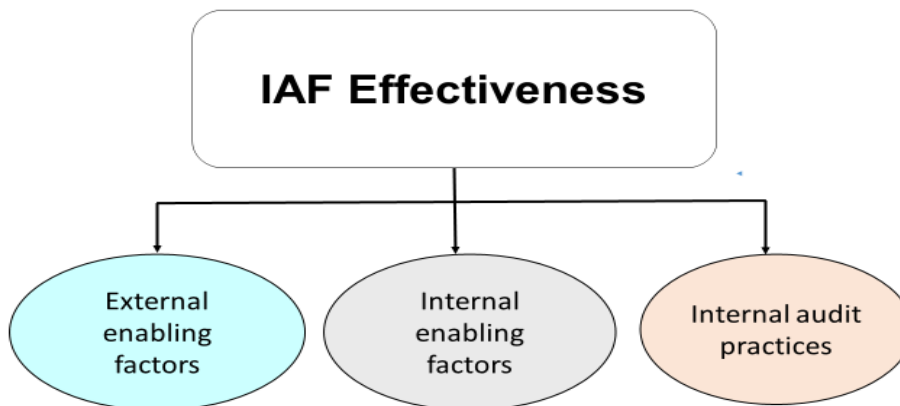
Acknowledging the significant role of the IAF in corporate governance, there are a growing number of regulators worldwide (NYSE, NASDAQ, Bursa Malaysia etc.) requiring the establishment of the IAF in their listed issuers. The Malaysian regulators have required the establishment of an IAF in listed issuers since the end of 2007. However, the Malaysian regulators are not explicit in respect of the operationalisation of the IAF. This has accorded considerable flexibility to listed issuers in respect of the structural and functional make-up of the IAF, which may consequently impact on the quality of the IAF deliverables. Accordingly, an IAF effectiveness framework that addresses this gap based

on the views of qualified and experienced AC chairs or members, the key IAF stakeholder, is crucial.

In the researcher's view, it is unrealistic to develop a conceptual IAF effectiveness framework without considering the key contextual and environmental factors that could impact on the effective practice of the IAF. This thesis aims to develop a comprehensive framework that looks beyond the conventional approach adopted by prior studies on IAF effectiveness. These prior studies examine the internal audit attributes narrowly prescribed within the external audit standards (ISA 2013; AICPA 1990) or the *Attributes Standards* and *Performance Standards* as stipulated in the IPPF (IIA 2013a).

In this thesis, the conceptual framework to be developed comprises three core components. The first and second components capture the key external and internal enabling factors (i.e. contextual and environmental factors) anticipated to impact on IAF effectiveness, and the third component depicts internal audit practices which in the AC participants' perspectives will support them in achieving their governance objectives. The categorisation of enabling factors into external (under the first component) and internal (under the second component) is to differentiate the factors that are within and beyond the control of the organisation on internal audit practices. The conceptual IAF effectiveness framework (basic) is illustrated in Figure 5.1.

**Figure 5.1: Conceptual IAF effectiveness framework (basic)**



## 5.2 External Enabling Factors (First Component)

Regulation is a governance mechanism (López de Silanes, La Porta, Shleifer and Vishny 1998). Regulators make use of regulatory reforms to ‘normalise’ the behaviour of managers and accountants (Stein 2008). In the aftermath of the Enron and Worldcom collapses, regulators worldwide have moved to adopt more stringent corporate governance regulations. For instance, BRC (1999) emphasises the importance of having a strong working relationship between the AC and the IAF to enhance governance; the *Sarbanes-Oxley Act 2002* (‘SOX’) provides the AC with oversight of internal controls over financial reporting; and the revised UK corporate governance code requires the AC to monitor and review the effectiveness of the IAF of corporations (FRC 2010). In addition, the regulators have also demanded that professional bodies develop new financial reporting standards and auditing frameworks to enhance the integrity of financial reporting and internal controls of organisations and to avoid inevitable corporate collapses (Abbott, Parker, Peters, & Rama, 2007). In Malaysia, the policymakers require the establishment of an IAF in all listed issuers with the IAF reporting directly to the AC (Listing Requirements 2011). Accordingly, the two main external enabling factors to be considered in this thesis that influence effective practice of the IAF in Malaysia are the rules and legislation and the professional body (specifically the IIAM).

### 5.2.1 Rules and legislations

The past two decades have seen the introduction of a significant number of new financial reporting standards, auditing frameworks and corporate governance codes by policymakers or regulators worldwide. While the regulators are consistent in their support for better corporate governance their regulatory approach varies, in particular on requirements about the IAF. In 2006 the NYSE<sup>41</sup> was the first regulator to require all its listed issuers to maintain an IAF (NYSE 2003; 2013 (revised)) to be followed by the NASDAQ Stock Market LLC (‘NASDAQ’) in 2013 (Beasley 1999). The Malaysian

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<sup>41</sup> Section 303A.07 of the NYSE listing manual

regulators have required the establishment of the IAF for its listed issuers since the end of 2007. Malaysia is the first emerging market in South-East Asia that has required the establishment of IAF in its listed issuers.

However, some regulators have opted for a more flexible approach. For instance, the London Stock Exchange, Singapore Stock Exchange ('SGX') and the Australian Securities Exchange Corporate Governance Council (2014) have adopted a 'comply or explain' approach about the establishment of an IAF by their listed issuers. In other words, if the listed issuers do not establish an IAF, management is required to report on the alternative monitoring mechanisms they have adopted and that the board has been given the assurance that the internal control system is functioning as intended. The UK Code (FRC 2010) also highlights that it is the Board's responsibility to assess on an annual basis and decide whether such alternative monitoring processes are adequate and meet its assurance objective taking into account the company's activities, markets or other aspects of its external environment as well as the risks faced<sup>42</sup> by the company. Similarly, the SGX<sup>42</sup> also requires the board of directors to provide an opinion, with the concurrence of the AC, on the adequacy of internal controls addressing financial, operational and compliance risks. The rule also emphasises on the position of the IAF as an internal control domain knowledge expert and reinforces the importance of internal audit as a third line of defence against risks. The SGX listing rule<sup>43</sup> also explicitly states that the responsibility of internal audit is to the entire board (not only the AC).

In Malaysia, the requirement to establish an IAF in listed issuers was first introduced in October 2007 as a best practice (CG Code (revised) 2007). The provision is reproduced as follows:

*The Board should establish an internal audit function and identify a head of internal audit who reports directly to the audit committee. The head of internal audit will be responsible for the regular review and/or appraisal of the*

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<sup>42</sup> SGX listing rules 1207(10)

<sup>43</sup> SGX listing rules 1207 (1)

*effectiveness of the risk management, internal control and governance process within the company. (CG Code 2007)<sup>44</sup>*

Although it is proposed as a best practice in the CG Code (2007), the listed issuers are however required<sup>45</sup> by the Bursa Malaysia to establish an IAF that is independent of the activities it audits and reports directly to the AC. In Malaysia, the CG Code (2000; 2007; 2012) is issued by the Securities Commission of Malaysia (equivalent to the Australian Securities and Investments Commission). The CG Code is a voluntary document and serves as best practice for the listed issuers. Conversely, the Listing Requirements (2001; 2007; 2011) are issued by the Bursa Malaysia (the capital market regulator). They are mandatory documents and failing to adhere to the provisions in the Listing requirements will attract penalties and reprimands from the Bursa Malaysia. A detailed discussion of governance framework in Malaysia is found in section 2.3.2.

The significance of IAF is further evidenced when the Securities Commission of Malaysia includes IAF-related provisions as one of the eight ‘principle’ practices in the recent CG Code (2012). The CG Code (2012)<sup>46</sup> stipulates that:

*The board should establish an internal audit function which reports directly to the audit committee.*

The Commentary section of the CG Code (2012) posits that it is the duty of the board of directors to engage a head of internal audit with relevant qualifications, and the head of internal audit will be responsible for providing assurance to the board that the internal controls are operating effectively. Internal auditors should also conduct regular reviews and appraisals, based on standards set by recognised professional bodies, on the effectiveness of the governance, risk management and internal controls processes within the company.

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<sup>44</sup> Best Practices - Part BB: Accountability and Audit, Paragraph VII, CG Code (Revised) (2007)

<sup>45</sup> See paragraph 15.28 of the revised Listing Requirements (2001)

<sup>46</sup> Principle 6, Recommendation 6.2 of CG Code (2012). Similar provision has also been reflected verbatim in paragraph 15.27, Listing Requirements (2011)

Based on the above provisions, it is apparent that the AC has been entrusted with the direct monitoring role over the IAF by the regulators. The ‘direct reporting’ structure (between the IAF and AC) aims to enhance the organisational independence of the IAF. However, this reporting structure may not align with the ‘dual reporting’ structure as recommended by the IIA (1999; 2013a). Under the IIA’s proposed dual reporting structure,<sup>47</sup> the IAF is to report functionally to the AC and administratively to the senior management (e.g. the CEO). Prior literature has emphasised the significance of reporting lines in maintaining autonomy and organisational independence of internal auditors. Unclear reporting structures or having to serve two masters (i.e. the senior management and AC) (Abbott, Parker and Peters 2010) or the lack of legitimate organisation status will result in role ambiguity of the IAF (Lenz and Sarens 2012; Cooper, Leung, Dellaportas, Ahmad, & Taylor, 2009) and consequently impact on the IAF performance.

In addition to the above provisions, the listed issuers are also required to disclose whether the IAF is performed by the in-house IAF or an out-sourced IAF and the cost incurred by the IAF in each financial year (Listing Requirements 2011).<sup>48</sup>

### **5.2.2 The role of the IIAM**

The IIA has a unique advantage over other professional accounting bodies that are country-bound, such as The Institute of Chartered Accountants in England and Wales (‘ICAEW’), the American Institute of Certified Public Accountants (‘AICPA’), the Chartered Accountants of Australia and New Zealand (‘CAANZ’) etc., as the IIA is the sole professional body for the internal auditing profession globally. It has over 180,000 members across over 170 countries and territories.<sup>49</sup> Although there is other professional guidance for the internal auditing profession, such as the COSO framework, the IIA is by far the most comprehensive resource provider for the internal audit profession globally. The IIA provides professional guidance through the IPPF, position papers and research

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<sup>47</sup> Practice Advisory 1110-1, IPPF (2013)

<sup>48</sup> See paragraph 30, Part A, Appendix 9C, Chapter 9 of the Listing Requirements, 2011

<sup>49</sup> <https://join.theiia.org/Pages/default.aspx> (Downloaded on 3 November 2016)



projects; organises conferences and training; manages professional certifications and examinations; and conducts a quality assessment on its members' audit work.

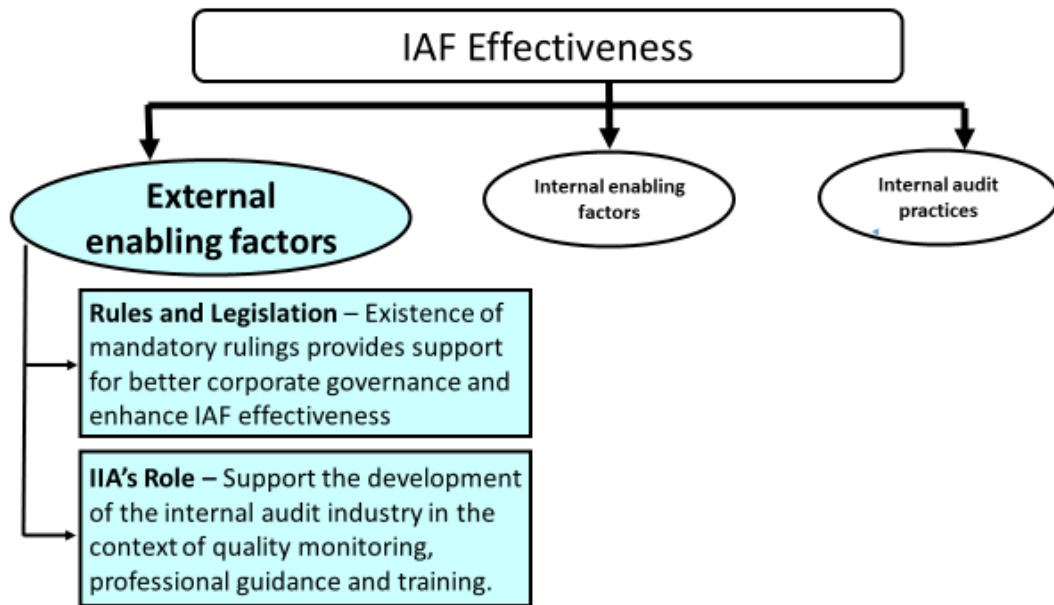
In Malaysia, while the establishment of IAF is mandatory, the internal audit industry is not regulated.<sup>50</sup> The IIAM, the Malaysian chapter of IIA Global, does not have direct professional influence over all IAF service providers other than its own members. The IIAM cannot compel other IAF service providers (who are non-IIA members) to adhere to the provisions in the IPPF (including the standards, practice advisory etc.) and its other pronouncements. Consequently, this could result in a quality gap in respect of IAF delivery across listed issuers in Malaysia. It is alleged that an organisation's affiliation with a professional body (e.g. the IIA) or employment of a qualified Certified Internal Auditor ('CIA'), or other professional members, could help 'internalise' the professional culture with that of the organisational culture and bring about a worthwhile contribution to the control environment of the organisation (Abernethy and Stoelwinder 1995; Fogarty 1992). Accordingly, it is important to investigate the role of the IIAM in supporting the internal audit profession enroute to its effectiveness. In this thesis, special emphasis is placed on the IIAM's professional influence, guidance and monitoring of the internal audit service providers.

Premised on the preceding discussions, the two constructs identified to inform the external enabling factors (first component) of the conceptual IAF effectiveness framework are the rules and legislation and the role of the IIAM as presented in Figure 5.2.

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<sup>50</sup> Anyone can practise as an internal auditor or IA service provider in Malaysia. The IA service providers require no professional certification nor practising license to operate. For an out-sourced IA firm, the founding members merely require to incorporate a limited liability company by registering with the Registrar of Companies, Malaysia under the Companies Act, 1965 to commence offering IAF services.

**Figure 5.2: Conceptual IAF effectiveness framework (1st component – external enabling factors)**



### 5.3 Internal Enabling Factors (Second Component)

The IAF is a key player in an organisation’s corporate governance system (Carpenter, Reimers and Fretwell 2011; Prawitt, Sharp and Wood 2011; Prawitt, Smith and Wood 2009). It is also a resource to other corporate governance stakeholders, such as the AC, top management and external auditors (Gramling, Maletta, Schneider, & Church, 2004). These stakeholders regularly rely on the IAF’s information in making decisions and judgements on issues critical to their organisations. However, the decision whether to rely on certain information is conditional upon the users’ confidence in the quality of that information (Neely and Cook 2011; Thayer 2011; O’Reilly 1982). Accordingly, for corporate governance stakeholders to rely on IAF information, the IAF themselves need to be effective. The IAF do not work in a vacuum. For the IAF to operate effectively, they need the support of not only the AC (as the key IAF stakeholders and service users) but also the support of top management. Also, the IAF needs to be adequately resourced in order for them to execute their role effectively. Accordingly, the three internal enabling factors identified under the conceptual IAF effectiveness framework are AC support, organisation support and IAF resources.

### 5.3.1 AC support: attributes and influence

The role of the AC as an important corporate governance stakeholder has long been acknowledged by regulators, academic researchers and practitioners. The creation of the AC role (Collier and Gregory 2000; Collier 1993; Pincus, Rusbarsky and Wong 1990) is motivated by the fiduciary principle (Scott 1949) and high agency cost (Jensen and Meckling 1976). Prior literature suggests that an effective AC has significant influence over corporate governance processes within an organisation, since an effective AC is associated with a firm's timeliness in remediating material weaknesses in internal control, which in turn will improve the quality of financial reporting and consequently enhance corporate governance (Goh 2009). However, not all ACs are effective as some could be serving merely a ceremonial role (Beasley, Carcello, Hermanson, & Neal, 2009).

The presence of an AC is not sufficient to ensure effectiveness in the IAF. The AC has to be truly 'effective' in order to fulfil their governance obligations. Recent studies have synthesised prior AC literature and informed how AC effectiveness is affected by certain attributes of the AC (see Ghafran and O'Sullivan 2013; Turley and Zaman 2004; DeZoort, Hermanson, Archambeault, & Reed, 2002). Believing that specific AC attributes will ensure AC effectiveness, regulators worldwide have attempted to codify in their governance code or listing rules the AC attributes that enhance effectiveness. For instance, the SOX (2002) emphasises the importance of AC composition and operational characteristics such as their function, independence and financial literacy. The BRC (1999) and the National Association of Corporate Directors (2000) both provide numerous recommendations for improving AC effectiveness. Consistent with the worldwide trend, the Malaysian regulators (the Securities Commission of Malaysia and Bursa Malaysia) have also placed much emphasis on the composition of AC, specifically on financial literacy, independence and diligence<sup>51</sup> of the AC.

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<sup>51</sup> Refer to Paragraphs 15.02, 15.09 & 15.10, Chapter 15 Corporate Governance, Bursa Malaysia Listing Requirements (2013) and Principle 3 Reinforce independence as well as Principle 4, Foster commitment, CG Code (2012)

However, Turley and Zaman (2004)'s study, which relies on a synthesis of thirteen empirical studies, reports mixed findings on tests of the association between the AC structure and attributes with the achievement of particular governance effects. Hence, Turley and Zaman (2004) caution that companies should not overly rely on greater codification around factors such as the AC members' independence and expertise in attempting to 'correct' past weaknesses in the arrangements for the AC. The Enron Corporation debacle is the best testimony to this (McLean and Elkind 2013). Conformity with regulatory recommendations does not automatically translate into AC effectiveness. At the time of its collapse, Enron Corporation complied with all the US Securities and Exchange Commission and the NYSE requirements on ACs and was considered to have the smartest people on its board (McLean and Elkind 2013). Notwithstanding that, the AC structure and attributes are still major contributing factors to its effectiveness.

For the AC to extend the necessary support to the IAF, they need to be effective and able to wield the necessary influence within the organisation. Accordingly, this thesis has relied on DeZoort, Hermanson, Archambeault, & Reed (2002)'s framework in establishing the AC support to the IAF. The development of the framework was based on a synthesis of 37 empirical research studies (based on pre-SOX data between 1987 and 2002), identifying four components that contribute to AC effectiveness: composition, authority, resources and diligence. It is posited that AC effectiveness can be achieved if the members of the AC are independent and honest; have adequate financial expertise; have the authority to act; have timely access to information; and are willing to act in the best interests of the stakeholders (DeZoort, Hermanson, Archambeault, & Reed, 2002). A detailed discussion of each of the four components is presented in the following sections.

### **5.3.1.1 Composition**

Regulators decree that the simultaneous presence of an AC's 'independence' and 'financial literacy' are significant attributes in ensuring effectiveness. This is evidenced in the legislations, code of best practices and listing rules. For instance, the BRC (1999)

recommends that the AC be composed of only independent directors.<sup>52</sup> With effect from December 1999, the NYSE and NASDAQ required all its listed issuers to maintain at least three independent, financially literate AC members, with one of them having accounting or related financial management expertise. The NYSE and NASDAQ subsequently revised their rulings and required all the AC members to be independent (SOX 2002).

In Malaysia, the Bursa Malaysia Listing Requirement<sup>53</sup> requires an AC to comprise of no less than three members with all of them non-executive directors, with the majority independent and at least one of them financially literate.<sup>54</sup> No alternate director can be appointed as a member of the AC. The AC chair has to be an independent director. To address their concern on true ‘independence’ of independent directors (including in the AC), the Securities Commission of Malaysia has required the tenure of an independent director to be limited to not more than a cumulative term of nine years.<sup>55</sup>

While regulators are consistent in their position to instil better corporate governance, the definition of ‘independence’ varies across stock exchanges. Regulators in rule-based regimes such as the US and Malaysia are more explicit in their definition of ‘independent’ director. Conversely, regulators in principle-based regimes such as the UK and Australia adopt a ‘substance over form’ principle and allow the business community the flexibility to set the parameters of ‘independence’ to suit their situation. However, the ultimate objective of the ‘independence’ regulation is to enable the AC to make a judgement in the best interests of all stakeholders (including shareholders) without succumbing to pressure from top management (comprising owner-managers and professional managers).

The ACs are expected to play a key role in reducing agency costs by overseeing the effectiveness of the management’s financial reporting policy and ensuring financial

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<sup>52</sup> See the BRC’s guidance, ‘Improving the Effectiveness of Corporate Audit Committee’ (1999, p19)

<sup>53</sup> Paragraph 15.09, Part C –Audit Committee, Bursa Malaysia Listing Requirement (2011)

<sup>54</sup> The ‘financial literate’ AC must either be a member of the Malaysian Institute of Accountant (‘MIA’) or if he is not a member of MIA, must have at least three (3) years working experience and passed certain professional examination as specified in Part II of the First Schedule of the Accountant Act, 1967. (Paragraph 15.09(c), Bursa Malaysia Listing Requirement)

<sup>55</sup> Recommendation 3.2, Principle 3: *Reinforce Independence*, CG Code (2012)

statement integrity (Archambeault, DeZoort and Holt 2008; Bedard, Chtourou and Courteau 2004; Klein 2002a). It is posited that the AC's level of independence moves in tandem with their monitoring activities, which consequently leads to improved financial reporting processes and reduced incidence of fraud or earnings management (Gendron and Bédard 2006; Abbott, Parker and Peters 2004; Bedard, Chtourou and Courteau 2004). A 'truly' independent AC will defend the integrity of its monitoring mechanism and is less likely to succumb to pressure from top management. For instance, a pre-SOX study reveals that an AC with greater independence, greater governance expertise and lower stockholdings is more effective in protecting auditors from dismissal after the issuance of non-going concern reports (Carcello and Neal 2003). The findings suggest that an independent AC plays a mitigating role in reducing the negative consequences associated with a qualified audit report and hence defend the integrity of financial reporting.

A larger board size with a majority of independent members is envisaged to enhance AC independence (Klein 2002b). The ACs are said to not be able to function effectively if their members comprise the CEO or executives from within the organisation (Brick and Chidambaran 2010; Bronson, Carcello, Hollingsworth, & Neal, 2009). Based on a post-SOX study (2004 to 2008), if the appointment of the AC is through a social ties of the CEO (e.g. personal friends) instead of through an 'advice network', the AC's oversight quality is more likely to be impinged and more likely to engage in earnings management, even though the AC may tick all the boxes of 'independence' requirements (Bruynseels and Cardinaels 2013).

To further enhance independence, the Malaysian regulators have confined the tenure of an independent director to no more than a cumulative term of nine years. There are mixed views on the impact of tenure of independent directors on AC effectiveness. From an *expertise* perspective, long-tenured directors are associated with greater experience, commitment and competence as they have acquired company-specific knowledge of the organisation and its business environment. Forcing these directors to retire leads to a waste of talent and experience (Abbott, Parker, Peters, & Rama, 2007). This perspective is supported by several studies. For instance, Chan, Liu and Sun (2013) report that long-tenured AC members need lesser external audit effort as they can effectively oversee the

financial reporting process themselves resulting in a lower audit fee. Other studies that provide accumulated knowledge and experience of long-tenured directors (albeit using all directors) are Beasley (1996) and Marrakchi, Chtourou, Bedard and Courteau (2001). Both studies report a positive association between director tenure and financial reporting quality.

Conversely, from a *management-friendliness* perspective, long-tenured independent directors are alleged to befriend and thus less likely to monitor management, which may be detrimental to the shareholders' interests. This is reflected in some recent studies. For instance, DeZoort and Salterio (2001) report that accounting expert AC members who are independent, hold lower shareholdings and have a lower tenure would have a positive impact on accruals quality. Juhl, Juhl, Subramaniam, & Cooper (2013)'s study documents directors with twenty or more years of board service are almost twice as likely to be classified as 'grey' than their less experienced colleagues. This study suggests the need for setting term limits for directors. It would be interesting to gauge the AC participants' view on the impact of tenure on AC independence.

Besides independence, financial expertise is another crucial make-up of AC members in their effort to safeguard accuracy and reliability of corporate financial information (Seetharaman, Wang and Zhang 2013; Raghunandan, Read and Rama 2001). It is posited that the AC should have at least one member who is a financial expert and that the CAE should have private access to this member (usually the chair) (Raghunandan, Read and Rama 2001). Krishnan (2005)'s pre-SOX study suggests that independent ACs with financial expertise are significantly less likely to be associated with incidences of internal control problems in their organisations. The finding is supported by Zhang, Zhou and Zhou (2007)'s post-SOX study, which emphasises the importance of having a close working relationship between the AC and other key corporate governance stakeholders, such as the external auditors, to achieve their governance role. In this pretext, it is expected that an independent and supportive AC with extensive financial expertise will help enhance the effectiveness of the IAF.

A post-SOX study by Dhaliwal, Naiker and Navissi (2010) highlighted the significant difference between a financial expert who is accounting-trained with one who is non-

accounting-trained (finance and supervisory). The study concludes that an accounting-trained financial expert who is independent, holds fewer directorships and has a shorter tenure in their company makes a more significant governance contribution to the company. Clearly, as an accounting-trained financial expert, they would have a domain-specific knowledge and could detect whether the accounting methods accurately reflect the underlying economic substance of transactions, thus leading to high quality financial reporting. DeZoort and Salterio (2001)'s findings are consistent with other studies (Desai, Gerard and Tripathy 2011; Abbott, Parker, Peters, & Rama, 2007; DeFond, Hann and Hu 2005).

In addition to financial expertise and independence, AC members with oversight experience are envisaged to have the same level of judgemental skill as external auditors compared to the less experienced AC members (DeZoort and Salterio 2001). AC members with both financial expertise and a high relative status vis-a-vis senior management are associated with a lower incidence of earnings management (Badolato, Donelson and Ege 2014).

Recent studies on AC effectiveness have extended beyond independence and financial expertise to include industry experience of the AC members. However, regulators have rarely incorporated ACs' industry experience as one of the AC requirements in their best practices or regulations. Gramling, Maletta, Schneider, & Church (2004) argues that 'the best-qualified audit committee members will often be those who have practical management experience, and industry knowledge, as opposed to those with a financial or accounting background' (p. 1108). The AC's industry experience is valuable because accounting guidance, estimates and oversight of the external auditor are often linked to a company's operations within a particular industry (Cohen, Hoitash, Krishnamoorthy, & Wright, 2013). As an extension to the Gramling, Maletta, Schneider, & Church (2004) study, Cohen, Hoitash, Krishnamoorthy, & Wright (2013)'s study posits that AC members with both accounting and industry expertise tend to perform better than those with only accounting expertise. Similarly, supervisory experts who are also industry experts tend to perform better than supervisory experts alone. Overall, their study postulates that industry expertise, when combined with supervisory experience and accounting expertise, can



improve the AC effectiveness in monitoring the financial reporting process. Hoitash, Hoitash and Bedard (2009)'s study also reports that when there are relatively more AC members with accounting and supervisory experience, the incidence of material weaknesses disclosure about internal control over financial reporting is lower. Also, an AC with a former audit partner (regardless of whether affiliated or not with the listed issuer) as a member is expected to have more effective monitoring of internal controls and financial reporting (Naiker, Sharma and Sharma 2012).

A recent trend in corporate board composition reveals an increase in the appointment of directors with legal expertise. A recent study by Krishnan, Yuan and Wanli (2011) suggest that as opposed to financial expert AC, a legal expert AC serves as a monitor rather than as a signal of financial reporting quality. The study also reveals that the positive effects of legal expertise are greater in the post-SOX era compared with a pre-SOX period. This finding suggests that an effective AC should have a mixed composition of members regarding expertise and experience.

In summary, an AC comprising truly independent members with at least one financial expert and relevant industry and supervisory experience is expected to contribute positively to the effectiveness of the AC. These attributes of the AC are expected to support an effective practice of the IAF in listed issuers.

The second construct of AC effectiveness is 'authority' and is considered below.

### **5.3.1.2 Authority**

Authority should be commensurate with the delegated responsibilities (Nielsen 1986). For ACs to be effective, they need to have authority over the resources that support them in discharging their governance obligations. Their formal role is widely acknowledged and is clearly depicted in regulations, code of corporate governance and listing rules of most countries. For instance, the SOX (2002) bestows upon an AC the power to appoint, decide on the audit fee and oversee the work of external auditors. The ACs also have the authority to hire outside counsel or other necessary advisors. In Malaysia, the rights of the AC (full and unrestricted access to any information obtaining to the listed issuer, direct

communication channels with the external and internal auditors, rights to obtain independent professional advice etc.) are explicitly provided in the Listing Requirement.<sup>56</sup> The AC has also been accorded with direct authority over the IAF by virtue of the regulators requiring the IAF to report directly to the AC.<sup>57</sup>

Kalbers and Fogarty (1993) examine the relationship between an AC's organisational power and AC effectiveness (based on the AC's oversight of financial reporting, external auditors and internal control). The authors allege that formal organisational power (i.e. written authority) together with informal organisational power (i.e. observable support from top management) play the most important role in the AC power as it relates to AC effectiveness. Aghion and Tirole (1997) theorise that an increase in agent's (i.e. senior management) real authority, or effective control over decisions, will result in a loss of control for the principal (i.e. the AC<sup>58</sup>). Badolato, Donelson and Ege (2014) posit that individuals with higher 'status' are perceived to have a higher ability, command more authority and obtain better information. Unlike 'power', which is derived from an external source (legal empowerment, top management empowerment etc.), 'status' is dependent on an individual's personal attributes, perceived skills and ability to influence outcomes (Pollock, Chen, Jackson, & Hambrick, 2010; D'Aveni 1990). The relative 'status' of the AC and senior management is a crucial determinant of either party's ability to influence outcomes, particularly when parties face conflicting goals (D'Aveni 1990).

Accordingly, in enhancing their effectiveness, the AC must be able to 'manage' the senior management and heighten the AC's real authority over the monitoring mechanisms (i.e. external or internal audit). This could be achieved if the AC has particular attributes (e.g. financial expertise, industry-specific knowledge) or skills. Also, it is suggested that the AC can enhance its power or influence if they have private and regular meetings with the CAEs as well as active participation in the review of internal audit activities and findings

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<sup>56</sup> Paragraph 15.17, Chapter 15 *Corporate Governance*, Bursa Malaysia Listing Requirements (2011)

<sup>57</sup> Paragraph 15.27, Chapter 15, *Corporate Governance*, Bursa Malaysia Listing Requirements (2011) and Principle 6.2, CG Code (2012).

<sup>58</sup> As the AC is acting as an agent of the principal to oversee the senior management.

(Abbott, Parker and Peters 2004; Bedard, Chtourou and Courteau 2004; Raghunandan, Read and Rama 2001).

The third construct of AC effectiveness is ‘resources’ and is considered below.

### **5.3.1.3 Resources**

It has been suggested that for the AC to be effective, it needs to have sufficient size (Anderson, Christ, Johnstone, & Rittenberg, 2012). This is because the ‘AC must have an adequate number of members to generate substantive discussion and to consider emerging issues, as well as access to management, external auditors, internal auditors, the full board and legal counsel’ (DeZoort, Hermanson, Archambeault, & Reed, 2002, p. 44). This view is shared by the regulators worldwide. For instance, the BRC (1999) recommends and NYSE and NASDAQ now require the AC to comprise a minimum of three members (SOX 2002). The Malaysian regulators take a similar stand. However, the size of AC varies from company to company. Braiotta Jr and Zhou (2006) suggest that the size of AC is dependent not only on the AC’s responsibility and authority but also the size of the company as well as the board size. A study by Anderson, Mansi and Reeb (2004) reveals that as the cost of debt reduces the board size, AC size and board independence increase. These results provide market-based evidence that boards and AC are important elements affecting the reliability of financial reports.

As well as the size of AC, resources could also impact on an AC’s access to accurate, timely updates from management and professionals (e.g. legal counsel, external auditors etc.), to information on significant changes in accounting, auditing and listing rules, and to details of changes in the company’s core business activities (Beasley, Carcello and Hermanson 1999). The AC is handicapped in regards to organisation-specific information due to their non-executive role. Timely access to relevant, critical information will enhance an AC’s decision-making process and consequently its effectiveness. Accordingly, if an AC has direct authority over the IAF, it is suggested that this will improve their monitoring role and consequently better support the IAF.

The fourth and final construct of AC effectiveness is ‘diligence’ and is considered below.

#### 5.3.1.4 Diligence

Diligence refers to ‘the willingness of AC members to work together, to prepare, ask questions and pursue answers when dealing with management, external auditors, internal auditors and other professionals’ (DeZoort, Hermanson, Archambeault, & Reed, 2002, p. 45). It is suggested that for the AC to be effective, it has to be active (Collier 1993; Hughes 1999). An active AC implies commitment of the AC to its oversight role and this is expected to enhance internal control and reduce incidences of fraud or restatement of financial statements (Hughes 1999; Collier 1993). Regulators worldwide have emphasised the need for frequent meetings of the AC. However, they are less explicit about the number of AC meetings required to achieve the desired effect.

Prior research generally relies on frequency of AC meetings to proxy presence of AC diligence as other measures of AC diligence are not publicly observable (DeZoort, Hermanson, Archambeault, & Reed, 2002) and this measure has been widely adopted in recent AC effectiveness literature (see Brick and Chidambaran 2010; 2012; Barua, Rama and Sharma 2010; Naiker and Sharma 2009; Collier 2008; Adams 2003; Vafeas 1999). The frequency of AC meetings is usually associated with positive governance effects. For instance, Adams (2003)’s study reports that a board’s activity is determined by the company’s performance. Poor performing companies tend to have greater board monitoring as the board needs to intensify its activities in order to insulate itself from potential litigation. The complexity of companies and growth opportunities also demand higher board activity (Vafeas 1999). Brick and Chidambaran (2010)’s study posits that a firm’s prior performance, characteristics (e.g. size) and governance characteristics are important determinants of board activity. Corporate events such as a proposed merger and acquisition or a restatement of financial statements will also intensify board monitoring. The study concludes that board activity has a positive impact on firm value as investors perceive an active board will yield more effective monitoring. Anderson, Christ, Johnstone, & Rittenberg (2012)’s study suggests that frequency of AC meetings is an indicator of an organisation’s commitment to corporate governance. Having said that, if the impetus behind intensified board activity (i.e. purported increasing of the meeting

frequency) is simply to comply with regulations, then it will only yield an additional financial burden and unintended consequences without any real oversight benefits.

AC diligence could also involve informal interactions or meetings with the IAF in addition to the scheduled formal meetings as this is seen to present additional opportunities for the AC to monitor the IAF (Zaman and Sarens 2013). AC diligence could also be reflected in their active participation in the IAF report review (Abbott, Parker and Peters 2004; Raghunandan, Read and Rama 2001).

Another emerging attribute of AC effectiveness is the number of directorships of AC members. Some researchers suggest that multiple directorships can be used as a measure of a director's expertise (Francis 2011; Fama and Jensen 1983). Conversely, some researchers have advocated that serving on numerous boards can result in overstretched directors which may compromise their effective monitoring on any board. For instance, Meyerinck, Oesch and Schmid (2016) contend that independent directors who hold three or more directorships are associated with weak corporate governance. Naiker, Sharma and Sharma (2012)'s study reports a significant positive association between financial misstatements and multiple-directorships of independent directors. However, Tanyi and Smith (2014)'s study confines the adverse impact of overstretched independent directors on effective monitoring to only AC chairs and the financial expert AC, not across all independent directors. This argument is sensible since they contribute relatively more to financial reporting and internal controls matters.

### **5.3.2 Organisational support**

This section seeks to consider the impact of 'organisational support' on IAF effectiveness as a factor included in the internal components. The IAF do not operate in a vacuum. Their operation and effect cannot be evaluated without regard to the operational and organisational context in which they function and the power relationships intrinsic to that context. Under the context of organisational support, two constructs have been identified from the literature and are considered in the following sections: the IAF's organisational status (e.g. legitimacy and reporting structure) and organisational culture (e.g. Tone at the top).

### 5.3.2.1 The IAF's organisational status

The IAF's organisational status can either be accorded 'formally' by legislation or listing rules, or 'informally' through empowerment by another legitimate corporate governance stakeholders such as the board of directors or senior management. It is alleged that without a legitimate role, the IAF could not operate effectively as they would not be able to garner the support and cooperation of its auditees (Lenz and Sarens 2012). However, Goodwin-Stewart and Kent (2006b)'s study reveals that in a non- mandatory internal audit regime, companies that voluntarily establish an IAF are less likely to engage in earnings management. This may infer that if the top management is committed to good corporate governance, the IAF can operate effectively even in the absence of any legislative backing. This contradicts the views of Lenz and Sarens (2012). Accordingly, it will be interesting to investigate whether the IAF in Malaysia has indeed become more effective after the implementation of the mandatory IAF ruling.

While the regulators have required the establishment of IAF, the operationalisation of the IAF is not explicit. The IIA suggests that for the IAF to be effective, it should be free from interference in determining its audit plan, performing its work and reporting on audit findings (Standard 1110.A1, *Organisational independence*, (IIA 2013a)). For that to happen, the IIA suggests that the IAF should be placed 'at a level within the organisation that allows the IAF to fulfil its responsibilities' (Standard 1110, IIA 2013). However, the IIA (2013) is not explicit on which 'particular' level in the organisation chart the IAF should be placed.

The IAF role fits the description of the techno-structure 'staff' function as suggested by Mintzberg (1993). The techno-structure staff function is described as comprising those analysts or experts outside the formal 'line' structure who apply analytic techniques or technical skills to maintain the structure of the organisation. They include accountants, business planners etc. With a 'staff' function role, the IAF does not have direct authority over other 'line' function departments (e.g. manufacturing, production, marketing etc.). Accordingly, it is critical for the IAF to have the support of senior management so that it can discharge the monitoring role effectively (including free access to information, present its audit findings etc.). In Malaysia, the regulators have required that the IAF report

directly to the AC. Hence, it will be interesting to investigate whether such a reporting arrangement has enhanced the IAF's organisational status and accorded them with the necessary authority to execute their entrusted role.

Extant literature suggest that the IAF's organisational status can be enhanced if the CAE has direct access to the AC, particularly the AC chair, through, for example, an informal interaction outside the formal scheduled meetings (Zaman and Sarens 2013; Arena and Azzone 2009; Turley and Zaman 2007) or if the CAE is invited to attend and participate in the board meeting or senior management strategic meeting (Bromilow, Berlin and Anderson 2005). The IIA posits that the CAE should attend board meetings regarding the board's oversight responsibilities for auditing, financial reporting, governance and control as this will accord the CAE with the opportunity to appraise strategic business and operational development and raise high-level risk, systems, procedures or control issues at an early stage (IIA 2013a).<sup>59</sup>

In Malaysia, the regulators require the IAF to report directly to the AC. This may infer the regulators' intention to eliminate ole-ambiguity of the IAF over 'who is the master?' (see Abbott, Parker and Peters 2010) and to enhance the IAF's organisational independence. However, this ruling may appear to contradict with the IIA's 'dual-reporting' structure (IIA 2013a; IARF 2003).<sup>60</sup> Under the IIA's dual reporting arrangement, the CAE is expected to report functionally<sup>61</sup> to the AC and administratively<sup>62</sup> to the CEO. There have been debates from both the academics and practitioners over this 'dual reporting' arrangement (see Lenz and Sarens 2012; Abbott, Parker and Peters 2010). Based on the IIA's pronouncements, the AC maintain the ultimate approving authority over all matters regarding the IAF, but the CEO has the power over day-to-day affairs and IAF operations.

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<sup>59</sup> Practice Advisory 1111-1, Board interaction, IIA (2013)

<sup>60</sup> Practice Advisory 1110-1, Organisational Independence, IIA (2013)

<sup>61</sup> To report 'functionally' to the AC means, the AC has the authority to approve the IA charter, the IAF audit plan, to have direct access to the CAE on IAF findings and other functional matters.

<sup>62</sup> To report 'administratively to CEO', IIA means, CAE were to report to CEO on their day-to-day operations. And CEO has control over IA's funding budget, human resource management (e.g. evaluation and compensations), IAF policies and procedures and information flow.

This will inevitably cause confusion as to who is the master and impact on the organisational independence of the IAF.

The argument against dual reporting is that having the IAF to serve two masters (i.e. AC and senior management) with conflicting objectives (Gray 2004) would result in the IAF being unable to meet the expectation of either (see Lenz and Sarens 2012; Abbott, Parker, & Peters, 2010). This is because senior management view the IAF as a means to achieve operational goals and generate cost savings (Anderson 2003; Hermanson and Rittenberg 2003) while the senior management consider the use of the IAF by the AC as a means to meet the AC's heightened governance obligations. It is posited that the ACs' concern over litigation (Veasey 2005) and reputational liability (Srinivasan 2005; Abbott and Parker 2000; Carcello and Neal 2000) have motivated the AC to demand greater monitoring efforts from the IAF on financial reporting-related internal controls (Krishnan 2005).

Hence, it will be interesting to investigate whether the 'direct reporting' to the AC ruling has indeed resolved the role ambiguity of the IAF; and consequently enhanced their organisational independence and effectiveness. It is also interesting to explore whether the 'direct reporting' to the AC ruling has caused any tension between the AC and top management in Malaysia.

### **5.3.2.2 Organisational culture and top management support**

Recently, despite heightened efforts to reduce fraudulent financial reporting and misappropriation of assets, it appears that fraud in various forms is still increasing in frequency and severity. Fraud involving employees, particularly the upper executives, is concerning. It is reported that in the US, 89% of the fraud cases under investigation by the US Securities Exchange Commission between 1998 and 2007 implicate the CEO or CFO (Beasley, Carcello, & Neal, 2010), 70% of which are directly linked to the CEO. This is an increase from 83% for the period between 1987 and 1998 (Beasley, Carcello and Hermanson 1999). Fraud involving upper management is usually of larger magnitude and harder to detect, which is not surprising considering the broad influence the CEO has over operations and stakeholders of organisation (Claybrook 2004; Clarkson 1995).



Most studies that examine fraud adopt Cressey (1953)'s 'Fraud Triangle' model, which identifies the three conditions that generally present when fraud occurs:

- incentive/pressure (e.g. lavish lifestyle, living beyond one's means)
- opportunity (e.g. poor internal control, poor monitoring, lack of prosecution of fraudsters, weak ethical culture, ineffective anti-fraud mechanisms)
- rationalisation/attitude (i.e. justify misdeeds and view illegal behaviour as acceptable).

Wolfe and Hermanson (2004) have expanded Cressey's 'Fraud Triangle' by including a fourth element – capacity (i.e. personal traits and capabilities of fraudsters) and called this model the 'Fraud Diamond'. According to Wolfe and Hermanson (2004), 'opportunity opens the doorway to fraud, incentive and rationalisation can draw the person towards it. However, the person must have the capability to recognise the open doorway as an opportunity and to take advantage of it by walking through it, not just once but time and time again' (p. 38–39). Wolfe and Hermanson (2004)'s study identifies the personal traits of a fraudster as egoistic/over-confident (e.g. would not be detected or even if detected could get out of the mess); persuasive (e.g. coerce/persuade others to commit fraud); consistent and effective liar (able to remain resolute even when queried); and able to deal with stress. Also, potential fraudsters are intelligent and have a solid grasp of the company's controls and vulnerabilities and typically possess a position of authority or power within the organisation.

Most empirical research examining the involvement of senior management in fraud (particularly the CEO/CFO) support Cressey's and Wolfe's fraud models. For instance, it is posited that the involvement of a CEO in fraudulent reporting is due to, amongst others, equity compensation incentives (Feng, Ge, Luo, & Shevlin, 2011), CEO's narcissism (Amernic and Craig 2007) and the excessive power of the CEO within an organisation (Cohen, Krishnamoorthy and Wright 2010). Boyle, Carpenter and Hermanson (2012) posit that lower level staff involvement in a fraud scheme is mainly due to coercion by top management. Feng, Ge, Luo, & Shevlin (2011) defend CFO involvement in fraudulent reporting or accounting manipulation is because they succumb to pressure from the CEO.

In reducing fraud, regulators have enacted tougher laws and increased enforcement action, organisations are implementing tighter controls and broader oversight, and professional bodies are developing more stringent accounting and auditing standards. For instance, in the US, the Treadway Commission (formerly known as the National Commission on Fraudulent Financial Reporting) introduced a five-point recommendation on how to improve financial reporting processes and early detection and reporting of fraud, in which the phrase ‘tone at the top’ was first introduced (NCFRR 1987). In 1992, COSO released its first integrated framework of effective internal controls, which again used the phrase ‘tone at the top’. Since then, ‘tone at the top’ has been associated with ‘internal controls’ (Abbott, Parker, Peters, & Rama, 2007).

There is no standard definition for ‘tone at the top’. Reding et al. (2007) define ‘tone at the top’ as ‘the entity-wide attitudes of integrity and control consciousness, as exhibited by the most senior executives of an organisation’ (p.7–10). Based on studies commissioned by the accounting profession and academic researchers, it is posited that ‘tone at the top’ broadly refers to how upper management creates the tone or atmosphere in the workplace and this has a trickle-down effect on the employees. However, to instil a positive ethical culture among employees, it is posited that upper management has to lead by example in a consistently established ethical environment (Law 2011). In short, if top management upholds ethics and integrity so will employees. When top management embraces core values and a strong ethical culture, this will reinforce employees’ ethical perceptions and behaviour at work and consequently reduce the likelihood of fraud being committed (Law 2011; Key, Messina and Turpen 1999).

The CEO has been cited as the key individual in an organisation who can set the tone at the top affecting integrity and ethics and other factors of a positive control environment (COSO 2002). This is not surprising considering the CEO (who leads the senior management) has the broadest influence over the operations and stakeholders of an organisation (Claybrook 2004; Clarkson 1995). However, researchers’ views are mixed about who should set the tone for the organisation. For instance, Hansen, Stephens and Wood (2009) suggest that the setting of the ‘tone’ should be at senior management level. However, it should not be confined to only the CEO/CFO but expanded to include other

C-suited executives (chief information officers, chief risk officer etc.) or even middle-level managers directly above the employees.

Chambers (2014) suggests a ‘top-down’ approach whereby the board and the AC should take the lead in setting the tone by instilling a strong ethical culture with senior management ultimately responsible for its implementation. Chambers (2014) posits that integrity at the top will encourage and support a strong tone in the middle, which, in turn, will promote a robust and sincere ethical culture across the organisation. To ensure a sustaining ethical culture, Chambers (2014) suggests that the AC has firstly to set a clear expectation of the code of ethics (for all levels, top to bottom) and incorporate proper communication mechanisms (e.g. a whistle-blower hotline); secondly, to check the tone in the middle (i.e. speak to the manager below the C-suite); thirdly, to make ethics a priority (i.e. set the tone and modelling ethical behaviour) but be explicit that senior management are ultimately responsible; fourthly, to enforce and incentivise the code ‘walk-the-talk’, leading by example; and finally, to look to the IAF to assess and objectively report on the organisation’s ethical culture.

A corporate ethics policy or code of ethics could help define or outline the organisations’ philosophy, values and norms of business conduct. The adoption of such documents reveals the organisation’s commitment to the development of an ethical corporate culture (Melé, Debeljuh and Arruda 2006) and can guide an employee’s actions and avoid violation of an organisations’ code of business conduct. Hite, Bellizzi and Fraser (1988) suggest that corporate ethical policies have to be in writing. However, they also acknowledge that written ethical policies alone are inadequate to support high-quality corporate ethical conduct. Investing in ethics (e.g. tone at the top, lead by example, code of ethics) and using the IAF to get a better sense of the ethical climate at the company they oversee is an effort of the organisation to instil corporate governance. Positive corporate culture is allegedly able to ease the monitoring tension between internal audit and the auditee and may enhance IAF effectiveness (Schwartz, Dunfee and Kline 2005).

### **5.3.3 IAF resources**

This section seeks to consider another internal enabling factor – the impact of ‘IAF resources’ on IAF effectiveness in Malaysia. Internal audit has been a behind-the-scenes player serving as an ‘organisational policeman and watchdog’ (Morgan 1980, p. 161) for a long period. Today, the IAF is widely acknowledged as one of the key corporate governance players together with the AC, senior management and external auditors in guarding the governance fort of companies (Gramling, Maletta, Schneider, & Church, 2004). However, the mere presence of the IAF alone is inadequate and it is the quality of the IAF that is critical for achieving the desired outcomes (Abbott, Parker and Peters 2012a; Carcello, Hermanson and Zhongxia 2011).

A well-resourced internal audit department is crucial in supporting the smooth operation of the IAF (Anderson, Christ, Johnstone, & Rittenberg, 2012). However, staff size should not be the only consideration in whether a department is ‘well-resourced’. A highly competent team, for example, with the majority a CIA, is alleged to be able to compensate for small staff size (Anderson, Christ, Johnstone, & Rittenberg, 2012). Accordingly, two constructs have been identified to inform how IAF resources could support IAF effectiveness: investment in IAF and IAF attributes.

#### **5.3.3.1 Investment in IAF**

Despite the IIA (2013) positing that a well-sourced internal audit department is key to its effectiveness, there have been limited studies on determinants of companies’ investment in IAF. Earlier studies<sup>63</sup> use ‘presence of IAF’ as a proxy measure for a firm’s commitment to IAF investment (see Goodwin-Stewart and Kent 2006a; Wallace and Kreutzfeldt 1991).

Recent studies on IAF investment examine the association of the size of IAF with various governance variables (see Anderson, Christ, Johnstone, & Rittenberg, 2012; Sarens and Abdolmohammadi 2011; Barua, Rama and Sharma 2010). For instance, Sarens and

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<sup>63</sup> Before the mandatory IAF establishment ruling.

Abdolmohammadi (2011)'s finding reveals that a supportive control environment (characterised by formalised integrity and ethical values, a high level of risk and control awareness etc.) is associated with a relatively larger IAF size, which is an indication of greater appreciation of the IAF's monitoring role by the board and executive management. However, the study suggests that number of independent members on the board is inversely associated with the size of IAF. This can indicate a substitution effect, which infers that independent board members may be considered as an alternative monitoring mechanism. Also, the study posits that management ownership is positively associated with the size of IAFs. This is an interesting finding as it contradicts the general belief that owner-managers prefer lower monitoring. Barua, Rama and Sharma (2010)'s study suggests potential substitution and complementary effects between the IAF and AC. The study posits that investment in internal auditing (IAF budget) is negatively associated with the presence of an AC (who are auditing experts) and averagely long-tenured AC (an indication of enhanced company-specific knowledge and reduced information asymmetry). This is an inference of potential substitution effect. Apart from that, the study also reveals a positive association between IAF budget and frequency of AC meetings. This suggests a possible complementary effect inferring that a more diligent AC demands more vigorous monitoring support from the IAF. Looking from the angle of the structural set-up of IAF on IAF investment, Anderson, Christ, Johnstone, & Rittenberg (2012)'s study suggests that size of IAF is inversely associated with the extent of assurance and compliance activities being out-sourced and the percentage of CIAs on the internal audit team (a proxy for IAF competency and proficiency).

### **5.3.3.2 IAF attributes**

In identifying the key IAF attributes and structure that could support its effectiveness, this thesis has relied on the IIA (2013)'s Attributes Standards – with particular focus on Attribute Standard 1100 (Independence and objectivity) and Attribute Standard 1200 (Proficiency and due professional care) and supplemented by extant research literatures. The rationale for relying on these two IAF attributes, 'independence and objectivity' and 'proficiency and competency', is that they have been widely used (either singly or jointly) as measuring proxy for IAF effectiveness or IAF quality in most academic literature (see

Abbott, Daugherty, Parker, & Peters, 2016; Christ, Masli, Sharp, & Wood, 2015; Pizzini, Lin and Ziegenfuss 2014; Abbott, Parker and Peters 2012a; Dominic and Nonna 2011; Lin, Pizzini, Vargus, & Bardhan, 2011; Prawitt, Sharp and Wood 2011; Stewart and Subramaniam 2010; Arena and Azzone 2009; Christopher, Sarens and Leung 2009; Prawitt, Smith and Wood 2009; Goodwin and Yeo 2001). The discussion of IAF attributes is categorised into two parts: general IAF attributes and specific CAE attributes.

(i) *General IAF attributes*

- *Independence and objectivity*

Independence is the ability of the IAF to carry out their responsibilities in an unbiased manner or without interference from any parties at an individual, engagement, functional or organisational level (IIARF 2001). Objectivity is an unbiased mental attitude of the IAF to perform engagements without compromising on their quality (IIARF 2001). Accordingly, while independence is subject to external influences, objectivity is the ‘state of mind’ within one individual.

Independence and objectivity are two critical attributes of an IAF (Bailey 2007b). While the IAF can be the AC’s useful tactical and strategic support (Sarens, De Beelde and Everaert 2009), their audit findings and information will only be relied upon if the AC has implicit trust and confidence that the IAF have acted objectively. Bailey (2007b) alleges that it is the responsibility of the AC to ensure the IAF’s organisational independence. Abbott, Parker and Peters (2012a) suggest that the IAF’s objectivity is a direct function of the IAF’s organisational status, which in turn lies on the strength of the oversight relationship between the AC and IAF. However, it must be acknowledged that the IAF do not work in isolation. They need the support of not only the board (including the AC) but also senior management. It is imperative for the IAF to work closely with senior management so as to gain their support and trust (Kawashima 2007). This could be the rationale behind the IIA proposition for a ‘dual-reporting’ structure. However, this reporting structure has attracted criticism from academic researchers and practitioners for its propensity to compromise on the organisational independence of the IAF (see Lenz and Sarens 2012; Abbott, Parker and Peters 2010).

In an organisation, staff occupying a position of privilege will be accorded opportunities to intervene and secure an advantage over others (Kalbers and Fogarty 1993; Powell 1991). Under a 'dual-reporting' arrangement, senior management is said to have more influence over IAF resources than the AC since the IAF's daily activities are dependent on the support of senior management (Sarens and De Beelde 2006b). Accordingly, there is a tendency for the IAF to acquiesce to the senior management's requests.

The acquiescence of the IAF to either 'master' (the AC or senior management) is dependent on how the IAF perceive the 'masters' from a power-dependence perspective. Power is defined as the capacity or potential to influence others' attitudes or behaviours despite resistance (Pfeffer 1981; Bacharach and Lawler 1980). It is a zero sum game – as the power of one party increases, the opponent will have less ability to influence decisions (Salancik and Pfeffer 1977). Thus, if the IAF perceive senior management to be more powerful (ability to control or influence the IAF's budget allocation, recruitment and dismissal, performance evaluation, remuneration etc.), there is a tendency for them to acquiesce to the senior management's requests (Bacharach and Lawler 1980). Also, they may not pursue tough questions on senior management for fear of reprisal; thus diminishing their objectivity (Abbott, Daugherty, Parker, & Peters, 2016; Abbott, Parker and Peters 2012a; Cohen, Krishnamoorthy and Wright 2010; Norman, Rose and Rose 2010). Conversely, if the IAF perceives the AC to be more powerful and have the ability to influence the outcomes, they are more likely to acquiesce to the AC's requests. Accordingly, it is crucial for the AC to amass its power within the organisation so that they can exert more influence over the monitoring mechanisms (e.g. internal and external auditors) within the organisation.

Kalbers and Fogarty (1998) allege that financial expertise of the AC will significantly enhance and signal the power of the AC to both senior management and the IAF. Interactions, both formal (scheduled meetings, active involvement of AC in the internal audit plan, audit findings etc.) (Zain and Subramaniam 2007; Goodwin and Yeo 2001) and informal (i.e. interaction outside scheduled meetings) (Zaman and Sarens 2013; Arena and Azzone 2009; Turley and Zaman 2007), are also envisaged to augment the influence of the AC over the IAF (Khelil et al. 2016). Close rapport between the IAF and the AC

can heighten organisational status of the IAF and accordingly support its organisational independence (Stewart and Subramaniam 2010; Arena and Azzone 2009).

While Abbott, Parker, Peters, & Rama (2007) suggests that companies systematically rotate internal auditors out of the IAF and into operational management to enhance their skills and proficiency, some governance literature seems to disapprove this proposition. Goodwin and Yeo (2001) posit that internal auditors become less objective in discharging their role when they expect to move into a line management position since they do not want to upset the auditee who could be their future superior. The internal auditors also become less objective and are more inclined to support management's aggressive revenue recognition policies if they expect to move into a senior management position (Rose, Rose and Norman 2013). Companies that use a rotational staffing model for their IAF are associated with significantly lower financial reporting quality due to compromised objectivity of their internal auditors (Christ, Masli, Sharp, & Wood, 2015).

Another pronouncement of the IIA that may compromise the independence and objectivity of internal audit is its 'duality' role (i.e. assurance and consultancy) as stipulated in the *Definition of Internal Auditing* (IIA 1999). At the onset, the roles may seem to complement each other. However, there are concerns that such practice may compromise the IAF's organisational independence (Kawashima 2007). By undertaking consultancy role, the IAF have to display their professionalism and gain the trust and confidence of management; thus, they have the onus to assist management in achieving their targeted goals. A confusion in the relationship between the IAF and senior management can occur if the IAF advise management in designing and implementing control mechanisms and are then required to conduct assurance work, which requires them to be also objective in critically evaluating the design and operation of controls implemented by the same management team. This arrangement creates a confusing identity for internal audit due to the different hats worn by them. Kawashima (2007) suggests that the internal audit department create a firewall between the consulting and assurance teams. However, this is only possible if the organisation concerned has an internal audit team of a reasonable size and expertise to facilitate such arrangement.



In summary, a closer working relationship between an effective AC and CAE/IAF will promote the IAF's organisational independence. If the AC is accorded with the real power or control over the appointment, dismissal, remuneration and performance evaluations of CAEs (Turley and Zaman 2007; Braiotta 2004; IIA 2002; Raghunandan, Read and Rama 2001; McHugh and Raghunandan 1994), it will send a clear message of the AC's real power to the IAF and senior management. It is only with the support of a strong AC that the IAF can discharge their role independently and objectively. Using IAF as a training ground for a future management position will only compromise the IAF's objectivity and consequently impact on monitoring mechanism of organisations.

- *Proficiency and competency*

Proficiency and competency are the second general IAF attributes identified in this study. Professional qualification (CIA,<sup>64</sup> CPA<sup>65</sup> etc.) has been widely used as a proxy for IAF quality and IAF competency (see Choi, Choi, Hogan, & Lee, 2013; Bame-Aldred, Brandon, Messier, Rittenberg, & Stefaniak, 2013; Prawitt, Sharp and Wood 2011; Prawitt, Smith and Wood 2009; 2012; Myers and Gramling 1997). Other studies have relied on 'membership affiliation to the IIA' (see Arena and Azzone 2009) and IAF investment, i.e. an average hourly rate of budgeted IAF resources (Abbott, Parker and Peters 2012a) to proxy IAF competency.

The CIA designation is used as a proxy as it is the only globally accepted certification for internal auditors (Reding et al. 2007). Prior research indicates that the percentage of CIAs in an organisation is inversely related to the risk of fraudulent or misleading financial statements (Prawitt, Sharp and Wood 2011), and is inversely related to abnormal accruals (Prawitt, Smith and Wood 2009). Anderson, Christ, Johnstone, & Rittenberg, (2012)'s study has included both CIA and CPAs to proxy IAF competency.

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<sup>64</sup> Certified Internal Auditor

<sup>65</sup> Certified Public Accountant

Besides professional qualification, the IAF's experience is another contributing factor to IAF competency. It is posited that line managers often do not take into account the IAF's advice, as they perceive the IAF do not have enough knowledge to provide useful help (Van Peurse 2004; 2005). Individuals with varying experience levels and background may further enhance the collective experience and skill of the internal audit department (Trompeter, Carpenter, Desai, Jones, & Riley, 2012; Carpenter, Reimers and Fretwell 2011). However, while experienced external auditors do outperform inexperienced external auditors, the variation can also be explained by the innate ability of the person (Abdolmohammadi 2012). Although Abdolmohammadi (2012)'s study is on external auditors' expertise, the findings should also be applicable to internal auditors. To be consistent with the IIA (2013a), in this study I have not considered 'expertise' of the IAF as expertise has a wider meaning than mere competency and experience (Abdolmohammadi 2012). 'Expertise' includes experience, knowledge, ability and performance (Libby and Tan 1994; Libby and Luft 1993).

While it is expected that the competencies and skills of IAF staff will also influence its effectiveness, it has been suggested that the skills requirement varies with the rank of internal auditors. Abdolmohammadi (2012) posits that leadership attributes (e.g. negotiating) are perceived to be the most important for upper ranks while technical skills (e.g. analytical) are the most important for lower ranks.

*(ii) Specific CAE attributes*

In the aftermath of the Enron/Worldcom debacle, the governance responsibilities of ACs have heightened, and they are turning to the IAF, more specifically the CAE, for strategic and tactical support. The IIA requires the CAE to communicate and interact directly with the board and regularly attend and participate in board meetings that relate to the board's oversight responsibilities for auditing, financial reporting, organisational governance and control.<sup>66</sup> It is suggested that the CAE's participation in board meetings will enable them

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<sup>66</sup> Attribute Standard 1111, IPPF, 2013 and Practice Advisory 1111-1, IIA, 2009.

to appraise strategic business and operational development and to raise high-level risk, systems and procedures or control issues at an early stage. Leung, Cooper and Perera (2011)'s study suggests that the CAE's impression about whether they are regarded as having a significant role in corporate governance is dependent on their access to the CEO and the AC chair.

However, for the CAE to be the board and senior management's 'trusted advisor', they must possess the necessary expertise and skills to gain their respect and support for quality corporate governance (Hermanson, Ivancevich and Ivancevich 2008a). Since the CAEs' domain of expertise is in risk management and controls (Hermanson, Smith and Stephens 2012), CAEs perceive they have significant influence over key management decisions concerning risks and controls matters (Leung, Cooper and Perera 2011). The CAE's length of service and experience in an organisation has a positive impact on their performance. A long-tenured CAE will be more knowledgeable about the organisation (e.g. process, culture and system) and have a better-established relationship with the senior management and AC. Accordingly, they will be in a better position to secure sufficient resources to maintain and grow the IAF (Van Staden and Steyn 2009; Beasley, Branson and Hancock 2008).

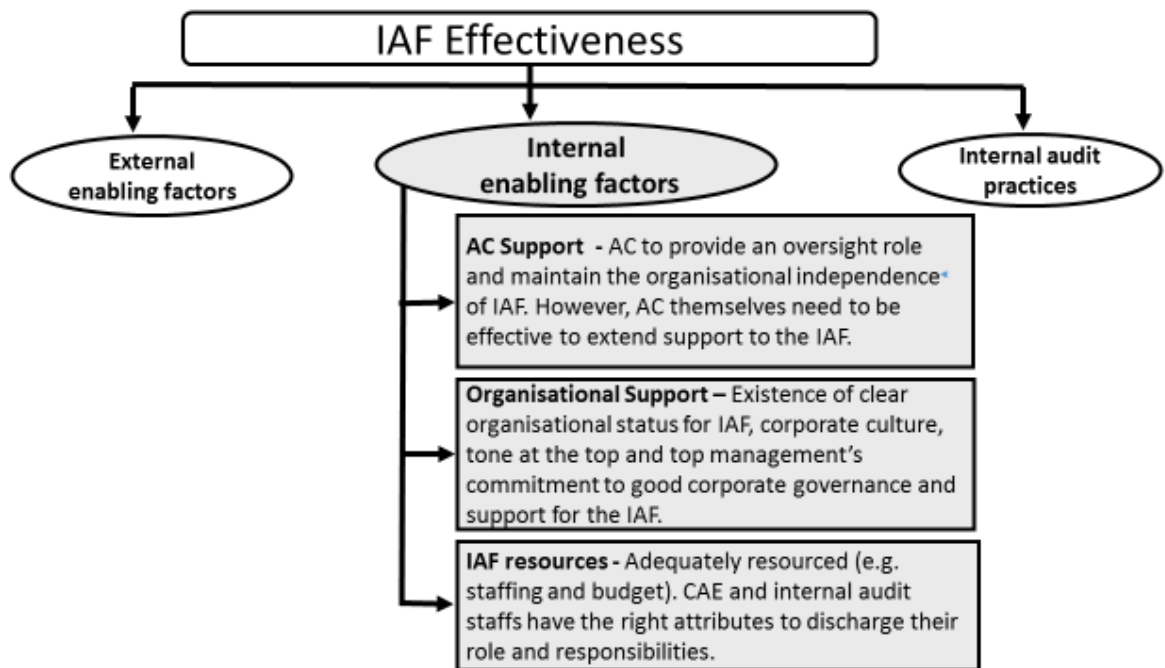
In addition to solid technical expertise, an ideal CAE candidate should possess strong management and leadership skills (Rittenberg and Anderson 2006). An assertive CAE will help to drive the organisation's commitment to the tough internal control environment (Rittenberg and Anderson 2006). They must be willing to ask difficult questions or raise issues with the senior management and the AC, even at the expense of their popularity (Rittenberg and Anderson 2006). They should not succumb to pressure by senior management (Bailey 2007a).

The ideal CAE should have strong business acumen and a solid understanding of the company's business, core strategies and risk profile (Baker 2010). The CAE must be comfortable operating at the strategic level, that is, to attend and participate at board and senior management meetings (Baker 2007). They must be able to advise the board and senior management with sound business judgement but not compromising on their objectivity and independence.

While auditing often is viewed as a technical function, the softer audit skills are equally critical. Interpersonal skills are particularly crucial in building an effective working relationship with other corporate governance stakeholders (e.g. the AC, senior management and external auditors). An ideal CAE is one that can engage parties from both within and outside the organisation (Boyle, Wilkins and Hermanson 2012). Also, the CAE must possess superb management skill in areas such as resource allocation, staffing management etc. It is posited that an effective CAE can attract and develop calibre staff, and consequently, contribute to the effectiveness of the IAF.

In Malaysia, a qualitative study by Mat Zain and Subramaniam (2007) conducted before the enforcement of the ‘mandatory IAF ruling’ reveals that CAEs lack frequent informal interactions such as private meetings with the AC and have ‘blurry’ line of reporting. It will be interesting to investigate whether there have been any significant improvements after the implementation of the mandatory IAF ruling. In summary, the factors that have been identified to inform the internal enabling factors are presented in Figure 5.3.

**Figure 5.3: Conceptual IAF effectiveness framework (Second component – internal enabling factors)**



## **5.4 Internal Audit Practices (Third Component)**

The third component of the conceptual IAF effectiveness framework is ‘internal audit practices’. A stakeholders’ survey conducted by Deloitte and the IIA UK and Ireland (2008) reveals that about two-thirds of the IAFs surveyed do not demonstrate their value. A recent study based on Australian public listed companies reveals some misalignments between the CAE’s perception of IAF objectives and actual time spent on particular internal audit activities (Leung, Cooper and Perera 2011). This suggests that the IAF may not know what is expected of them by the key service users, namely the AC and senior management. For the IAF to operate effectively and to add value to corporate governance, it is essential to know what is expected of them by the key service users, specifically the AC. The discussion of ‘internal audit practices’ is categorised into three parts: Planning: internal audit planning, Implementation: nature of internal audit activities and Evaluation: performance evaluation.

### **5.4.1 Planning: audit planning**

The ultimate mission of IAF is to ‘help an organisation accomplish its objectives’ (IIA 1999). Audit planning is essential as it helps to organise the internal audit activities in achieving the desired goal or objective, which is aligned with that of the organisation. However, the IAF needs to have clear terms of reference for them to execute their role effectively. The two main elements to be discussed under planning are the internal audit charter (‘IA charter’) and internal audit planning.

#### **5.4.1.1 IA charter**

The IIA posits that the IA charter is a document that ‘defines the internal audit activity’s purpose, authority and responsibility. The internal audit charter establishes the internal audit activity’s position within the organisation; authorises access to records, personnel and physical properties relevant to the performance of engagement and defines the scope

of internal audit activities' (IIA 2013a).<sup>67</sup> The IA charter is endorsed by the AC (on behalf of the board) and sends a message throughout the organisation depicting the organisational status and task responsibilities of the IAF. The document also denotes top management's commitment to better governance, control and ethical business conduct across the organisation (IIA 2013a). The IA charter is also a useful tool for the board and top management in their performance evaluation of the IAF as it outlines the scope of work committed to being undertaken by the IAF.

In Malaysia, although listed issuers are required to establish an IAF, the regulators are not explicit in the implementation of the IAF which has accorded flexibility in terms of the structural and functional make-up of the IAF in listed issuers. The IAF role, activities and audit findings/opinions are rarely 'communicated' to external stakeholders (minority shareholders, watchdog groups etc.) unlike external auditors, whose audit opinion is a mandatory disclosure in annual reports of listed issuers. The only disclosure in the annual report about the IAF is in the AC charter section, which includes the role, function and responsibilities of the AC<sup>68</sup> and its monitoring responsibilities over the IAF<sup>69</sup> (Listing Requirements 2011). This under-representation of the IAF's role and activities in annual reports (which is seen as a 'report card' of an organisation to its shareholders and external stakeholders) may result in the IAF's contribution not duly comprehended by external stakeholders and investors. Accordingly, this study aims to explore, from the AC participants' perspectives, whether it is necessary for listed issuers to maintain an IA charter and whether the disclosure of the key IAF role and activities in annual reports will enhance IAF effectiveness.

#### **5.4.1.2 Internal audit planning**

Internal audit planning is crucial as quality inputs (i.e. audit plan) are positively associated with quality outputs (i.e. IAF deliverables) although the relationship is not always

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<sup>67</sup> See Practice Advisory 1000-1, IIA, 2013

<sup>68</sup> See Paragraphs 15.15(3)(b) & (e), Listing Requirements, 2011

<sup>69</sup> See Paragraph 15.12(1)(f), Listing Requirements, 2011.

consistent since the outcome may be affected by other factors (implementation/processes etc.) (Chinander and Schweitzer 2003; Aghion and Tirole 1997). The IIA requires the IAF to adopt a risk-based approach in the development of an audit plan, which is aligned with the organisation's goals and mission. The audit objectives need to address the risks confronting the auditees and the audit tests developed should support the audit objectives. Hence, by meeting the audit objectives, the IAF could indirectly support the organisation in achieving its goals or objectives.

There have been limited prior empirical studies that associate the existence of an IA charter and adoption of risk-based audit planning with IAF effectiveness. Hence, it will be interesting to explore what is in practice and what is the AC's perspective on IA charter and risk-based audit planning in enhancing IAF effectiveness in Malaysia. The next section seeks to consider nature of internal audit activities practised by the IAF.

#### **5.4.2 Implementation: nature of internal audit activities**

Internal control has been the core function of the internal audit profession for decades. However, before the new role of IAF was instituted in the *Definition of Internal Auditing* in 1999 by the IIA, there was great debate over the establishment of the boundaries of internal control definition (Maijoor 2000) and confusion over what were effective internal controls (Power 1997). Although it is assumed that internal control contributes to corporate governance, its real contribution has never been empirically proven. This has resulted in other stakeholders casting doubt over the extent of the IAF's contribution to corporate governance (Hermanson 2000).

In recent years, although the debate on definition and boundaries of internal control has significantly reduced, the new expanded role of the IAF<sup>70</sup> has rekindled new waves of debate among academic researchers and practitioners. Some posit that the revised definition is too grandeur resulting in internal auditors not able to deliver their own

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<sup>70</sup> As instituted in the new *Definition of internal auditing* (IIA 1999)

assertion (Chambers 2008). The new *Definition of Internal Auditing* (IIA 1999) is stipulated as follows:

*Internal auditing is an independent, objective assurance and consulting activity designed to add value and improve an organisation's operations. It helps an organisation accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control and governance processes.*

Under the *Definition of Internal Auditing* (IIA 1999) the three core internal audit activities are control, risk management and governance. The IAF are also expected to provide consultancy advice to add value and improve an organisation's operations. In this thesis, the expanded role of the IAF under the new *Definition of Internal Auditing* (IIA 1999) is referred to as the 'theoretical role' of the IAF. This study seeks to investigate whether the internal audit practices in Malaysia have fulfilled the 'theoretical role' of IAF and to gauge the AC participants' view on whether this 'theoretical role' will help to enhance IAF effectiveness in Malaysia.

#### **5.4.2.1 Control, risk management and governance**

This section considers the three core activities under the 'theoretical role'. The CAEs are responsible for establishing the IAF, whose scope of work includes the activities that revolve around the review of risk management, control and governance processes of an organisation (IIA 2013).<sup>71</sup> The IAF are expected to operate in accordance with the IA charter, IPPF standards and Code of Ethics in an efficient and effective manner so as to provide reasonable assurance to the various stakeholders.

Since the re-definition of the role and function of 'internal auditing' (IIA, 1999) by the IIA close to two decades ago, there has been a change in audit work from a system-based to a process-based to a risk-based auditing audit approach (IIA UK and Ireland 2003).

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<sup>71</sup> See Performance Standard 2100, Nature of Work (IIA, 2013).



This business-risk driven approach is a shift away from the traditional control-driven audit approach. Under a risk-based audit approach, instead of identifying and testing controls, the IAF identifies business risks and test how management mitigates those risks (McNamee 1997). This paradigm allows the IAF to look at the business processes in an environment of risks rather than looking at the business processes in a system of internal control (McNamee 1997). Under this risk-based audit, the IAF's focus is on 'how well are these risks being managed?' instead of 'are the controls over this risk adequate and effective?' (McNamee 1997). In short, the IAF have to place more emphasis on strategic analysis and business process evaluation (Campbell, Adams, Campbell, & Rose, 2006).

Under a risk-based approach, the IAF are expected to conduct a risk assessment before developing an audit program. The risk assessment entails identifying, measuring and prioritising risks so that focus is placed on the auditable areas of greatest significance (e.g. highest priority risk area) (Griffiths 2006; McNamee 1997). This enables the IAF to ensure resources are focused on priority areas. Jackson (2005) suggests the IAF share with management and the board the knowledge they acquire from the comprehensive annual risk assessments as well as from the risk assessments undertaken at the onset of the IAF engagement. McNamee (1997) reports that IAF service providers who adopt a risk-based auditing approach inform that it is easier to prepare and 'sell' the audit reports without creating unnecessary conflicts. As the IAF's role has moved from a 'controller' (e.g. to finger-point at an auditee on any controls weaknesses) to that of a 'controller-adviser' (e.g. whether risks have been adequately mitigated or managed), i.e. a partnership relationship with the auditee (McNamee 1997).

The traditional IAF are said to focus too much on the past, providing advice and recommendations based on examination of the historical transaction records and historical operation of the internal control system. A risk-based audit approach changes the entire audit vision. The internal auditors now shift their focus from the past to the future, thus add value to the organisation. A risk-based auditing approach also allows the internal auditor to reassess their position and remove excessive or outdated controls or those with low-priority (McNamee 1997). Moving forward, more academic researchers acknowledge

that internal auditors should play a more prominent role in monitoring an organisation's risk profile (Fraser and Henry 2007; Lindow and Race 2002).

In respect of risk management, the IAF's involvement as a 'controller' or third-line of defence as stipulated in the IIA's position paper *Three Line of Defence for Risk Management* (IIA 2013b). It clearly highlights that the operational unit (being the risk owners) are the first line of defence. They are to prepare a risk register, which identifies the risks, ranks and prioritises them and establishes the mitigating plans and strategies, for the review of the second line of defence (comprising the risk management officers). The IAF is the third line of defence in this structure, and their role is to review the risk register and mitigation plans and strategies to ensure critical risks are duly identified and adequate controls are in place to manage or address the identified risks.

In respect of governance, the scope of the IAF includes promoting appropriate ethics and values, ensuring effective organisational performance management and accountability, communicating risk and control information to appropriate areas of management, and coordinating the activities of and communicating information among the board, external and internal auditors and management (IIA 2013a).<sup>72</sup>

Compared to other aspects of IAF, there are a relatively few studies in the post-SOX era that examine the influence of key IAF service users on the nature of internal audit activities undertaken by the IAF. Leung, Cooper and Perera (2011)'s study examines the influence of the accountability structure (i.e. key IAF service users such as the AC and CEO) over the five core internal audit activities of internal control, risk management, compliance, corporate governance and financial reporting on public listed companies in Australia.

Leung, Cooper and Perera (2011)'s study reaffirms the perception that the IAF is the 'internal controls expert' and has significant influence over key management decisions on matters concerning controls and risks. However, in companies where the CAEs report only to the CEOs, significantly higher internal audit activities are focused on financial

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<sup>72</sup> See Standard 2110 – Governance, IIA, 2013

reporting. This finding is consistent with Abbott, Parker and Peters (2010)'s study, which suggests that the AC and senior management tend to compete for IAF resources in a manner that best meets their respective objectives. Hence, when CAEs report only to the CEO, it is possible that CEOs could divert IAF resources away from other IAF value-add activities to those that (in the senior management's view) could produce immediate and contemporaneous cost savings, for example, to assist external audit in financial reporting matters (Gray 2004; Anderson and Reeb 2003).

Leung, Cooper and Perera (2011)'s study also reports that the corporate governance function does not rank highly across the various categories of accountability structure. Generally, the CAEs are expected to present key audit reports on a 'regular' basis covering internal control, risk assessment and compliance and on 'ad hoc' basis covering corporate governance and financial reporting (Leung, Cooper and Perera 2011).

A review of the Malaysian literature failed to identify studies examining the nature of internal audit activities in practice among listed issuers after the implementation of the mandatory IAF ruling. Hence, it will be interesting to explore what the prevailing internal audit practices are and what the AC's perspective is on the nature of internal audit activities that would best support them in achieving their governance obligations.

#### **5.4.2.1 Assurance versus consultancy role**

Based on the IIA (2000)'s pronouncement, the IAF's role has been extended to include more consultancy-based reviews (Fraser and Henry 2007; Beasley, Clune and Hermanson 2005; Page and Spira 2004) as opposed to its traditional function, which focused on financial audits and compliance. This role requires the IAF to focus on integrated audits of governance, risk management and controls as well as to help managers understand enterprise-wide risks and manage them so as to achieve their expected targets.

Before 2000, the prediction is the IAF would move away from basic assurance work to focus more on consulting assignments to add value to organisations. However, the series of corporate scandals such as Enron and Worldcom and the introduction of SOX (2002)

in the US and the Combined Code of Corporate Governance in the UK<sup>73</sup> caused the profession to refocus their internal audit activities to financial reporting risks controls. For instance, PwC (2006)'s survey of internal audit managers reveals that 50% of IAF resources are tied up to meet SOX (2002)'s first-year compliance. PwC (2007)'s *Internal Audit 2012 Report* based on Fortune 250 company CAEs' views of future IAF work scope for the next five years (2007–2012) reveals two distinct IAF models, one which focuses on traditional assurance around adequacy of internal controls and one with a strong emphasis on SOX compliance work. It is apparent that companies' resources are being channelled into compliance rather than revenue-generating activities (Abbott, Parker, Peters, & Rama, 2007; Hass, Abdolmohammadi and Burnaby 2006). The over-emphasis on a compliance role may drain IAF resources from broader issues in supporting corporate governance of organisation (Hass, Abdolmohammadi and Burnaby 2006).

Interestingly, there appears to be a theory-practice gap in the undertaking of IAF activities in practice. The CBOK 2010 study revealed that only 57% of the IAFs include enterprise-wide risk management ('ERM') processes in their work (IIARF 2010b). Corporations are overly focused on operational and control risk (PwC 2009; Ernst & Young 2008) at the expense of strategic and business risk (PwC 2009). Researchers have called for a realignment of the IAF role in strategic and business risks. PwC (2010) echoes this sentiment and recommends the IAF focus on critical risks and issues and align its value proposition with stakeholders' expectations.

While the involvement of the IAF in risk management is desired, the IIA Position Statement (2004) cautions that the IAF should not play an 'operational role' in ERM but a 'reviewer role' to ensure the ERM 'provides an objective assurance to the board on effectiveness of an organisation's activities to help ensure key business risks are being managed appropriately and that the internal control system is operating effectively'.

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<sup>73</sup> The Combined Code amalgamates the recommendations of the Cadbury, Greenbury, Hampel and Turnbull Committees. Companies listed on the London Stock Exchange are required to comply with the Code, reporting on how the provisions have been implemented and explaining any instance of non-compliance.

However, the IAF may be required to perform beyond the ‘reviewer role’ since there could be a misalignment of CEO’s perception on what the IAF can deliver in reality. Cooper, Leung and Mathews (1994) suggest this could be due to the lack of understanding by CEOs of the audit process and support ‘mechanical’ aspects of the process as opposed to a ‘management/review-oriented’ role of the IAF. Although Cooper, Leung and Mathews (1994)’s study was conducted more than two decades ago (prior to the enactment of the revised definition of ‘internal auditing’ (IIA, 1999)), it will be interesting to investigate whether the Malaysian top management share the same view as that reflected in the study.

The IIA posits that to be effective; the IAF should provide value-add services to the organisation. However, the IIA is not explicit in what constitutes value-add activities. In addition, the IAF is also expected to perform a consultancy role in addition to the traditional assurance role. Extant literature has cautioned that the IAF should be mindful not to overstep their role and compromise on their objectivity (Stewart and Subramaniam 2010). After a discussion of the nature of internal audit activities that inform its ‘theoretical role’, the next section seeks to consider how the internal audit activities are being evaluated.

### **5.4.3 Evaluation: performance evaluation**

In the evaluation of the IAF performance, the IIA (2013a)<sup>74</sup> requires the CAE to develop and maintain a Quality Assurance and Improvement Program (‘QAIP’). The QAIP includes both internal and external assessments.<sup>75</sup> The internal assessment includes ongoing monitoring (i.e. day-to-day supervision) and periodic self-assessment or assessment by a third-party within the organisation. The internal assessment seeks to ensure that the IAF is implemented in conformance with the *Definition of Internal Auditing* (IIA 1999) (or the ‘theoretical role’), Code of Ethics and Standards in the IPPF. The tools or processes used in ongoing monitoring includes audit and procedures manual or checklists, feedback from auditees and other stakeholders, project budgets, timekeeping

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<sup>74</sup> See Standard 1300, Quality Assurance and Improvement Program (IIA, 2013)

<sup>75</sup> See Standard 1310, Requirements of the Quality Assurance and Improvement Program (IIA, 2013).

systems, audit plan completion and cost recoveries, and analyses of other performance metrics (e.g. cycle time and recommendations accepted). Periodic internal assessments may include in-depth interviews with stakeholder groups, self-assessment by the IAF, assessment by an independent and competent audit professional (e.g. CIA), or benchmarking against best practices of the internal audit profession. The CAEs are expected to report the results of the internal assessment to the senior management and board at least annually (IIA 2013a).<sup>76</sup>

In addition to internal assessment, the IAF is also required to engage in external assessments, which must be conducted at least once every five years by a qualified, independent assessor. It can be in the form of a full external assessment or a self-assessment with an independent external validation (IIA 2013a).<sup>77</sup> The assessor must demonstrate their competency (internal audit experience in companies of similar size, complexity, sector/industry or technical issues), theoretical learning and independence (i.e. free from actual or apparent ‘conflict of interest’ relationship), and they must also have high a standard of integrity and objectivity in undertaking their tasks. The external assessment entails a broad scope of coverage, requiring the IAF to conform with the *Definition of Internal Auditing* (IIA 1999), IPPF Code of Ethics and Standards, IA charter, audit plans, policies and procedures plus applicable legislative and regulatory requirements; the IAF to meet the expectation of the board and senior management; the IAF to integrate with governance processes of organisation; and the IAF to add value and improve the operations of the organisation. The external assessor is required to express an opinion and make any recommendations for improvements, where appropriate. The CAEs are required to communicate the action plan and implementation dates together with the external assessor’s opinion to the board and senior management.<sup>78</sup>

It is suggested that the QAIP process be performed by or under the direct supervision of the CAE. However, for large or complex environments (e.g. numerous business units

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<sup>76</sup> See Practice Advisory 1311-1, Internal Assessments (IIA, 2013).

<sup>77</sup> See Standard 1312, External Assessments (IIA, 2013).

<sup>78</sup> See Practice Advisory 1312-1, External Assessment, (IIA, 2013).

and/or locations), the CAE may establish a QAIP function to be headed by an internal audit executive (with limited staff), independent of the audit and consulting segments to monitor the IAF.<sup>79</sup> The IIA posits that the CAE is responsible for ensuring the IAF is implemented in an effective and efficient manner and in accordance with the IA charter (consistent with the *Definition of Internal Auditing* (IIA 1999)), the Code of Ethics and IPPF's Standards so as to provide reasonable assurance to the various stakeholders as well as to impress upon them IAF's value-add to the organisation.<sup>80</sup> It is suggested that focusing on improving the internal audit process is an important activity that will improve the key users' perception over the IAF's performance (Elliott, Dawson and Edwards 2007).

A global study by Ernst & Young (2007) reveals that the top two widely used measurement metrics of IAF effectiveness are the completion of audits in comparison to the audit plan and the length of time in issuing IAF reports. The survey findings also suggest that to demonstrate the value and relevance of the IAF, value tracking (e.g. cost savings and/or revenue enhancements) should be adopted. However, based on the Ernst & Young (2007)'s report, 51% of respondents do not perform any value tracking of the IAF, and only 13% measures the IAF based on actual cost savings. The Ernst & Young (2007)'s findings reveals a lack of industry commitment to evaluate IAF performance. This has resulted in the IAF not being able to evaluate its value-adding role of enhancing governance effectively.

The IIA suggests that to be effective, the IAF should extend beyond its traditional assurance role to engage in value-add activities (e.g. consultancy role). However, the 'theoretical role' as depicted in the *Definition of Internal Auditing* (IIA 1999) is not only multi-faceted but is also extensive and complex in nature (Lenz and Sarens 2012). However, the performance evaluation mechanisms of IAF have not evolved contemporaneously. Dominic and Nonna (2011) suggest that the misalignment between

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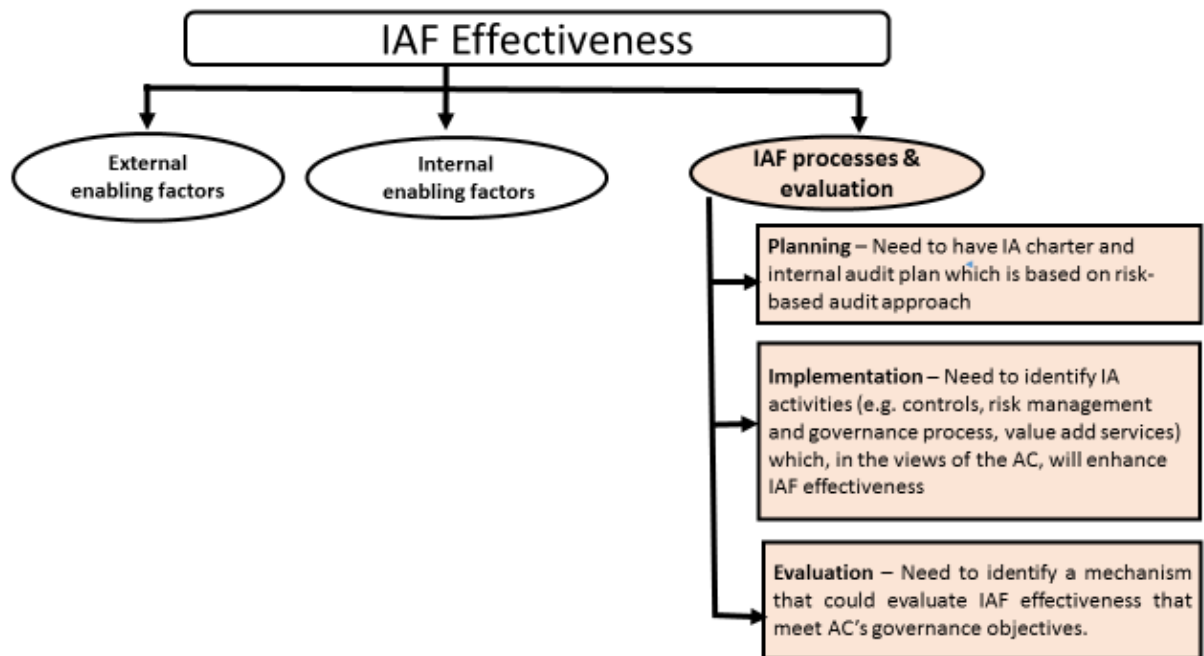
<sup>79</sup> See Practice Advisory 1300-1, paragraph 3, IIA (2013).

<sup>80</sup> See Practice Advisory 1300-1, Paragraph 2, IIA (2013).

the role and evaluation has given rise to difficulty in assessing the extent to which the internal audit activities are meeting stakeholders' expectations.

Hence, it will be interesting to explore to what extent the IIA's QAIP is adopted in practice and to garner the AC participants' perspective on whether such evaluation mechanisms are relevant in enhancing the effectiveness of IAF in Malaysia. There has been no prior study conducted in this aspect of IAF. A summary of the constructs identified to inform 'internal audit practices' (being the third component of the conceptual IAF effectiveness framework) is presented in Figure 5.4.

**Figure 5.4: Conceptual IAF effectiveness framework (Third component – internal audit practices)**



## 5.5 Overview and the Conceptual IAF Effectiveness Framework

The objective of this thesis is to develop a conceptual framework which from the perspective of the AC participants, as the key IAF stakeholders, best supports them in meeting their monitoring obligations. Based on the preceding discussions, a conceptual IAF effectiveness framework with three core components has been established.



The first component depicts the external enabling factors that are beyond control of corporations but could impact on effective practice of the IAF in Malaysia. The two external enabling factors under consideration are the rules and regulations and the role of professional body, that is, the IIA. Malaysia is one among the few countries worldwide that requires its listed issuers to establish an IAF. It goes a step further to require the IAF to report directly to the AC. Hence, it will be interesting to investigate whether the existence of mandatory rulings have indeed provided support for better corporate governance and enhanced IAF effectiveness. It is also necessary to consider the role of the IIA in support the development of the internal audit industry in the context of quality monitoring, professional guidance and training as the IIA is the sole global professional body for the internal audit profession.

The second component depicts the internal enabling factors which are within the control of corporations and could have consequential implication on effective practice of the IAF. The three internal enabling factors under consideration are AC support, organisational support and IAF resources. In Malaysia, the AC are entrusted with the monitoring role over the IAF. However, only an effective AC can lend support and augment IAF effectiveness. In addition, organisational support such as commitment of top management to corporate governance (tone at the top) and clarity of the IAF's organisational status are considered crucial to support an effective IAF. The third internal enabling factor under consideration is the adequacy of IAF resources (staffing and budget allocation etc.)

The third component depicts the internal audit practices based on the IPPF. The discussion focused on the three core processes: planning, nature of internal audit activities and evaluation. The comprehensive conceptual IAF effectiveness framework is presented in Figure 5.5.

It is important to accentuate that the key enabling factors identified in the Conceptual IAF Effectiveness Framework as presented in Figure 5.5 is by no means exhaustive nor conclusive. A three-component framework has been adopted in this study. The intention is to categorise the contextual and environmental factors that could impact on internal audit practices (the third component) into 'internal enabling factors' (second component) and 'external enabling factors' (first component). The categorisation is made to

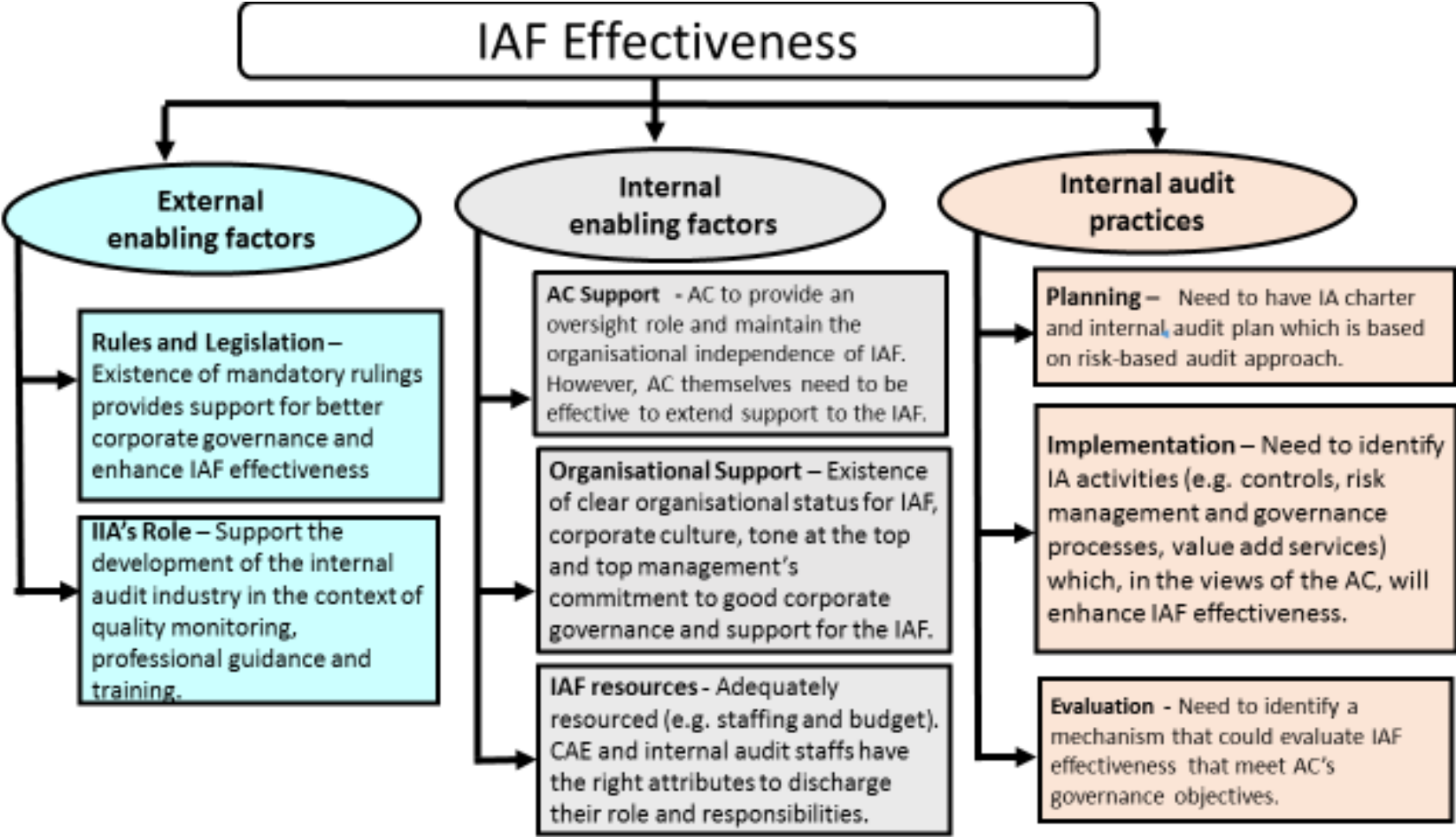
differentiate the factors that are within the control of the organisation (termed as the ‘internal enabling factors’) from those beyond their control (termed as the ‘external enabling factors’).

This is an exploratory study which attempts to develop a framework that identifies the key enabling factors (both internal and external) which could impact on the effective practice of IAF. No framework of this nature has previously been developed. Hence, this conceptual framework can be relied on as the basis for future studies of similar nature.

## **5.6 Chapter Summary**

Chapter 4 highlighted the two-phase research design employed in addressing the research objectives and questions of this study. This chapter addressed Phase I of the two-phase research design – to develop a conceptual IAF effectiveness framework. Chapter 6 seeks to address Phase II of the two-phase research design, which is to conduct a qualitative field study (i.e. interview the AC participants) and to confirm/negate or refine the conceptual IAF effectiveness framework developed after critical literature review in this chapter.

Figure 5.5: Conceptual IAF effectiveness framework



## **CHAPTER 6: REFINEMENT OF CONCEPTUAL IAF EFFECTIVENESS FRAMEWORK**

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### **6.0 Introduction**

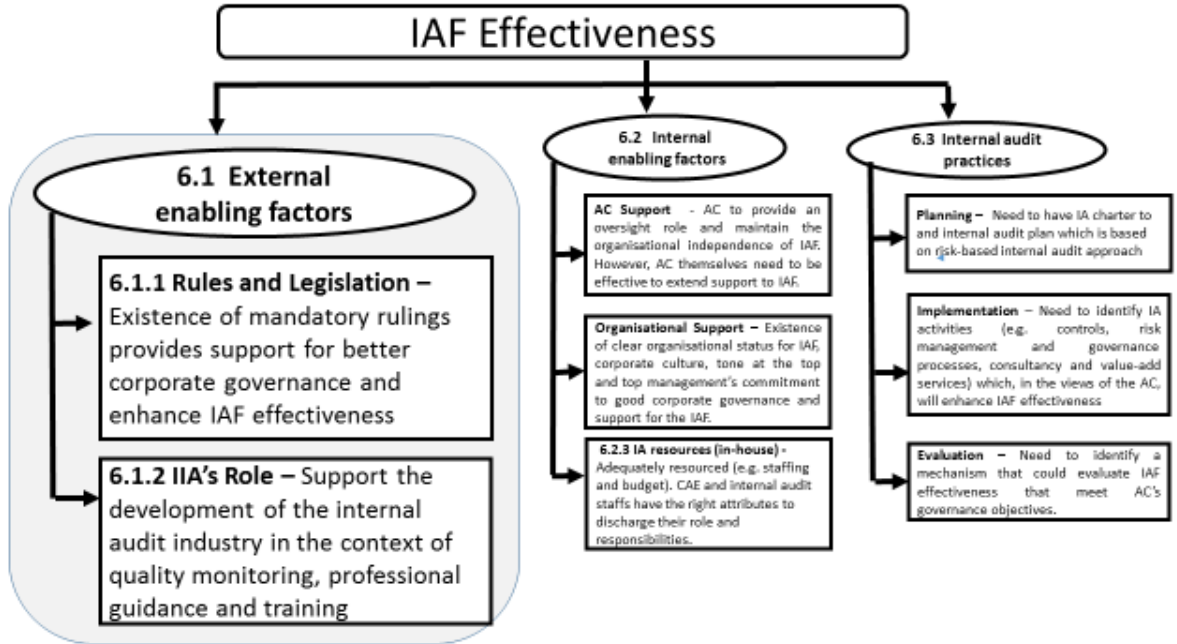
This chapter, through a series of semi-structured, in-depth interviews with AC chair and AC members of the Main Market listed issuers in Malaysia, seeks to confirm/negate or refine the constructs identified in the conceptual IAF effectiveness framework as developed in Chapter 5. Specifically this chapter addresses RQ2, ‘To what extent does the IAF effectiveness framework meet the AC’s expectation in fulfilling their governance obligations?’ and RQ3, ‘To what extent is the IAF effectiveness framework practised by the IAFs of the Main Market listed issuers in Malaysia?’ The discussion of the AC findings for RQ2 and RQ3 are combined to better reflect the flow of thoughts and responses of the AC participants. The chapter is structured around the conceptual IAF effectiveness framework and is organised as follows. The first and second sections address the external and internal enabling factors that could impact on the effectiveness of the internal audit practices in Malaysia through the lens of the AC. The third section of this chapter presents the internal audit practices in Malaysia vis-a-vis the ‘theoretical role’ (as defined in the *Definition of Internal Auditing* (IIA 1999)). The refined conceptual IAF effectiveness framework is developed after incorporating the AC participants’ views and is presented in the final section of this chapter.

### **6.1 External Enabling Factors (First Component)**

The first component of the conceptual IAF effectiveness framework as identified in Figure 5.5 is the external enabling factors. The two constructs identified are the rules and legislations and the IIAM’s role, discussed in sections 6.1.1 and 6.1.2 respectively. During the AC interviews, a new theme emerged, that is, the readiness of the internal audit industry to cope with the rising demand for internal audit professionals. This new emerging theme is included as the third external enabling factor and is presented in section 6.1.3. A summary of the key findings and the refined external enabling factors

(first component) is presented in section 6.1.4. The conceptual IAF effectiveness framework is reproduced in Figure 6.1.

**Figure 6.1: Conceptual IAF effectiveness framework (first component – external enabling factors)**



### 6.1.1 Rules and legislation

The regulatory framework constitutes the most significant pillar of institutional theory (DiMaggio and Powell 1983). In a highly regulated country like Malaysia, the policymakers are expected to take lead in any major structural reforms to the corporate governance landscape of the country. On the same note, in a study of IAF effectiveness it is essential to review the principal ruling that governs the internal audit practices in Malaysia. The benchmark IAF-related ruling is presented as follows:

*The board should establish an internal audit function which reports directly to the audit committee.*<sup>81</sup>

<sup>81</sup> Principle 6, Recommendation 6.2 of CG Code (2012) and Paragraph 15.27, Listing Requirements (2011)

This benchmark ruling has two requirements: first, that all listed issuers establish an IAF in their listed issuers; and second, that the IAF report directly to the AC. The AC participants' views are structured around these two key requirements and are presented in the following sections.

### **6.1.1.1 Mandatory IAF establishment**

Malaysia is one among the few countries worldwide that has mandated the establishment of the IAF for its listed issuers. All the AC participants support the regulators lead in mandating the establishment of an IAF, although some suggest that the ruling should have been introduced earlier. The support for the mandatory IAF ruling is reflected in the AC participants' statements below:

[AC#3] [...] yes, you need to make it mandatory for any improvements to be brought into our capital markets.

[AC#11] Because making it mandatory - forces the directors, the management and the AC to think seriously about the internal audit function. If it is not mandatory, then I think people will not give it the consideration that it deserves and that is also helped by the fact that there are penalties for not doing it. [...] So it's a little bit of carrot and stick if you like.

The last quote also reaffirms the 'wait and see' mentality of the Malaysian business community, which would not volunteer to establish an IAF without enforcement by the regulators.

Having said that, all AC participants acknowledge that the IAF plays a significant role to support the AC in fulfilling their governance obligations. The mandatory ruling has also changed the perception of top management on the IAF, resulting in an overall improvement in the control environment of listed issuers. The views of the AC participants are reflected in the statements below:

[AC#2] Having an IAF, I think is critical and paramount. I always tell my members that IA [internal audit] actually is the hands, mouth, legs and nose of the audit committee. Basically, the IA serves as an extension to do what the audit committee physically cannot do.

[AC#7] There have been improvements from the time when we - there was no such function so at least now there's more focus from the board on internal controls. [...] Definitely there has been an improvement over the years. Of course, some companies do it better than others. But, generally, we have improved.

The last quote also suggests a gap in the internal audit practices among listed issuers. This could be due to the fact that while the regulators have mandated the IAF, they are less explicit in the operation of the IAF. Consequently, this has accorded listed issuers the flexibility in the structural and functional make-up of the IAF. Some AC participants have expressed concern over the fact that smaller listed issuers are complying with the mandatory ruling in ‘form’ and not in ‘substance’ (i.e. form over substance). These listed issuers either out-source their IAF (with limited scope audit engagement) or establish a ‘skeletal’ in-house IAF (with one or two relatively ‘junior’ internal audit staff). This may implicate an attempt by certain listed issuers to decouple the mandatory IAF ruling. This AC participants’ view is reflected in the statement below.

[AC#6] Again, form over substance. Many, I think, I can’t say for a fact that I believe many companies are just complying with form. The regulators asked you for an IA, so either they go and engage some small out-sourced providers to come in and do a few audits, then at least they can disclose in their annual report - yes, we have internal audit. Or if they have an in-house team, the tendency will be to recruit somebody quite junior. Cheaper. Because if you want a senior person, you have to pay quite a lot in terms of not just the remuneration package but also all other add-ons. So the supply and demand situation is such that to get somebody good, experienced, you’re going to have to pay and many people are not willing to pay.

In summary, despite some concerns over its practice, all AC participants confirm that the mandatory IAF ruling is a necessary move by the regulators to enhance effectiveness of IAF in Malaysia.

#### **6.1.1.2 Direct reporting to the AC**

Another requirement of the benchmark IAF ruling is for the IAF to report directly to the AC. A majority of the AC participants perceive this requirement as critical as it derives benefits to both the AC and the IAF. On one hand, the IAF can garner greater organisational independence by reporting directly to the AC, and the AC can seek comfort from the IAF on company-specific information when fulfilling their governance obligation. This direct reporting ruling will also absolve the IAF from the ambiguity of ‘who is my master - the senior management or the AC?’ (see Abbott, Parker and Peters 2010). This AC participants’ view is reflected in the statement below:

[AC#11] I think if you really want the internal audit function to be independent, you have no choice but to make it entirely direct line to the AC. [...] Otherwise, the internal audit personnel will have a conflict - who is my boss? Who am I reporting to? He may get differing requests as to what needs to be done.

Prior literature suggests that in achieving their conflicting objectives,<sup>82</sup> the AC and senior management are normally in competition for IAF resources (Gray 2004). Strangely, all the AC participants deny the existence of any apparent conflict between the AC and senior management over the 'direct reporting' to the AC ruling. Further discussions with the AC participants reveal that while the regulators require the IAF to report directly to the AC, a 'dual reporting'<sup>83</sup> structure is a common practice in Malaysia as the AC are non-executive directors and are not involved in the daily operation of the listed issuers; thus for practical reason a 'dual reporting' structure has been widely adopted by listed issuers in Malaysia.

Further discussions with the AC participants reveal that listed issuers do not fully comply with the 'dual reporting' provisions as stated in the Practice Advisory 1110-1, IIA (2013a). The IIA's guidance suggests that all matters relating to the CAE, for example, hiring, firing, performance appraisal and remuneration package, should lie in the hands of the AC. However, in Malaysia, although the hiring and firing decisions of the CAE lies with the AC, the performance appraisal, increment and remuneration package of the CAE are still decided by senior management. This is reflected in the AC participant's statement below:

[AC#2] For practical reasons it doesn't work out as well as the law intends to be. Even though the line of reporting is to be from the IA to the audit committee. But day-to-day operations, the pay master is still the management. So sometimes this put a lot of pressure on the IA, particularly the CAE. Because on one hand they know that they are responsible to the audit committee; on the other hand, they know their increment, the recommendation comes from the management.

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<sup>82</sup> This is because senior management view IAF as a means to achieve operational goals and generate cost savings (e.g. by supporting the external auditors), while the AC view the IAF as a means to meet their heightened monitoring obligation.

<sup>83</sup> The 'Dual reporting' structure is a proposition of the IIA (2013). Under 'dual reporting' structure, the IAF is to report 'functionally' to the board (including the AC) and 'administratively' to the CEO. (See Standard no. 1110 Organisational independence and Practice Advisory 1110-1).



The last quote suggests that the organisational independence and objectivity of the IAF (including the CAE) may be compromised if the AC do not have direct control over IAF resources. This concern is best illustrated in the AC participant's statement below:

[AC#11] If I'm the internal auditor - who's my boss? Who is more important for my livelihood? The CEO or the AC chairman? Human behavior is - a function of who decides my livelihood.

The two previous quotes suggest that the IAF may have a tendency to align with the party they perceive has the greater influence over their livelihood. This could explain the AC participants' overwhelming support for the 'direct reporting' to AC ruling as the AC participants are seeking legislative endorsement to enhance their formal organisation power vis-a-vis the senior management in order to gain the IAF's 'loyalty'.

The senior management's ability to exert significant influence over the monitoring mechanism vis-a-vis the AC may be a cause of concern. However, several AC participants comment that the stricter governance rules and mounting litigations against senior management in recent years may have led senior management to reconsider their management approach. The fear of litigation loss (e.g. legal cost and jail term) and reputational risk may deter their propensity to 'managerial opportunism'.<sup>84</sup> Consequently, their objectives may align with that of the AC. This is reflected in the AC participant's statement below:

[AC#5] I think top management is adjusting to it. [...] I think because top management may not be aware of what is in detail in operations. Maybe you leave it to operation manager so if the internal auditors are able to bring up something for their attention and direct to AC, they also like that. So that they also feel comfortable because they are answerable to investors public.

Although acknowledging the 'direct reporting' to the AC ruling will eventually lead to effectiveness of the IAF, one AC participant however warns that adherence to the ruling in its strictest form is not practical for organisations as it may cause unrest among co-workers and run the risk of empire building within organisation. This is reflected in the AC participant's statement below:

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<sup>84</sup> The third assumption of agency theory (Jensen and Meckling 1976).

[AC#3] [...] how do you have this management structure when someone on a day-to-day basis reports to the CEO, which is a must. Otherwise you undermine - you are not creating another empire within an organisation. It's not healthy.

In summary, the majority of the AC participants agree that 'direct reporting' to the AC will enhance the IAF's organisational independence and consequently lead to its effectiveness. They also confirm that for practical reasons a 'dual reporting' arrangement is commonly practised by listed issuers in Malaysia. However, the AC participants' main concern is their lack of control over IAF resources (e.g. the CAE's performance appraisal and remuneration package decision), which may cause the IAF to align with senior management and consequently compromise on the IAF's organisational independence and objectivity.

### **6.1.2 The role of the IIAM**

The second construct of the external enabling factor is the influence of the IIAM on IAF effectiveness in Malaysia. The IIAM is a chapter of IIA Global<sup>85</sup> and as such is expected to play a significant role in supporting the development of the internal audit profession in Malaysia. It is expected to extend its professional support to its varied stakeholders including the regulators and other corporate governance stakeholders (e.g. the senior management and AC) as well as its own members. The IIAM's professional support could come in various forms, such as provision of professional guidance (e.g. IPPF and other professional pronouncements), professional examination/certification, continuing education and training, collaboration with the policymakers in the development of corporate governance rules and code, and IAF quality monitoring. To gauge the AC participants' view on the IIAM's professional support to the business community, this thesis focused specifically on the IIA's professional guidance and the IIAM's monitoring support. The AC participants' views are presented in the following sections.

#### **6.1.2.1 The IIA's professional guidance**

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<sup>85</sup> The IIA Global is the sole global professional body for the IA profession.

A majority of the AC participants are not familiar with the IIA's professional guidance and do not rely on the IIA's IPPF in fulfilling their monitoring duty. This is an interesting finding considering more than 75% of the AC participants are deemed 'financial experts', that is, current or retired audit partners of public accounting firms (ranging from sole proprietorship to Big Four firms) with extensive external audit experience and knowledge. Their unfamiliarity with the IPPF provisions could have great implications. It could infer a greater number of AC appointees (who are non 'financial expert') may have lesser knowledge of the IPPF and lesser appreciation of the IAF role and function. This is highlighted in one of the AC participant's statements below:

[AC#7] In fact, for myself even though I am in practice,<sup>86</sup> I'm not conversant with the internal audit standards too. Because they are not well publicized. I think we need education on what standards are actually in place and what is the methodology. [...]. I think the IIA should be more aggressive in this to publicize what are the standards - minimum standards and so on. [...] I think that they're a professional organization so they need to focus more on the professional activities and not just their membership.

This AC participant continues:

[...] They seem to be like a training organization for external parties and holding a lot of conferences and seminars and charging very good fees.

The last quote shows the AC participants generally perceive the IIAM as active in organising revenue-generating events (e.g. conferences, seminars and training programs) and membership drive events instead of supporting the business community as a professional body. The AC participants believe that the IIAM should take a more proactive role in engaging with its stakeholders, particularly the AC, who are entrusted with the direct supervision role over the IAF. This lack of knowledge of the IPPF provisions and other IIA pronouncements may affect the AC's ability to vigorously scrutinise the quality of the IAF work and consequently impact on the effectiveness of the IAF. This AC participant's view is reflected in the statement below:

[AC#7] I merely asked what methodology are they carrying out, is it in conformity with the standards as prescribed by the Institute of Internal Auditors and so on. I ask these kind of questions but really I don't have a good understanding of what those standards are.

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<sup>86</sup> This AC participant is a managing partner of a medium-sized public accounting firm.

In summary, it is apparent that from the perspectives of the AC participants, the IIAM has an important role to play. However, the IIAM has to heighten its professional presence and be more proactive in engaging and supporting the business community, specifically the AC. Since greater infusion of professional culture is only possible with the support of the AC, being the key IAF stakeholder who has been entrusted the role to directly oversee the IAF in listed issuers.

### 6.1.2.2 The IIAM as a monitoring agent

While the Malaysian regulators have mandated the establishment of an IAF in listed issuers, the internal audit industry itself is not regulated. The IIAM's monitoring power is confined to internal audit practitioners who are its members (corporate or individual through either certification or professional membership).<sup>87</sup> As such, to ensure a certain standard of IAF quality is maintained, the majority of the AC participants agree that the internal audit industry needs to be regulated or monitored as reflected in the statement below:

[AC#10] I personally as an external auditor, I also think that is very important to have a very competent internal audit. But seeing the industry, you don't have the comfort and I don't understand how the independent directors can be comfortable. [...] You need to have a body, you need to have a body to also regulate or monitor.

However, the majority of the AC participants do not believe that the IIAM is the appropriate institution to be accorded the legislative backing to monitor or regulate the internal audit industry. A lack of resources (e.g. manpower) and a small membership base<sup>88</sup> have been cited as its two main drawbacks. This is reflected in the AC participant's statement below.

[AC#13] Not the correct time I would say. Because if we were to mandate IIAM, they do not have enough members then - I think quite a number of PLC will end up with no internal audit, then that will have an industry issue. [...] My proposal is that [...] until the day the IIAM can create the kind of value for the PLC.

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<sup>87</sup> Professional membership is awarded to IA practitioners who are member of professional bodies (e.g., ACCA, MICPA, CIMA) but has been in internal audit practice for more than 3 years. Such professional membership is known as The Chartered Member of the Institute of Internal Auditors Malaysia ('CMIIA')

<sup>88</sup> The IIAM has a membership (corporate and individual) of about 3,000 and 800 CIAs (source: <http://www.iiam.com.my/index.php/profile/>) Date downloaded : 29 September 2016

One AC participant, who supports legislative backing for the IIAM, acknowledges that the IIAM needs to be more proactive in supporting the business community in order to raise its professional presence and influence as reflected in the following statement:

[AC#7] I think without legislative backing it would be very difficult to enforce. But again, the IIA must be able to stand up to meet their professional expectations. You can be a professional body. You can be designated by the government. You can be made mandatory. But at the end of the day, they must also perform.

For purpose of effective monitoring, the AC participants are asked whether all internal audit practitioners should be a CIA<sup>89</sup> or be required to register as a member of the IIAM. The majority of the AC participants do not view this as necessary. In their view, internal audit practitioners who are members of other professional bodies (MICPA, ACCA, CIMA, CAANZ etc.) could also discharge the IAF role competently. In addition, specialised industries may need internal audit practitioners with specialised skill sets (e.g. oil and gas, insurance). This is reflected in the following statement:

[AC#3] [...] from a Bursa's perspective, we shouldn't micro-manage. We leave it to the organisation. They should know. You know what are your requirements, if you feel that the person is performing, its fine. And like I said an internal audit doesn't have to be a member of IIAM.

This AC participant continues:

[...] we would definitely encourage all our people to do IIAM examinations. [...] In [PLC-A], the CAE herself is a CIMA member but her team, she has taken staffs with various skills - investment analyst who had worked in stock exchanges overseas and IT graduates.

In summary, although majority of the AC participants agree that the internal audit industry needs to be monitored, the majority of them do not believe the IIAM is the appropriate institution to be accorded the legislative backing to regulate the internal audit industry. It is apparent that the regulators are leaving it to the market players to decide on the best course of action in addressing the concern over the quality of internal audit service providers and practitioners.

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<sup>89</sup> The professional qualification of the IIA.

### **6.1.3 Internal audit industry readiness (a new emerging theme)**

During the AC interviews, a consistent theme that emerged was the lack of competent and qualified internal audit professionals to meet the heightened market demand. In order to comply with the mandatory IAF ruling, many listed issuers have out-sourced their IAF to third party internal audit service providers or an outside internal audit firm ('out-sourced IAF'). In the AC participants' view, although the compliance issue is met, the quality of the IAF deliverables remains an industry-wide concern. The two main issues consistently raised by the AC participants are human resource shortages and the quality of internal audit service providers.

#### **6.1.3.1 Human resource shortages**

A common view expressed by the AC participants is the difficulty in recruiting and retaining qualified and competent internal audit staff, which in turn significantly affects the quality of the IAF deliverables. This is reflected in the AC participant's statement below:

[AC#12] First of all, you have difficulty in hiring talent in internal audit and secondly in retaining talent. But then even in [PLC-B] where it's a very big company, hiring and retaining talent in internal audit is still extremely difficult. There's obviously a shortage of professionals in this profession. [...] Generally, there's difficulty in finding experienced and qualified members of the internal audit team. Our company has got vacancies that could not be filled up. [...] The one area of difficulty is also in getting the experienced auditors in information technology to do systems work.

This AC participant's view is echoed in another AC participant's statement as follows:

[AC#6] Once you have enough experience, people will always be looking for managers and heads of internal audit. So they will tend to be poached by the head hunting firms.

An AC participant comments that the current pool of internal audit professionals are previously in-house internal audit staff of government-linked corporations, larger listed issuers (e.g. FTBM100 companies)<sup>90</sup> or financial institutions as these organisations have a long history of IAF establishment. However, in the AC participants' view, although these internal audit professionals have the skill set of

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<sup>90</sup> FTBM100 companies refers to the top 100 largest public companies (in terms of market capitalisation) listed on the Main Market of the Bursa Malaysia

internal auditing, they may not have the relevant industry experience. This is reflected in the AC participant's statement below:

[AC#5] Most of the IA existing in the market - actually they are all in-house IA from other larger corporations, like Lion Group.<sup>91</sup> I understand Maybank<sup>92</sup> has 190 IAs. [...] a few resigned and are in the market, that's how we have them but they are not specialised in our industry.

The inability of the IAF industry to attract or retain internal audit professionals (particularly young professionals) could be due to problems inherent in the internal audit profession. Several AC participants comment that these problems may relate to the nature of the internal audit job (e.g. stress, loneliness, boredom due to job familiarity) and the prestige attached to the internal audit profession (e.g. lack of career progression).

The AC participants' views on the impact of the nature of the internal audit job are reflected in the statements below:

[AC#6] It's very difficult to keep them because - the job itself is, maybe a little bit difficult, stressful - so some people will leave internal audit after a while. Maybe they just used it as stepping stone.

[AC#11] You hire someone and you must expect that in two or three years these challenges will happen. They may want to move on, they're bored, and they get too familiar. It's not a job that you will stay on forever.

[AC#7] Again, the corporation must have sufficient size to give them an adequate scope of work. I think that's also very important, not just about the remuneration or the financial package. It must be an interesting job for them too.

[AC#5] You have to write report, you have to go and visit the site - too much work, and they will leave after a while. So that's why we encourage the management to get a few more so that they have a team. Segregate out the work then they find that it's challenging then they will stay. You have to make an environment. If the senior staff is good, the junior staff will be okay.

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<sup>91</sup> The Lion Group is a conglomerate Main Market listed issuers. It has operations in Malaysia, China, Singapore, Indonesia, Vietnam, Hong Kong, Cambodia, Myanmar, USA and Mexico. It is involved in the retail, property development, mining, steel, agriculture and computer sectors. <http://www.liongroup.com.my/> (updated on 8 February 2017)

<sup>92</sup> Maybank Berhad is the largest listed company on Bursa Malaysia. It is also the largest banking and financial group in Malaysia. It has branch offices in Singapore, London, New York, Hong Kong and Bahrain. <http://www.maybank.com/en/index.page> (Updated on: 8 February 2017)

The AC participants' view on the impact of the prestige attached to the internal audit profession are reflected in the statements below:

[AC#8] Not everybody wants to work as an IA. It's not a glamorous job. If I'm going to do audit, I may as well join a Big Four company for a couple of years, I'll probably be a partner if I put in the hard work. But here, IA is a dead-end job. What can they promote you to? CEO? No. You'll always be an IA.

[AC#9] Once you've been transferred to internal audit, it's like some of them told me they feel as though they've gone to Siberia. So they're lost from the mainstream.

In addition, the AC participants suggest that the high turnover of experienced internal audit professionals could be partly attributable to frustration at the lack of intra-departmental support (e.g. incompetent junior staff, job overload) and inter-departmental support (e.g. uncooperative colleagues) as highlighted in the statement below:

[AC#5] If you engage me as a team leader, I don't have assistant, I have to do all by myself. If the junior that you take in [recruit] is not knowledgeable in that area, by teaching them, I would have finished the job already. So the team leader normally will leave - the junior normally will stay.

This AC participant continues:

Some actually leave because of they can't get cooperation from certain level - top management level especially - like factory manager. They don't want to give you more information. The storekeeper don't want to give you more information; then you find that you can't get the cooperation, you might as well go to another company because you are in demand now.

In summary, the industry's inability to attract and retain internal audit professionals (particularly young professionals) is mainly due to the nature of the job and the prestige attached to the profession. In addition, the high staff turnover at senior internal audit staff levels are 'due to staff-poaching' [AC#6] or lack of cooperation from intra- or inter-departmental colleagues.

### **6.1.3.2 Quality of internal audit service providers**

The shortage of qualified internal audit professionals in the marketplace has resulted in a majority of the small and medium-sized listed issuers outsourcing their IAF. This is to ensure they conform to the mandatory IAF ruling. The AC participants are inclined to have regulators (instead of the IIAM) monitor and regulate the internal audit industry, particularly for the out-sourced internal audit firms. However, they also



foresee the regulators may opt to stay out due to manpower constraints and practicality issues (e.g. client confidentiality), as highlighted in the statement below:

[AC#10] Of course, there's always manpower and practicality side of it also. Because these are dealing with information of an organisation. [...] But perhaps, they can look at maybe like our external audit<sup>93</sup> we have ISQC. At least, the minimum we can have - is a quality review framework within each internal audit firm so that they have a certain standard to follow. Even then not necessarily that you review their work but just review their policies and procedures of the company. In that sense, it is possible I believe. So at least you know that the internal audit firm is actually structured and has an internal review function there.

This AC participant continues:

I think the regulators foresee the reviewing could be tough so that's the reason why they do not want to be involved. And then I think IIA is not that strong. So they just leave it and end of the day everything comes back to the AC. So they expect the AC, because there are 900 over counters in the Main Board, so they expect the AC themselves to do the reviewing of the quality and the accessing of the IA work.

This AC participant has proposed two measures of monitoring. First, he suggests the regulators issue a 'quality review framework' so that the monitoring body could review the 'policies and procedures' instead of the detailed audit work of the out-sourced IAF firms (this view is reflected in the previous quote). This will absolve the issue of client confidentiality. The second proposed measure is for the regulators to issue a basic set of requirements so that the AC can conduct their monitoring over the IAF more systematically and to ensure a certain benchmark standard is maintained across listed issuers. This view is reflected in the AC participants' statements below:

[AC#10] [...] because different AC have different thought or different standard. For AC to tell them what to do – unless we know the IIA standards well, then okay. With a basic framework, to reach a certain benchmark then it'll be easier. And also, of course, then it makes the internal audit more professional and serious about their work.

[AC#13] Bursa can list down what are the basic or minimum requirement they need to have for the IAF. [...] Then they can make the AC to give a statement. [...] The only way to move toward is for Bursa to come up with a basic guideline with basic parameters. For instance, you must have certain qualifications, certain framework that the IAF need to carry out. And the AC should report based on those parameters. Without a framework at this moment, everybody will just - nobody dares to express an opinion.

This AC participant continues:

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<sup>93</sup> This AC is a current principal of a one of the largest public accounting firm (after Big Four firm) in Malaysia. He is making a remark based on his external audit experience.

If IIA has already got an IAF framework, Bursa can adopt IIA’s framework. [...] With the framework then we can do an assessment. [...] Otherwise, with no framework - what kind of measurement we can do - no KPI then we all set our own KPI then the report will be very confusing. Just like at this moment, some say in the statement of internal control, what are we measuring against? Then nobody know what are we measuring. And you look at some of the annual reports, they say it can cut and paste, the context looks similar then you will have a problem.

The last quote also suggests that the lack of clear guidance from the regulators on performance evaluation has affected the monitoring effort of the AC. It has also accorded certain listed issuers the opportunity to decouple by using a boilerplate disclosure of their internal audit activities in annual reports.

In summary, the AC participants do not view the internal audit industry as ready to cope with the heightened demand for internal audit professionals, in the context of both quality and quantity. In their view, the inability of the internal audit industry to attract and retain professionals is due predominantly to inherent problems of the internal audit profession, that is, the nature of the job and the prestige attached to the profession. The lack of inter- and intra-departmental support is another contributory factor to the human resource shortage. In respect of the quality of internal audit service providers, the AC participants believe the regulators should be more explicit in setting a minimum benchmark to ensure a more systematic monitoring by ACs across listed issuers.

#### 6.1.4 Summary

A summary of the AC participants’ expectations for each of the main constructs for external enabling factors and the corresponding practices in Malaysia are shown in Table 6.1.

**Table 6 1: Summary findings for external enabling factors (first component)**

Construct	Key interview questions	AC (n=14)*		AC’s expectation	In practice
		Agreed	Disagreed		
Rules and regulations (Section 6.1.1)	Do you think that the mandatory IAF ruling has helped to enhance IAF effectiveness?	14	0	Mandatory IAF ruling has compelled listed issuers to establish an IAF in their organisations	However, some listed issuers (particularly the small and medium-sized) are complying in ‘form’ rather than in ‘substance’ (evidence of decoupling)

Construct	Key interview questions	AC (n=14)*		AC's expectation	In practice
		Agreed	Disagreed		
	If yes, how? If no, why?				
	Do you think that the 'direct reporting' to the AC' ruling has helped to enhance the IAF's organisational independence? If yes, how? If no, why?	14	0	'Direct reporting' to the AC will enhance organisational independence of IAF and accordingly the IAF's effectiveness	'Dual reporting' is commonly adopted by listed issuers for practical reason
IIAM's role (Section 6.1.2)	Do you rely on IIA's professional guidance in your monitoring over the IAF? If not, why?	0	9 <sup>^</sup>	The IIAM should provide more professional support to the business community, in particular the AC. IIAM underperformed the AC's expectation.	The IIA's professional guidance is not known to the AC due to lack of publicity by the IIAM.
	Do you think that the IIA should be given the legislative backing to be the monitoring agent of the internal audit industry? Why?	3	11	The IIAM is not ready to assume the regulating/ monitoring role.	This is due to the IIAM's small membership base and lacks of resources (e.g. manpower)
<i>Readiness of the internal audit industry (new emerging theme) (Section 6.1.3)</i>	<i>Human resource shortage</i>	9 <sup>^^</sup>	0	The IIAM should work hand-in-hand with relevant parties (e.g. tertiary institutions) to enhance the profile and image of the IAF so as to attract more young graduates in this profession. Listed issuers to encourage their	Inability of internal audit industry to attract and retain internal audit professionals are due to problems inherent in the profession, i.e. the nature of the job and prestige attached to the profession. Lack of support from intra- or inter-departmental staff is another contributory factor.

Construct	Key interview questions	AC (n=14)*		AC's expectation	In practice
		Agreed	Disagreed		
				internal audit staff to pursue professional qualifications (CIA etc.).	
	<i>Quality of the IAF</i>			The AC call for regulators to provide a 'quality assessment framework' or a set of basic requirements that set out the basic parameters to evaluate IAF performance.	The AC are concerned over the quality of the IAF, particularly the out-sourced internal audit firms as the industry is currently not regulated or monitored.

Notes:

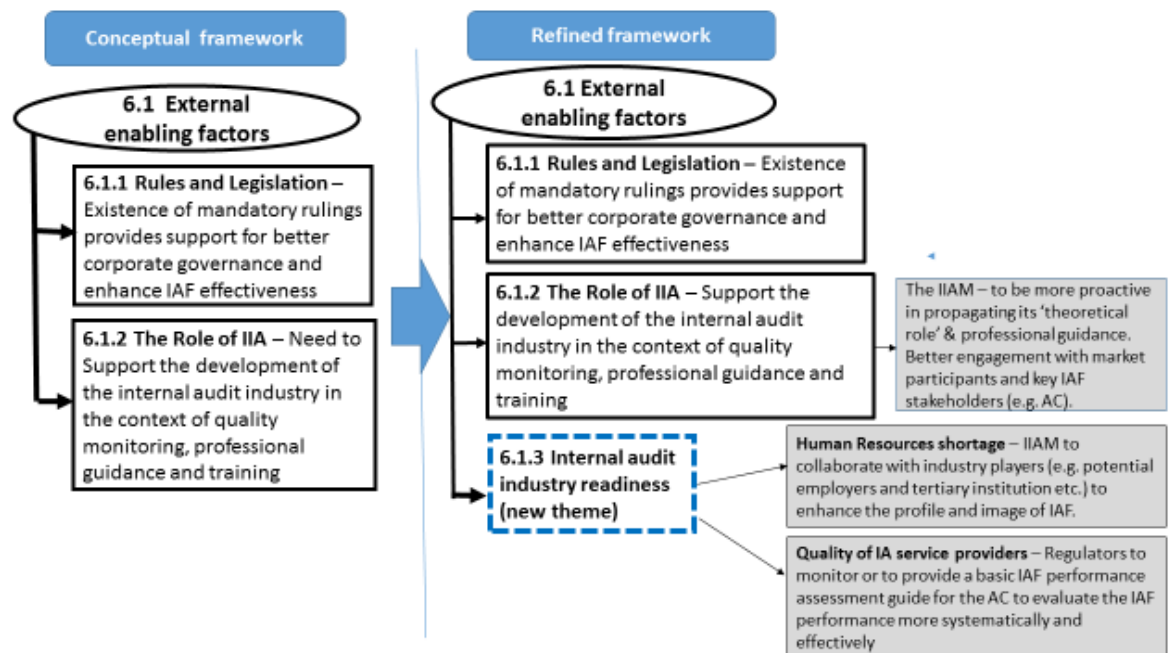
\* (n=14) represents the total number of AC participants who participated in this study. The number in each column below represents the number of AC participants who responded that particular item/question.

^ Five AC participants refrained from responding to this interview question due to lack of knowledge of the IIA professional standards and framework.

^^ This new theme was brought up by later AC participants; the researcher was unable to seek the views of earlier AC participants.

Following the discussions in the earlier sections, the first component of the conceptual framework is refined to incorporate the AC participants' expectations and is presented in Figure 6.2.

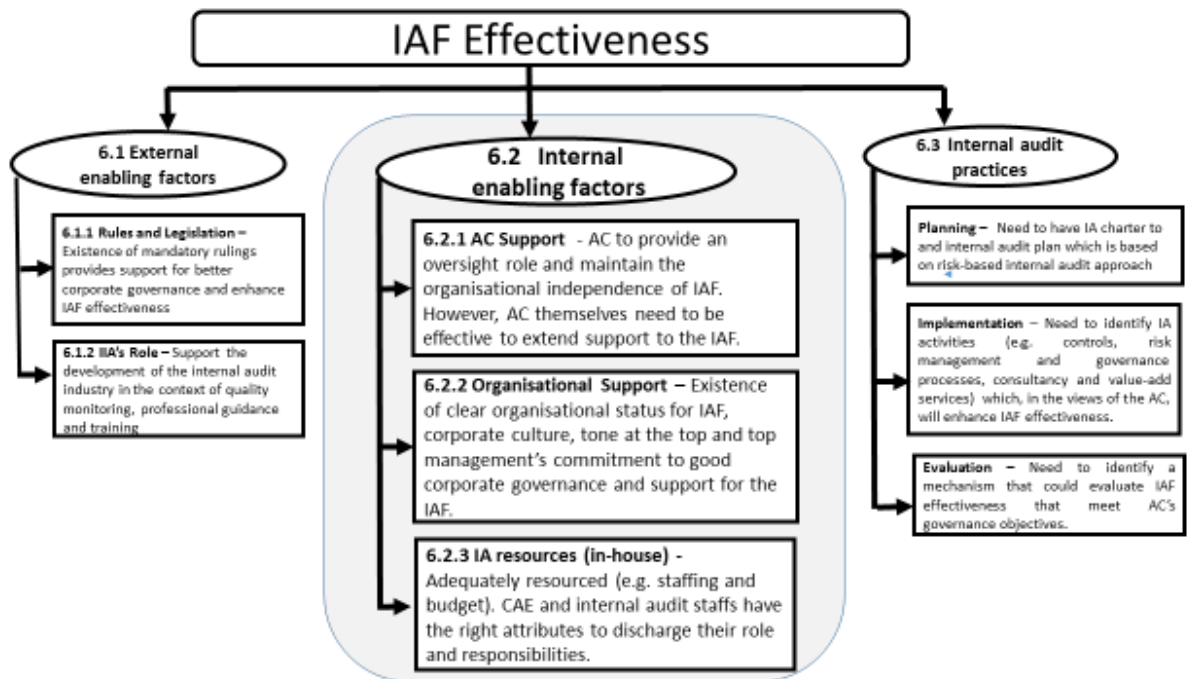
**Figure 6.2: Refined external enabling factors (first component)**



## 6.2 Internal Enabling Factors (Second Component)

The second component of the conceptual IAF effectiveness framework is the internal enabling factors, presented in Figure 6.3. The AC participants' views on each of the three constructs are presented in section 6.2.1 (AC support), section 6.2.2 (Organisational support) and section 6.2.3 (IAF resources). During the AC interviews, it was identified that a majority of the listed issuers out-source their IAF to third party internal audit firms. Considering the significance of this class of internal audit service provider to the development of the internal audit industry in Malaysia and the AC participants' expectation of them, the researcher has included the 'out-sourced IAF' as a new emerging theme/construct to the internal enabling factors. This has been presented as section 6.2.4. Following these discussions, a summary of key findings and the refined framework is presented in section 6.2.5.

**Figure 6.3: Conceptual IAF effectiveness framework (second component – internal enabling factors)**



### 6.2.1 AC support: attributes and influences

Only an effective AC can augment IAF effectiveness. This section reveals the AC participants' views on what constitutes an effective AC. The interview questions are structured around the DeZoort, Hermanson, Archambeault, & Reed (2002) framework, which examines AC effectiveness from four aspects: board composition (independence, financial expertise, experience etc.), authority, resources and diligence. The AC participants' views are presented in the following sections.

#### 6.2.1.1 Board composition

##### (i) Independence

All AC participants concur that 'independence' of an AC member is of utmost important to ensure AC effectiveness. They perceive a balanced board composition as crucial to its independence. This is reflected in the AC participant's statement below:

[AC#1] There must be a balance on the board [with a good mix of independent and non-independent directors]. As this goes down to how you manage the senior management by requiring certain things. One of which is the robustness of the internal audit function.

In addition, the AC participants contend that independent directors must be ‘truly’ independent for them to discharge their fiduciary role diligently. However, several AC participants reported that certain listed issuers appoint an AC merely to conform with the regulatory requirements, that is, a ‘form over substance’ exercise. In most instances, these AC appointees are ex-senior government servants, nominees of politicians or political parties, or confidantes of controlling shareholders – the so-called ‘friendly’ independent directors. This is reflected in the AC participant’s statement below:

[AC#2] Sad to say not all audit committee members have the full appreciation of their roles in Malaysia. Some people are appointed by virtue of the fact they are friends, they are ‘connected’ and some, especially Malaysia, there is a lot of retirees from the government. As a golden handshake, they are offered positions as directors. They’re accepting the position without knowing the obligation and implication and their roles and responsibilities. And for that, therefore, exposes the company to risk. [...] if you have EDs [refers to executive directors] who have ill intention; then the whole company is exposed. So you will render the IA function meaningless because if IA doesn’t have a backup of the audit committee then the whole structure fails.

Several AC participants highlight that if the AC or more specifically the AC chair is ‘perceived’ to be not independent, it may also set a wrong ‘tone’ for the organisation. This is reflected in the AC participant’s statement below:

[AC#6] The AC chairman is an independent director, he’s got a role to play, a very major role. Unfortunately, many companies this doesn’t happen. [...] the major shareholder who’s usually the chairman or CEO, just has to appoint a few of his buddies, golf buddies, drinking buddies, whatever and one of them becomes the AC and you know the tone at the top will completely be different. Because everybody will know that he and the chairman are close. And they’ll be reluctant to act on certain things.

In getting rid of this ‘form over substance’ practice in the appointment of independent directors, one AC participant suggests that the regulators could follow the Bank Negara Malaysia (Reserve Bank of Malaysia) by providing the listed issuers with a list of ‘approved independent directors’ to choose from. This is reflected in the AC participant’s statement below:

[AC#11] I would go so far as saying that the choice of Independent directors should not only be with the owner but they should have a list of approved - the same as the financial institutions have to be approved by Bank Negara. Independent directors have to be approved by somebody, it could be SC [refers to the Securities Commission of Malaysia]. And the moment you are not seen to be independent or misbehaved, your name goes out of the list. So a PLC [refers to public listed companies] would have to choose from the list.

In ensuring ‘independence’ of directors, the regulators have required independent directors to step down or otherwise to serve as non-independent directors after a cumulative tenure of nine years as an independent director with the same listed issuers (Recommendation 3.2, CG Code (2012)). There are mixed views pertaining to this ruling with a majority of them querying the rationale behind such ruling. This is reflected in the AC participant’s statement below:

[AC#5] It’s somewhat controversial. But there are some people who think that independence is in the mind. If you’re not independent whether you’re one year or two years, you’re still not independent. So I guess for the authorities, it was some way to have some measurement. I think the downside is that you could lose good people. If I think I can be independent but I’m forced to step down then it’s the company’s loss. [...] But there no right or wrong number. Nine, twelve, five, what’s the right number? Depends on the person.

Whilst majority of the AC participants are not in favour of the nine-year ruling for independent directors, two (in their 40s or early 50s) view this ruling favourably. This is reflected in the AC participant’s statement below:

[AC#13] To take an ID [refers to independent director] to be effective, really effective, you need about three to five years. After five years, then he should be contributing. After nine years, he would be too familiar already. [...] The pros of this exercise is to whip out some ineffective ID. But on the other hand, you may lose some good ID who have contributed to the company. But, generally, I agree with the rule.

On the issue of AC independence, several AC participants assert that AC appointees must be financially stable and/or have good social standing (professionals, ex-partner of legal practice or audit practice, etc). They acknowledge that ACs who possess these attributes are less likely to succumb to major shareholders’ pressure, for fear of reputational risk and litigation liability. This is reflected in the AC participant’s statement below:

[AC#2] My basic philosophy is, don’t become a director because you want the fee. Director should be appointed because of their standing, not because they need the money and I think directors should be rich. If not, then the person - accepting the post of director becomes an issue.

This AC participant’s view is supported by another participant as reflected in the following statement:

[AC#13] So the financial stability of the ID (refers to independent director) also important. Otherwise, because of the money, people may say ‘yes’ to major shareholders. So if your ID are more senior, more financially stable they tend to be more independent.



(ii) *Competency*

- *Financial expertise*

Financial expertise of the AC has long been cited as another key attribute to ensure AC effectiveness. Responses from all the AC participants confirm this past findings. An AC member who is not a financial expert may not be able ‘to appreciate internal control and system problem’ [AC#4]. This sentiment is echoed in another AC participant’s statement below:

[AC#11] If internal audit were to report to AC chairman, then it’s the blind leading the blind. So the AC chairman should be a MIA member (refers to the Malaysian Institute of Accountants), which is not a requirement now.

The last quote suggests that it is even more crucial for the AC chair to be a financial expert. This is probably due to the fact that the AC chair has to spearhead the AC meetings and lead the review and comment on the audit findings (internal or external). In addition, they need to highlight to the main board any significant financial anomalies or controls weaknesses.

The consistent sentiment among the AC participants is that they view AC’s effectiveness not on an ‘individual’ but a ‘collective’ basis (i.e. AC composition). They support teamwork and diversity in the AC composition. This is reflected in the AC participants’ statements below:

[AC#5] You don’t need the whole team of accountants. They can make up of various people with different backgrounds. It also depends on the industry that the company is in. So it’s actually a teamwork. Not one person can know everything.

[AC#13] We need diversity in the AC board as well. Some people with other perspectives. Legal would be one area that we should actually look at because of the complexity of doing business now and the other one would be the business acumen of some senior businessmen who have certain standing in the market. That will make the AC more competent.

The current legislation requires at least one member of the AC to be a ‘financial literate’.<sup>94</sup> The majority of the AC participants, however, assert that this requirement

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<sup>94</sup> Paragraph 16.09(1)(c), Listing Requirements (2011) stipulates that **at least one member** of the AC must be: (i) a member of the MIA, or (ii) if not a member of the MIA, he must have at least 3 years working experience and passed certain examinations or a member of one of other association of accountants.

may be inadequate for the AC to meet its heightened responsibilities under prevailing market environment. This is reflected in the AC participant's statement below.

[AC#13] By involving MIA members in the committee, I think it should help to resolve the internal control issue. But to what extent it also depends on that independent director's qualification and exposure. I would say this is an area that we can still improve on.

- ***AC's industry experience and business acumen***

In addition to financial expertise, several AC participants regard the AC's possession of relevant industry experience could further enhance their effectiveness. The benefit of having a mixed composition of AC members is that each could bring their past experience and knowledge to the boardroom. This is reflected in the AC participant's statement below:

[AC#10] You could have people from other industries. For example, in the board we have one person that is - with many years of experience in insurance. So that person can really contribute from the perspective of risk management because of the insurance industry he is in. [...] So he brought in very different perspectives. Very different from a finance guy.

- ***AC's judgement skills***

Several AC participants suggest that one attribute of AC effectiveness is their ability to make sound judgements and bold decisions for the organisation. Below are two instances where AC participants are required to exercise their judgemental skills:

[AC#4] Being an accountant, we have a good grasp of control and system operation of businesses. We are able to assess whether the quality of the IA reporting on certain item is superficial, adequate or in-depth for our purpose. However, cost plays an important factor as well. For instance, a recent incidence, where our IA (outsourced) highlighted a certain system weakness [...] after going through the IA report the AC inquired the impact on the company. They then realised that the IA findings were based on only two samples. This is not acceptable. Thus the AC requested to expand the sample size. However, by expanding the sample size means more cost to be incurred. AC must be able to make a good judgement on cost and benefit. Budget is a key determinant factor in this incidence. More extensive or detailed IA work would mean higher IA fee. Hence, AC's experience and knowledge come into play again.

[AC#3] Which is more important - the cake or the icing? Where I'm trying to survive, I can do this 18-month cycle but at an expense where I wouldn't be paying dividends to my shareholders. The decision is - I lose my status for the year or I am going to go into losses or I'm going to come down to a critical point which puts me under PN status.<sup>95</sup> To

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<sup>95</sup> The AC participant is referring to a listed issuer which is being placed under Practice Note 17 (PN17) status. Listed issuers will be classified under PN17 by the Bursa Malaysia on occurrence of any of the following events: if their shareholders' funds are less than 25% of their total paid-up capital; receivers

me, then I will say hold on, under the priorities. So I must be magnanimous enough as an AC chairman to know because I'm also a board member at the end of the day. I don't want to be accountable for a loss-making company. So I'll say can we defer this for third quarter next year, I think it can wait. We will prioritise to save the company during a critical period. [...] So for that, I must be broad enough to judge and make a decision for the company.

These quotes suggest that an effective AC should not indulge themselves in having the best internal control mechanisms (with exorbitant IAF spending) at the expense of other stakeholders' interests (e.g. no dividend for shareholders) or place unnecessary financial burden on the listed issuers. In brief, an effective AC must know to weigh the cost and benefit of IAF investment.

**(iii) Assertive AC chairs and AC members**

Several AC participants inform that an assertive AC, particularly an assertive AC chair will accord greater support to the IAF. This support will enable the IAF to act more objectively and consequently enhance their effectiveness. This is reflected in the AC participant's statement below:

[AC#6] I think the key is to have a strong AC and strong AC chairman. Because once this is in place where the AC chairman will act without fear or favour, then it flows down to the internal auditor. He's also confident he has got the backing. He has got the support so that's how it works in my view. And if you have an AC chairman and AC members who are all very subservient to the chairman or CEO of the company then you have situations like that.

According to one AC participant, the IAF is merely a tool for the AC to assess and unearth systems weaknesses. Eventually, it is the AC who should deal with the top management (comprising owner-managers and professional managers) to fix the problem area. An effective AC is one who need to be assertive. This is highlighted in the AC participant's statement below:

[AC#1] IA is to highlight the issues and unless you're able to interpret the issues, you are not making full use of them. The objective is to get them to give you an assessment of the position at a certain date for a certain item, to allow you to take it up with senior management. That's all. But you must, as audit committee, ask the question to senior management and figure out what it is for yourself.

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have been appointed to take control of the companies' assets; the winding-up of some of their subsidiaries and associated companies; the auditors have expressed adverse opinions on the companies; default in loan interest and principal repayments; the companies have suspended or ceased their operations; or companies do not have any significant businesses or operations.

*(iv) AC's people management skills*

It is interesting to note not many AC participants cite people management and soft skills, for example, good communication and negotiating skill, as an AC attribute in enhancing its effectiveness. However, some expressions used by the AC participants, such as tactfulness in 'managing' the CEO or controlling shareholders etc., reveal that good people management and negotiating skills are paramount in enhancing AC effectiveness. This is reflected in the AC participant's statement below:

[AC#1] [...] it's a big role to be a audit committee member. You have to be able to - just as management coax employees, directors also have to work with each other, with management, to coax performance out. So this is personality. But its important.

**6.2.1.2 Authority: AC control over IAF resources**

The authority or control by the AC over IAF resources<sup>96</sup> will signify to the IAF the AC's organisational power or influence within the organisation. If the IAF perceive the AC has greater control over the IAF resources vis-a-vis the top management, they will be less likely to succumb to pressure from top management. Consequently, this will enable them to discharge their role more objectively. This is as illustrated in the AC participant's statement below:

[AC#8] The IA can't have a check and balance - if he is beholden to the guy at the top then essentially what he will become is a whistle-blower if he's brave enough. Otherwise, you tell me, how many guys are willing to put principle ahead of their livelihood knowing that by doing the right thing - knowing that they'll be out of a job, their families. You've got to understand the IA guy has all the same aspirations as the rest of us and you have got to protect that if you [refers to AC] want them to be able to do the right thing for you.

A majority of the AC participants concur that they must have control and authority over the IAF resources in order to accord the necessary support to the IAF. However, the AC participants acknowledge that whilst they have the final approving authority over the hiring and firing of CAEs, it is the top management (particularly the CEO) who have an active involvement in the recruitment, performance appraisal and remuneration review process of the CAEs. Accordingly, this may weaken the AC's

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<sup>96</sup> For an in-house IAF, the AC control over IAF resources includes the AC's control over the hiring and firing, remuneration package, performance appraisal and career progression of the CAE. For an out-sourced IAF, the AC control over IAF resources would include the decision to appoint and dismiss as well as determination of the professional fee of the out-sourced IA firm.

‘perceived’ organisational power vis-à-vis the top management. This is reflected in the AC participants’ statements below:

[AC#4] The hiring process is the same as recruiting any other staffs. However, AC is involved in the final interview process of CAE’s selection. But interviewing of junior IA staffs is done by the CAE and HR staff. For remuneration, it is by the CEO. However, final endorsement is by the AC.

[AC#8] If you have them reporting to AC, to me, its like - if I am IA, if I know I report to the AC and my performance appraisal is all - KPIs are all set and evaluated by AC then I will do my job. I know I won’t be Mr Popular but I don’t need to rely on the CEO for my promotion, for my salary, for my increments.

### 6.2.1.3 Resources

The Listing Requirements (2011) requires all listed issuers to maintain at least three AC members with a majority of them ‘independent’ directors.<sup>97</sup> In addition, as AC members they have the right to full and unrestricted access to any information pertaining to the listed issuer, direct communication channels with the external and internal auditors, and rights to obtain independent professional advice.<sup>98</sup> The AC participants view these provisions as key to supporting them in the effective discharge of their role. Although there are adequate legislative provisions pertaining to the ‘resources’ to support the AC, the AC themselves must know how to pursue their course and exercise their rights. This is reflected in the AC participant’s statement below:

[AC#1] [...] At the end of the day, you want something, you ask for it. The board has the right to ask for any piece of information from – in relation to the operations of the company and we cannot be denied. So you go right down to the bottom and you get that piece of information.

### 6.2.1.4 Diligence and commitment

To ensure directors are committed to their fiduciary role, it is a requirement for the AC appointee to declare to each listed issuer their time commitment prior to the appointment.<sup>99</sup> In addition, the Listing Requirements (2011) prohibit any director from

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<sup>97</sup> Paragraph 15.09(1)(a) & (b), *Composition of Audit Committee*, Listing Requirements (2011)

<sup>98</sup> Paragraph 15.17 *Rights of Audit Committee*, Listing Requirements (2011)

<sup>99</sup> Principle 4, Recommendation 4.1, CG Code (2012).

accepting directorship in more than five listed issuers.<sup>100</sup> All AC participants concur that time commitment is the basic requirement for any person who accepts appointment as an AC member as reflected in the statement below:

[AC#10] Dedication, time, all these I think is fundamental. Everyone, once you are in the board you can't say you have no time - you just have to make time for it. You have to spend time for it. You can't say that it's okay, I am skipping this meeting and going somewhere and we just have a comm-call [teleconferencing call].

Another AC participant suggests that the AC members's commitment should go beyond their commitment to attend meetings, they must also be diligent and 'prepare' for the meetings. This includes prior reading of meeting minutes, reports, understanding business proposals etc. This sentiment is reflected in the AC participant's statement below:

[AC#4] It is important that the AC must be prepared to spend time to read or understand the business of the PLC. I have come across where AC members were absence on pre-scheduled AC meeting. They were overseas. Normally, we were given AC meeting report two-three days prior to AC meeting. If they were overseas, do you think they have time to read the reports? How to deliberate or raise any constructive matters through teleconferencing?

The heightened expectation of the regulators on the ACs in recent years has resulted in a demand for greater commitment from the AC in the discharge of their monitoring role. It is inadequate for the AC members to just attend meetings without having an in-depth understanding of the listed issuers' operations and businesses. This is reflected in the AC participant's statement below:

[AC#11] Today I don't think you can come and just have four meetings<sup>101</sup> or five meetings a year. You can't. As an independent director you can't anymore. You really need to understand the business. You need to spend time with the people even at middle and even junior level management. Understand the business, understand the risk and so that when the internal auditor talks to you, you understand what he's trying to say.

This AC participant continues:

The regulators have now put a lot of responsibility and onus on independent directors. So today we can no longer just tick the box. They have to be worried about their personal liability. We've had cases now of independent directors going to jail, being fined,

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<sup>100</sup> Paragraph 15.06 *Restriction on directorship in listed issuers*, Listing Requirements (2011)

<sup>101</sup> It is mandatory for the AC to meet at least four times a year to deliberate on financial result and year-end financial statements in preparation for quarterly reporting to the Bursa Malaysia.

something that was almost unheard of in the Malaysian context. So unless you know what you are doing, you'd better not be an independent director.

The recent introduction of the peer assessment<sup>102</sup> further reinforces the regulators' stand in requiring greater commitment and diligence from the directors, particularly the independent directors. This is reflected in the AC participant's statement below:

[AC#13] We have moved from general assessment to peer assessment so every year we're supposed to assess the fellow directors. [...] But Asian being Asian [...] but you can see that there are more dissenting voice to say what need to be done and what are the steps need to be taken to improve it. If you are too quiet in the meeting, other directors may report on that director is very quiet, are not participang in the discussion.

However, several AC participants comment that some ACs are not prepared to challenge or ask difficult questions that may provoke other board members. This could partly be due their cultural background in that Asian culture tends to be more subservient to leaders. In this instance the AC would perceive owner-managers as in the leadership role. Another AC participant suggests that the involvement of younger AC members (e.g. generation X or Y as opposed to the 'baby boomer' generation) may encourage more effective exchange of mind. These views are reflected in the AC participants' statements below:

[AC#3] I think probably Asian mindset is very - they are not so direct and very tactful in speaking out. So I do encounter these kind of things so that's why sometimes we will just discuss how should we raise it up so that, of course, we don't want to sound offensive to the major shareholders but we want it to be done.

[AC#13] We need maybe a younger group of people who are more vocal.

Several AC participants comment that commitment and diligence also include 'staying current' with laws and regulations as well as the market development. This is crucial as it enables the AC to contribute constructively to the listed issuers. One AC participant<sup>103</sup> suggests that this aspect of commitment is still lacking despite the regulators have made 'continuing education' a mandatory requirement and organised

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<sup>102</sup> Principle 2, Recommendation 2.2, CG Code (2012). Under peer assessment, the directors are assessed by their peers (i.e. other board members) in terms of their contributions during board meetings.

<sup>103</sup> This AC participant is a professional AC and an ex-partner of a Big 4 public accounting firm. He sits on several FTBM100 companies (including Bursa Malaysia Berhad) as AC chair or member. He is also a member of the Disciplinary Committee of the stock exchange.

other events, such as the breakfast series, to update the directors of market development. This is reflected in the AC participant's statement below:

[AC#3] [...] the sad thing is we have a lot of training programs, not just done by MICPA or MIA or any of the other professional bodies. But you'll see the same faces - normally like say 200 people. Sometimes whether it's organised by MASB<sup>104</sup> or Bank Negara or SC, you see the same faces. These are not my problem people. These are the guys who really know what they do. But I need 1000 over people who run all those listed companies. Where are the rest? They are just not bothered. The stock exchange has what we call breakfast series. [...] all companies are invited and often it's free training for the directors and you'll still see the same faces.

This AC participant continues:

But just because you are a chartered accountant and you are like a dinosaur, you qualified 20 years or 30 years ago and never stayed relevant with all the CPU programs, gosh, then you are putting yourself on because there's the retail investors relied on you as a member of an institute of repute to carry out that task. So if you failed then you need to be admonished, that's all.

The last quote reiterates the importance of the AC to continually update and stay current with market development in order to be effective and be able to contribute to their listed issuers. In this AC participant's view past qualifications will become 'dated' if one does not constantly update themselves.

#### **6.2.1.5 AC support via empowerment and close rapport with the IAF**

The AC support through empowerment and close rapport with the IAF is not deliberated in the DeZoort, Hermanson, Archambeault, & Reed (2002) framework. However, its significance is evident as it has been repeatedly brought up by several AC participants. As such, it has been included as a refinement to the conceptual IAF effectiveness framework under the construct 'AC support'.

The mandatory establishment of the IAF in listed issuers does not infer automatic acceptance of the IAF by other stakeholders or employees of the organisations. Although they may understand why the listed issuers need the IAF, generally in their view the IAF is '[m]ore of a nuisance' [AC#11]. The AC participants suggest that for the IAF to act objectively and to value-add to the organisations, they need the

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<sup>104</sup> The Malaysian Accounting Standards-setting Board.



assurance or support from their ‘direct boss’ (i.e. the AC). The AC’s support could come in several forms, as suggested by the AC participants, for instance, the AC’s open support and recognition in the presence of top management, and close rapport with the IAF (private meetings outside standard work schedule etc.). These views are reflected in the AC participants’ statements below:

[AC#11] [...] as an audit committee chairman, you can be quite powerful and you can say to the management - my guy (refers to the IAF) is coming in, I want you to whatever - then it gives a lot of weight to your internal audit function.

[AC#3] [...] The internal audit head has also got this avenue of a private meeting with the audit committee. So usually a person who is professional, who is a member of various professional bodies, he or she who exercises independence and if they have pride and passion of their work, you will find that the CAEs are very, very communicative.

[AC#2] Recognition is another thing. Because failing which the IA is lost and most IA will come down to a level - he’s just another staff writing the normal report to you and earn his salary and move on. So he lost his objective, he lost his vision, he lost his focus - what is he exactly? Then it’s only another compliance.

This AC participant continues:

Most of the time I will encourage my IA head to call me personally, meet me outside - before the meeting. So I open the channel, I tell them you are my man, you are under me, anything come and see me. So in that sense, I think that will give him the confidence because sometimes they dare not especially if you have a very powerful MD (refers to managing director). [...] It is never easy for the ID (refers to independent directors) to know so much. I will tell myself because I’m fairly experienced and also I read. But a lot of people don’t. For the two or three hours you spent at the board meeting [...] you need to have that rapport with the internal audit so that you will roughly sense something.

In summary, the AC attributes and influences most significant to their effectiveness, as highlighted by the AC participants, are detailed in Table 6.2.

**Table 6.2: Key comments on AC attributes and influences/support (under second component)**

AC attributes and influences	AC (n=14)*	AC key comments
Independence (section 6.2.1.1 (i))	14	AC appointees have to be ‘truly’ independent, not only in ‘form’ but also in ‘substance’ (i.e. substance over form).
Competency (section 6.2.1.1(ii))		
<ul style="list-style-type: none"> <li>Financial expertise and experience (1<sup>st</sup> bullet point)</li> </ul>	10	The AC (particularly the AC chair) should be a financial expert as they need to spearhead the monitoring mechanism (internal and external audit) of the organisation. The prevailing qualifying criteria of ‘financial literacy’ for the

<b>AC attributes and influences</b>	<b>AC (n=14)*</b>	<b>AC key comments</b>
		AC members may be inadequate under current market environment.
<ul style="list-style-type: none"> <li>Industry experience and business acumen (2<sup>nd</sup> bullet point)</li> </ul>	8#	Without relevant industry experience and business acumen the AC will not be able to contribute effectively.
<ul style="list-style-type: none"> <li>Judgemental skill (3<sup>rd</sup> bullet point)</li> </ul>	3#	An effective AC is one who is able to make sound judgements and bold decisions for the organisation.
Assertive AC chair and AC members (section 6.2.1.1 (iii))	6#	An assertive AC chair must be prepared to stand up against top management.
People management skills (section 6.2.1.1 (iv))	1#	AC has to be 'tactful' when dealing with top management, particularly on sensitive matters (e.g. challenging audit findings).
Authority – control over the IAF resources (section 6.2.1.2)	9	The AC need to have or perceived to have significant control/influence over the IAF resources vis-a-vis the senior management in order to accord the IAF with its much needed support and backing.
Diligent and commitment (section 6.2.1.4)	14	To attend AC meetings alone is inadequate to signify an AC's diligence or commitment. An effective AC is expected to have knowledge of business and operations of listed issuers, stay current with market developments (including rules and regulations) and contribute constructively during board meetings.
AC support via empowerment and close rapport with the IAF (section 6.2.1.5)	12	Without AC support and empowerment, the IAF will not be able to function effectively. AC support could be via private meetings, rapport, open support in front of top management etc.

*Note:*

\* (n=14) represents the total number of AC participants who participated in this study. The number in each column below represents the number of AC participants who responded that particular item/question.

# These are not part of interview questions but additional contributions from the AC participants.

## 6.2.2 Organisational support

For the IAF to be effective, they need the support of not only the board of directors but colleagues across all management levels (senior management, middle management etc.). An organisation that supports good corporate governance is envisaged to pave a smooth passage for the IAF in their monitoring activities. Accordingly, the interview questions are structured around the two constructs: organisation hierarchy/status of the IAF and top management support. Several AC participants highlight that the discussion of top management support should include a discussion on the ‘integrity of top management’ as it is the compass of how corporate governance of an organisation is heading. Accordingly, the construct (top management support) has been refined to include ‘integrity of top management’. The AC participants’ view are presented in the following sections.

### 6.2.2.1 Organisation hierarchy/status of the IAF

The dismal performance of the IAF could be due to the lack of clarity in its organisational status and identity (Lenz and Sarens 2012). To enhance organisational independence, the IIA (2013a) suggests that ‘the CAE must report to a level within the organisation that allows the internal audit activity to fulfil its responsibilities’.<sup>105</sup> This is a form of organisational support to the IAF. However, a majority of the AC participants disagree that the lack of clear organisational hierarchy has compromised on the IAF’s effectiveness. Conversely, they suggest that the AC’s open support to the IAF carries more weight than a mere positioning on the organisation chart. This is reflected in the AC participant’s statement below:

[AC#2] I think importantly the AC must give the IA full support in front of the board and senior management. [...] That thing need to be repeated and mentioned at the top most level i.e. basically telling the EDs, the MDs - this guy is my man. We are not here to nail you, no. We are here to make sure company does well. I think once this is cleared then the IA will feel a sense of pride, feel a sense of importance, feel a sense that he is doing the right thing.

While the majority of the AC participants perceive that a formal organisational status for the IAF has trivial impact on its effectiveness, several AC participants view it

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<sup>105</sup> Standard no. 1110 – Organisational Independence, IIA (2013)

otherwise. The mixed views among the AC participants is probably because the majority of the AC participants' listed issuers out-source their IAF. Accordingly, the positioning of the IAF on organisation chart is of no relevance to them. This is best explained in the AC participant's statement below:

[AC#11] [...] any charting of the IAF's organization hierarchy is a mere formality. In addition, the organizational hierarchy is not a major issue in Malaysia since majority of the listed issuers out-source their IAF to third-party out-sourced IAF firms.

An AC participant who perceives clarity of IAF's organisational status as important suggests that good corporate culture (of multi-national corporations or head-office) could also encourage the local IAF to discharge their role more objectively as the local IAF perceives they could leverage on the support and backing from the group or regional IAF. This is reflected in the AC participant's statement below:

[AC#3] In fact, the more well-run ones are financial institutions, where I serve as an audit committee chair for a multinational group of insurance companies and Takaful insurance as well. What we find is that the internal audit heads, they can even override CEO because they come from the region or their group [refers to head-office]. And they encourage the local fellows, the local heads of internal audit to be also independent minded. If not, he or she doesn't get promoted and things like that. They go for training, et cetera. That's a culture. That I can say is multinational-driven.

Organisational support is not confined to support from the senior management. To ensure smooth conduct of its audit processes, the IAF needs the coordination and support of all staff (including middle- and lower-level management) within the organisation. This is illustrated in the AC participant's statement below:

[AC#11] In our particular case, we have a shareholder [refers to the owner-managers] who is very supportive. We have a CEO who is a professional. CEO is incredibly supportive because he comes from that culture. He's also a chartered accountant. But having said that trying to get our second level management to start subscribing to all this and even in the instance of one or two senior management is still a challenge because I think the primary challenge is that they've got so much to do in terms of make money and you know they're incentivized by performance, KPIs and operational issues. To them internal audit is just like external audit, it's a nuisance. So they don't give it as much thought as IA want to be. But it's work in progress.

In summary, a clear organisational hierarchy/status is crucial in the organisational independence of the IAF. The dissenting view from the majority of the AC participants is mainly because most of their listed issuers out-source their IAF. Thus, the positioning of IAF on organisation chart is of no relevance to them. However, in order to enable the IAF to discharge their monitoring role effectively, they need support not

only from top management but also from middle- and low-management level staff across the organisation.

### 6.2.2.2 Top management support

#### (i) *Corporate culture: ‘tone at the top’*

The consistent sentiment among all AC participants is that the right ‘tone at the top’ is fundamental to creating a positive corporate culture and work ethic across an organisation. Although a small number of AC participants are not familiar with this terminology (i.e. tone at the top), on elaboration their views are consistent with that of others.

Interestingly, all AC participants cite ‘controlling shareholders’ or ‘top-level management’ as the party to set the ‘right tone’ for the organisation. In their view, only the most influential party within the organisation can set such ‘tone’. None of them view that the independent directors (or the AC) could assume such a role. This makes logical sense as a high proportion of listed issuers in Malaysia started off as family-owned small- and medium-sized entities. The Asian families normally occupy senior management positions (e.g. managing director, executive directors or CEO) and continue to control the companies post-listing. They are commonly referred to as the owner-managers (i.e. controlling shareholders who also assume executive managerial roles). This is reflected in the AC participants’ statements below:

[AC#13] I think the MD is the one that - or the CEO should be the one that would drive this. Otherwise it’s very difficult to drive to every level of the company.

[AC#11] It’s changing a mindset and creating the culture of proper governance, transparency, accountability, doing the right things. To me that is the biggest challenge. [...] How serious you want to have that kind of culture also depends, not just on audit committee but [...], more importantly the shareholders. Because Asian companies are very much driven by the shareholders.

[AC#10] The top management especially the executive directors and the senior management. They are the ones that the employees look up to so it’s very important for them to reflect that values.

The AC participants also suggest that top management needs to ‘walk-the-talk’ and to act in accordance with good governance principles in order to set a good example for the subordinates. In addition, this positive ‘tone’ needs to be communicated to all levels within the organisation. Several AC participants suggest that the IAF could act

as the ‘mouthpiece’ of the top management in disseminating this positive ‘tone’ across the organisation, particularly the foreign subsidiaries where the top management may not have direct control over them due to geographical distance. This is reflected in the AC participant’s statement below:

[AC#11] [...] the internal auditor would be a more direct messenger. Like for example, in our case we have overseas operations which would function differently. But his job is to tell the country head you need to set this tone to the way you run business because that’s what the CEO wants and the CEO has to reinforce this message. Our CEO actually makes use of our internal auditor to hammer home what needs to be done.

Several AC participants posit that top management with a long-term view for the listed issuers (e.g. long-term sustainability) would be more committed to good governance practices. This is reflected in the AC participant’s statement below:

[AC#6] [...] Where the chairman is a non-independent, it’s important that he’s able to set the tone. Like if he’s part of the family that owns the business and he doesn’t behave in the right manner then the tone is all going to be, more slanted in a certain way. I mean there’s good and bad examples. You can see some of the family companies, the chairman is very strict and very firm in terms of doing the right thing. It all flows down and people have less issues. But if you see that the chairman is only interested in protecting the family interests or whatever, then it becomes very difficult.

This AC participant continues:

If he wants the company amongst the best run, if he’s thinking of sustainability, he’s looking beyond just his term as the major shareholder, he will be having true independence on that. He will be employing professionals to run the management. [...] If the whole management team is just family members then it will be difficult for other independent directors to act and will also put pressure on the internal auditor. So for this sort of company, no matter how good the IA is, you can’t actually perform if there’s no backing from the top.

The last quote reaffirms the AC participants’ view that if top management is not supportive of IAF or good corporate governance, nothing will happen to the corporate culture and values of its people. Accordingly, top management is the main driver behind good corporate governance of organisations.

Several AC participants reveal that larger listed issuers with diversified businesses or a large portfolio of overseas subsidiaries/investments are more inclined to value the IAF’s contribution than the small- and medium-sized listed issuers as geographical distance and complexity of the businesses mean top management is not able to have direct control over every aspect of the group of companies. This is reflected in the AC participant’s statement below:

[AC#7] I think also it depends on the MD and CEO. You look at [PLC-E]'s case the fact that they have a separate investigations arm<sup>106</sup> and also got an IA function. The MD, he views this as very important. He's very afraid of the various governance issues, about fraud happening and all that so to him it's important. So he does not mind having a very strong IA function. So actually if you look at it, it's not just the AC alone driving this kind of thing, the top management itself, the CEO himself, wants it. So it's a very different perspective.

This AC participant continues:

Whereas on the other side where I sit on a smaller PLC. Of course, you look at the nature of business, they are very small now. [...] management have a very different perspective. They think that it's very small, everything is within our span of control so the drive is different, you see. To them (refers to the controlling shareholders/Executive directors), they think they can manage themselves rather than incur an additional cost. So we have this kind of view still persisting today.

Another AC participant confirms that the IAF could not be implemented effectively without the support of top management. This is reflected in the AC participant's statement below:

[AC#11] If the owner [refers to owner-managers] is not someone who believes in internal controls and proper governance, then no matter what, it's not going to happen.

**(ii) CAE involvement at top management strategic meetings**

It is suggested that CAE involvement in top management strategic meetings is a sign of top management's support and recognition of the CAE's status within the organisation. However, the consistent sentiment among all the AC participants is that CAE participation at top management strategic meeting is not necessary. They are of the view that the IAF should only focus on their core activities: controls and risk management. This is reflected in the AC participants' statements below:

[AC#11] Not a compelling case to do so because internal auditor job is not ready to help you on strategic matter. It's more on the internal control framework, risk management framework so that's a very specific area. And for strategic matters, I would leave to the risk management committee, AC committee to do that.

[AC#2] I personally still like to see IA role to be confined to operational audit, such as, system and controls. It is not only costly but extremely difficult to hire a CAE who possess these skill sets. Further, the strategic business unit head may be skeptical of CAE's capability to contribute on this aspect. So, no.

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<sup>106</sup> Further clarification with AC participants revealed that the investigative arm is headed by a retired police-inspector. This division is responsible for investigating theft of car theft or spare-parts in the warehouse/car yard.

The last quote reveals the AC's scepticism that the CAE may not have the capability to contribute productively to the top management strategic business meeting. Cost is another major concern if a highly qualified CAE were to be engaged.

**(iii) Investment in IAF**

A majority of the AC participants are in agreement that size of the IAF budget is an indicator of an organisation's support for the IAF. However, they emphasise that listed issuers generally would not allocate a big budget for the IAF as it is perceived as a non-profitable centre, as illustrated in the following AC participant's statement:

[AC#2] IA being a non-profit center, nobody wants to pay so much money. So as long as you have enough people, the correct skill sets to cover - the cycles required for one year. Face it, I think bosses will try not to spend too much money on this.

This quote reveals the general sentiments of the AC participants that top management still see the IAF as a cost centre as the IAF has yet to show its true value contribution to the organisation.

**(iv) Integrity of top management (new emerging theme)**

During the AC interviews, several AC participants comment that the integrity of top management is the compass of how corporate governance of an organisation is heading. The AC participants regard integrity of top management so critical that some have made it a key consideration prior to acceptance of their AC appointment. This is reflected in the AC participant's statement below:

[AC#10] [...] if there's an integrity issue then we are also exposing ourselves by sitting on the board. So that is one of the considerations before we take on the appointment.

Another AC participant informs that integrity of top management is also a key factor for fund managers in their investment consideration/decision. This is as illustrated in the AC participant's statement below:

[AC#2] [...] the personal integrity of the person is very important. There are a lot of fund managers when they invest in companies, they don't invest in business model. They invest in person - the senior management. The key people who drive the business. AC is secondary, we are reactive.

Below is an example of how a well-managed multinational corporation, with a long history of strong financials and healthy corporate culture, is marred after a change of



leadership – from one with high integrity to one with low or no regard for good corporate governance practices. The AC participant’s account is presented in the statement below:

[AC#6] [...] if you look at [PLC-C], in the early days, there was no major shareholders influencing the board and the management. PNB<sup>107</sup> had a chunk of shares. But in those days PNB was passive and not as big in terms of their shareholding that they actually control now. Then, [PLC-C] had very widespread shareholdings. A lot of institutional shareholders - it means the entire board or majority were independent. I remember when I joined [PLC-C], the board of twelve, nine were independent. The chairman was, at that time, independent. He was Tun Tan<sup>108</sup> [Siew Sin]. Although he was the ex-minister of finance, I think no-one can doubt that he’s a very independent person. And then there were two executive directors, the CEO and finance director. If you look at that model, I mean whether you said it’s nine or ten independents, whether you include the chairman or not, the meetings were really very, very open in terms of discussion, in terms of questioning in what’s going on. As we moved on, unfortunately, then PNB became more involved. I think they saw their role as not just being passive shareholders. After Tun Tan passed away, PNB chairman became the chairman and the chairman then also appointed other PNB nominees. So then you could see that although they were still independent based on any standard of law, there became a bit of question mark over some of those directors. They were all very close to the PNB set-up. And they declared themselves as independents but PNB referred them as PNB nominees. How can you be PNB nominee, a nominee of one of the substantial shareholders and still call yourself independent? It becomes a little bit grey and that, I think to me, that’s when it started changing the character. So the ‘tone’ became different and history shows what happened. In later years, [PLC-C] went through all sorts of financial debacles where they lost so much money.

In summary, the organisational supports most significant to AC effectiveness, as highlighted by the AC participants, are tabulated in Table 6.3.

**Table 6.3: Key comments on organisational support (under second component)**

Organisational support	AC (n=14)*	AC key comments
Organisation hierarchy/status of the IAF (section 6.2.2.1)	9	A majority of the AC participants negate the fact that clarity of organisational status is crucial to enhance IAF effectiveness. This is mainly due to the fact that a majority of them out-source their IAF.

<sup>107</sup> Stands for Permodalan Nasional Malaysia (PNB). It was incorporated on 17 March 1978. PNB was conceived as a pivotal instrument of the Government’s New Economic Policy to promote share ownership in the corporate sector among the Bumiputera (son of the soil), and to develop opportunities for deserving Bumiputera professionals to participate in the creation and management of wealth. More details see [http://www.pnb.com.my/about\\_e.php](http://www.pnb.com.my/about_e.php)

<sup>108</sup> Refers to Tun Tan Siew Sin, the first finance minister of Malaysia after Malaysia gained its independence from England in 1957. [https://en.wikipedia.org/wiki/Tan\\_Siew\\_Sin](https://en.wikipedia.org/wiki/Tan_Siew_Sin)

Organisational support	AC (n=14)*	AC key comments
Corporate culture – ‘tone at the top’ (section 6.2.2.2 (i))	14	<p>Top management is cited as the right party to set the ‘tone’ since they are the most influential party in the organisation. However, they need to ‘walk-the-talk’ to ensure the message is filtered down to all levels of organisations. Top management is the main driver behind good corporate governance. Nothing will happen without their support.</p> <p>Top management will be more supportive of IAF if they have long-term view (sustainability) for the organisation. Larger listed issuers (with complex group structure or diversified businesses) value contribution of IAF more than smaller listed issuers. As top management do not have direct control over these operations.</p>
CAE involvement at top management strategic meetings (section 6.2.2.2 (ii))	3	The AC participants see the IAF role is in internal controls. They do not view the CAE could contribute constructively to strategic board meetings.
Investment in IAF (section 6.2.2.2 (iii))	11	A majority of the AC participants view this as important. But top management are not prepared to spend more on IAF due to their scepticism over the IAF’s true value contribution.
<i>Integrity of top management (new emerging theme) (section 6.2.2.2 (iv))</i>	5	Integrity of top management is utmost crucial. It is the compass of how corporate governance of an organisation is heading. Several AC participants assess ‘integrity’ of top management prior to acceptance of their AC appointment.

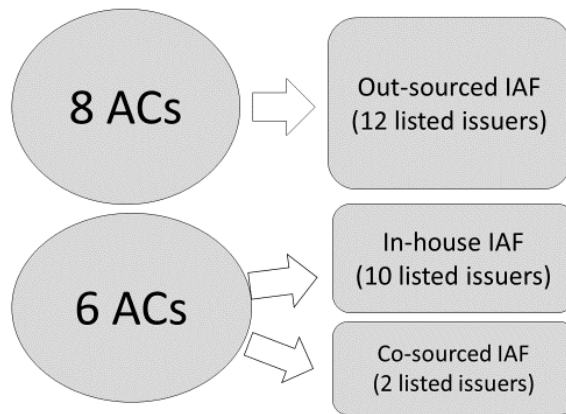
\* (n=14) represents the total number of AC participants who participated in this study. The number in each column below represents the number of AC participants who responded to that particular item/question.

### 6.2.3 Internal audit resources (in-house IAF)

For the IAF to operate effectively, the IAF department needs to be adequately resourced (competent internal audit staff, adequate staffing, computer software etc.).

The AC participants' views are presented under two main sections: investment in the IAF and attributes of internal audit staff. During the AC interviews, it came to the attention of the researcher that a significant number of listed issuers in Malaysia out-source their IAF. Eight AC participants inform that all their twelve listed issuers out-source their IAF. The remaining six ACs inform that ten of their listed issuers maintain an in-house IAF with two of their listed issuers co-sourcing their IAF. This is summarised in Figure 6.4. Following this new development, a new construct has been created to address this new emerging theme: 'out-sourced IAF'. The responses of the AC participants are presented in the following sections.

**Figure 6.4: AC participants and IAF sourcing arrangement of listed issuers**



### 6.2.3.1 Investment in the IAF

Whilst a majority of the AC participants acknowledge that size or investment in the IAF will impact on IAF effectiveness, the findings also suggest that 'big is not necessarily beautiful'. Several AC participants comment that high investment in IAF does not automatically translate into better IAF quality. To them, IAF spending should commensurate with the 'needs' of the respective organisations. Having said that, several AC participants report that certain listed issuers (predominantly the smaller listed issuers) have decoupled while conforming to the mandatory IAF ruling. These listed issuers either out-source their IAF for very low fee budget or establish a 'bare-to-bone' or skeletal in-house IAF team with only one or two-men junior internal audit staff on the team. This is reflected in the AC participant's statement below:

[AC#3] Yes and no. But why I say yes, because a lot of organizations do it as - form over substance. So if you give a one-man team or a two-person team with a limited budget, he or she is not going to work too long. [...] So it's a negative.

The AC participant continues:

Now, if you increase the budget, it doesn't necessarily mean that the quality of the internal audit function will improve. You have to look at the function first if you're doing the budget. I would do it bottom up. What is my internal audit function? How many people do I need? What's the resources that I would require? What does my audit committee allow me to do on cyclical visits? Certain critical processes are visited every year, certain on a three-year cycle or a five-year cycle. A lot of organizations say not more than 18 months, like my plantation audits will never go beyond 18-month-cycle. So that's an 18-month cycle so that needs a certain amount of resources. [...] Budget is a secondary thing, so if someone says we don't have money to do this. Then you have to reallocate resources. The CFO has to explain to us, the COO, the CEO have to tell us why couldn't have they allocated a little more on this. Another aspect of compliance work is to check on health and safety measure. I cannot afford even one death or one accident on my rigs or on my construction site or in my plantation. It's one too many. So our best in class won't tolerate a budgetary constraint, right? [...] Having said that, I'm not giving carte blanche to my internal auditor to go on holiday.

The last quote reveals that budgetary constraints should not be the reason to restrict the scope of the IAF as this will compromise on the quality of the IAF and accordingly defeat the purpose of the IAF. It is paramount for the scope of the IAF to be extensive enough to accord the top management and the AC with the necessary level of assurance in relation to the risk and controls environment of the organisation.

### **6.2.3.2 In-house IAF: attributes**

The discussion on the attributes of in-house IAFs is categorised under two main sections: core attributes and specific attributes. Sections (i) and (ii) focus on the core attributes staff (i.e independence and objectivity, and competency and proficiency), whereas sections (iii) and (iv) present the attributes specific to the CAE and internal audit staff respectively.

#### ***(i) Core attributes: independence and objectivity***

A majority of the AC participants acknowledge that independence and objectivity are one among the several core attributes that support IAF effectiveness. Several AC participants comment that an internal auditor's 'independence' or 'objectivity' is guided by his/her own personality and integrity. They suggest that the best way to gauge whether an internal auditor has discharged his/her role objectively is by looking

at the manner in which he/she pursues tough audit queries and challenging audit findings as reflected in the statement below:

[AC#12] You want someone who have a strong personality to be able to actually deal with management as an independent party where you do things without fear or favour. So that is very critical.

***(ii) Core attributes: competency and proficiency***

In prior literature, professional qualification such as CIA is normally adopted as a proxy measurement for competency of internal audit professionals. However, the majority of the AC participants do not view possession of a CIA qualification as necessary, particularly at junior staff level. In their view, a basic bachelor degree in accounting or finance will suffice. However, the AC participants' expectation rises as they move up the management ladder. The majority of the AC participants expect a calibre CAE to possess industry-relevant qualifications and experience in addition to professional qualifications (CIA, MICPA, CIMA etc.). However, all the AC participants who responded to this question negate the proposition that all effective CAEs must possess the CIA professional qualification. The AC views are reflected in the statements below:

[AC#4] Our CAE is a Certified Fraud Examiner and also has an IIA qualification. As IAs role is more to look at control and system, transaction flow, accounting degree is not the key selection criteria. So long as they have a basic knowledge in accounting.

[AC#3] [...] if you looked at Shell or Esso, don't be surprised if you find the CAE is a geologist or an engineer by training. Again, they all have very good analytical skills, they're very good at seeing where the risks are, where processes - at how critical processes are. In the case of an insurance company, if an actuary comes before me to be a CAE, yes, I will take them. So a property developer may want a surveyor. As long as that person has the skill sets to do the function but accountants invariably across on a macro basis, manufacturing companies, et cetera, trading houses should fit the bill.

The last quote also highlights the importance of analytical skill as a key criterion in determining competency of the CAE or internal audit staff. It also suggests that for a non-specialised industry (manufacturing, trading etc.), a professional qualification in accounting will suffice for a CAE to discharge their role competently. However, for specialised industries (insurance, oil and gas etc.), industry-related qualifications and experience take precedence over basic accounting or auditing qualifications. In the AC participants' view, an ideal internal audit team is one with a good mix of skillsets as reflected in the statements below:

[AC#7] [...] for IA if you focus on operational issues like controls, then to just focus on people with accounting and financial experience is not good enough.

[AC#3] In [PLC-A], my CAE is a CIMA member but her team, she has taken in staffs with various investment analyst skills, they have worked in stock exchanges overseas with CFA qualification. They are doing IIAM training programs now.

Several AC participants suggest that to enhance competency, the internal audit staff need to continuously upgrade their skills by either sitting for relevant professional examinations or attending ‘continuing education’ programs conducted by the relevant professional bodies such as the IIAM. This is reflected in the AC participant’s statement below:

[AC#3] [...] all our people are professionally qualified, professional accountants - MICPA or MIA members, et cetera. Or if they’re still in the semi-sitting for exams, they have to qualify then we also put them through IIAM training if they want to become IIAM members, it’s fine. Those who want to do IT audits and they want to do CISA exams, we encourage them as well. Anything to continuously learning, we welcome them. So as an organisation I give that culture.

The AC participants’ views are sought on whether past external audit experience will enhance competency of internal audit staff. Their views are mixed. The AC participants’ statements that support this view are presented below:

[AC#3] If you take a person working in a public accounting firm joining the private sector, who have had audit backgrounds would have an added advantage because day-in, day-out, they have been doing it. How they wrote their report, how to differentiate between a critical issues from a minor point, financial impacts, all those sort of stuff.

[AC#4] It will be good to have candidates with external audit background. As they would have the knowledge in internal control audit as well as exposure on various industries.

Conversely, several AC participants suggest that the internal audit mindset is very different from that of external auditors. Hence, past experience in external audit may not necessarily help to enhance the internal auditors’ competency. This is reflected in the AC participant’s statement as follows:

[AC#11] [...] I think while some people think external audit is very similar to internal audit, actually it’s not. It’s not. So what I’ve seen is that for many of the specialist internal audit service companies they would rather hire somebody from scratch - from a fresh graduate and train them up to think like an internal auditor.

**(iii) Specific attributes: CAE**

In addition to the core attributes as presented in earlier sections, the AC participants highlighted some CAE-specific attributes (e.g. people management skills, ‘seniority’

and leadership), which in their views are critical for an effective CAE. They are presented in the following sections.

- ***Integrity, professionalism and assertiveness***

In considering the attributes specific to the CAE, the majority of the AC participants cite integrity and strong personality of the CAE. In their view, these attributes will propel the CAE to act objectively and assertively. This is reflected in the AC participant's statement below:

[AC#2] Personal integrity of the person is very important. And the person must be firm, assertive and must know the objective because after the findings there is always that session whereby they would clear their findings with the management, whereby they will come up with a management response. Now, sometimes you may talk to a very powerful head, who maybe related to the owners. So it's never easy. So it's not so - in this scenario, it's not so much lack of skill. It is the fear of losing the job and sometimes if he's not careful, not only lose your job, you may lose your life. If you unravel a scandal that may put him in jail and you are so adamant about it and don't know how to play your cards right, injury may come to you.

- ***People management skills***

The AC participants who responded to this question perceive the soft skillset of CAE (people management skills, interpersonal skills, persuasion and negotiation skills etc.) as more critical than technical skillsets: '[p]eople management skill is a gift' [AC#11]. Without people management skills, the CAEs may not be able to garner the support of other departmental heads (their auditee), which could be detrimental to the smooth operation of the IAF. Below an AC participant recounts how his CAE diplomatically projects his IAF role – not as 'corporate police' but to help and support other department heads. This is reflected in the AC participant's statement as follows:

[AC#11] He's got to be sensible about it. But, in general, as an internal auditor - people management is really important especially when you deal with senior management e.g. CEO, CFO or Managing Director. People management skill is a gift. How do you ask questions in a way that is not hostile and diplomatic. Basically, be smart about how you ask the right questions. Because there will be a natural tendency for most people to be very guarded when they talk to you.

This AC participant continues:

One of the reasons why we hired our guy was that he's very aware of this perception that the IA is a policeman or is there to find out your mistakes. So in all his approaches, he's always been - I'm here to help you, I'm here to help you to make sure that nothing bad happens through lack of proper control, help you to make you aware, you being one of the managers that this area is weak and you need to strengthen it. If you don't, something

bad will happen without you knowing it and then you will have to take the responsibility for it. So I am here - to help you, not to catch you.

To reaffirm the significance of people management skills at the CAE level, below one AC participant recounts how his well-qualified and experienced CAE was re-assigned to an operational unit due to the CAE's lack of people management skills:

[AC#7] I think it was a decision proposed by the executive management and I think because [the CAE]<sup>109</sup> has been in that role for many, many years and maybe it's also good to have a change in approach and I think over the years, of course, I think [the CAE] interaction with operational management has not been that positive because there's been quite a lot of negative feedbacks on how [the CAE] handled various situations, how [the CAE] deal with them. Of course, there were opportunities within the group for [the CAE] to move on because in that particular operational area there was a vacancy and they needed someone to fill it so it was done as an internal transfer. I would say in a way it is a win-win situation.

- *'Seniority'*

Whilst formal organisational hierarchy/status is not crucial for an out-sourced IAF, it is important for an in-house IAF. The majority of the AC participants who responded to this question perceive 'seniority' of the CAEs as essential in gaining recognition and support from other departmental heads. In addition, the CAEs' 'senior' status within the organisation hierarchy will also accord them with the confidence and assertiveness to deal with other senior management staff (e.g. CEO, CFO) on tough internal audit related matters. The 'seniority' here refers to not only the organisational status but also their professional standing and industry status. These views are reflected in the AC participants' statements below:

[AC#3] This itself leads to the fact that the IA function should be led by a person senior enough to command respect of the peers and also senior enough to be ensuring he or she is confident enough to take on the CEO to check whatever assertion is being made in the interviews of the CEO or COO, rather than being subservient.

[AC#12] [...] if I could have my way, I'd like him to be at general manager level. But, of course, here I think the - it's not big enough department for him to actually get to the rank of a GM [refers to general manager] but I think in terms of seniority, in terms of experience - years of experience, he should have qualified as a GM or at least a CFO level if not higher. Anything lower than that then you are not seeing eye to eye with the senior management. [...] They must be able to see eye to eye with people they are going to test on or assist. [...] of course, salary should be comparable with their role. Not easy.

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<sup>109</sup> A generic term '[the CAE]' is used to disguise the identity of the CAE cited by the AC participant.



However, several AC participants with in-house IAF report that their IAF teams are headed by relatively ‘junior’ internal audit professionals in terms of organisation hierarchical status, experience and age. In most instances, they do not carry the CAE designation as reflected in the statement below:

[AC#11] In our case, this person is in his late 20s so in that sense he’s relatively junior. We thought his internal audit experience was pretty good and adequate. Obviously it’s a concern if you have a relatively young person talking to a senior person, my main concern is whether other senior management, how would they react to a younger person. [...] He is given the title of group internal audit manager so it’s senior - he’s the most senior person in the team basically.

A majority of the AC participants consider ‘seniority’ of the CAE as crucial in the enhancement of CAE’s effectiveness. However, not all listed issuers can afford an experienced and well-qualified CAE. Several AC participants comment that CAE or head of internal audit engaged has to be commensurate with the ‘needs’ of the listed issuers. There is no ‘one size fit all’ formula. This is illustrated in the AC participant’s statement below:

[AC#11] If I’m in Sime Darby<sup>110</sup> where I have many divisions then I need a very experienced, seasoned person with a lot of experience. If you’re a smaller medium-sized company then you hire accordingly because someone who’s very experienced in working in a big firm with a big team under him, that’s not going to happen in my company. So he’s not going to be very happy. We also need somebody who has to do a lot of work where an experienced person who’s used to having a lot of people doing the hard work may not find it so suitable. So we had to adjust for that. Someone who’s a doer rather than a person managing a big team.

- **Leadership**

Interestingly, no AC participants highlighted leadership as a critical contributory factor to CAE effectiveness. On enquiry, several AC participants report that ‘leadership’ is assumed if the CAE or head of internal audit are able to rise to that position. This is reflected in the AC participant’s statement below:

[AC#14] I think it must be in-built in them. Otherwise, how can they be the chief internal audit that heads the team? Leadership is important.

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<sup>110</sup> [www.simedarby.com](http://www.simedarby.com)

*(iv) Specific attributes: internal audit staff*

In addition to the core attributes of independence and objectivity, and competency and proficiency as presented in the earlier sections, the AC participants also highlighted some additional internal audit staff-specific attributes: inquisitive mindset, communication skills and people management skills. The AC participants' view are presented in the following sections.

- *Audit mindset*

All the AC participants comment that effective internal audit staff must have the right attitude towards their role. They must possess an inquisitive mindset and be able to highlight a problem when they 'see' it. In addition, they must be passionate about their job and willing to go the extra mile to unearth problematic areas as highlighted in the following statements:

[AC#5] [...] if the junior follow the audit program and do rigidly what is in the program, it doesn't help. [...] For the junior, it is important that whatever they see, if they think need to highlight even though its not in the audit program, must be able to write it down. That is a skill. [...] Some junior they are not able to write well but able to highlight. That is important. No need to write a lot but you must be able to 'see' things. [...] Doesn't matter where you are from, big, small [audit] firm or how big your qualification.

[AC#3] You have to recruit the people with the right aptitude. Something they sniff - a problem, they know doggedly, they will go. People can give you red herrings, but you must be able to go through. That's the sort of person without fear or favour. Even a junior staff, I like that because these are the people who are going to unearth problems.

[AC#2] [...] you can deduct whether he is just earning his keeps or is he doing the job as an IA from the way the issues are discharged. Whether he take the shortcut or is he inquisitive, he want to find an end, he just want to find an easy closure. From there you'll know because you read his report, you will know. Because especially if you deal with them, you talk to them, the way they answer you, you'll know whether he's passionate.

- *People management skills*

All AC participants who responded to this interview question report that people management skills, particularly interpersonal skills, are crucial for internal audit staff in order to get the cooperation of other departmental staff (the auditee). The AC participants' view is presented in the AC participants' statements below:

[AC#12] Interpersonal skills because no point having someone and, at the end of the day [...] it becomes very antagonistic. You want someone who is cordial, who's probably a little bit of - I would say in Chinese - 'thick skin'. You don't have to be afraid of being criticised or sneered at sometimes but you have to portray that your job is not so much of

finding fault. The job is actually trying to see that we have in the processes - internal control processes in place to ensure that the data - financial information is captured with integrity.

[AC#7] I think human skills are important because at the end of the day the operational management are their clientele and they should be seen to be working together to improve things. I think it cannot be just a case of IA come in to find fault. In that case they won't get very far because they will get rebuffed, they won't get the cooperation needed.

However, another AC participant warned that internal audit staff should not get too friendly with staff from other departments for fear of compromising their independence and objectivity. This is reflected in the AC participant's statement below:

[AC#8] My opinion is if they're too friendly with other staffs, then, IA have this issue of 'it's a small matter', 'no need to bring it up'. But that's not the point. The small thing could eventually become something, blow up into something.

- ***Communication skills***

The consistent comment from the AC participants is the poor communication skill, both in report writing and presentation of ideas, among junior internal audit staff. In the AC participants' view, this could be a set-back for IAF effectiveness. This is reflected in the following AC participant's statement:

[AC#2] [...] one of the thing is the - sad to say, we lost a generation of English writer, command of language is important -i.e. communication skill. You need to write, you need to present ideas, present your thoughts so some people, they may have the skill sets in IA but if you can't communicate, I think that is a very big disadvantage. Therefore, to find somebody, of course, obviously you must have experience - able to write and able to present. The AC has no time to read report this thick. So it's pertinent for the gentleman or lady over there when they present, succinct points, very clearly, issues, don't want to go round. [...] Reporting by exception - so the board appreciate that. When there's major issue, they must be able to explain well.

## **6.2.4 Out-sourced IAF**

### **6.2.4.1 Rationale for out-sourcing**

The out-sourced IAF is a new theme that emerged during the AC interviews. A majority of the AC participants posit that listed issuers out-source their IAF due to various reasons, such as human resource management, budget constraint, specialised skills (e.g. IT) and independence.

- ***Budget constraints***

It is highlighted by the majority of the AC participants that due to budget constraints or the size of their operations it may not be economical or viable for the smaller listed issuers to maintain an in-house IAF. This is reflected in the AC participant's statement below:

[AC#7] The smaller company because of its size, frankly, I don't think they would be able to hire and retain any IA capabilities. So the only alternative is to outsource.

- ***Human resource management***

Another rationale for listed issuers opting for an out-sourcing arrangement is to relieve the listed issuers from human resource management (i.e. hiring/retaining and training). This is reflected in the AC participants' statements below:

[AC#13] If we have an in-house IA team, we may have problem managing people. If that is not properly managed, it may not be effective as well. And second, to get people, talent is a problem. And, the IA staff turnover is quite high. It's not easy to get good people or even to maintain the team.

[AC#11] The challenge of internal audit is there's a high level of turnover and it also happens in the [external] auditing profession, I guess. But when it happens in an internal audit situation, [...] the impact is a bit more serious because once that person is gone, he takes away a lot of the knowledge and experience that is required.

- ***Independence and objectivity***

The majority of the AC participants comment that an in-house IAF could compromise on their independence and objectivity if they stay too long with the listed issuers and become too familiar with the auditees. This is reflected in the AC participant's statement below:

[AC#12] Too familiar then you don't do your job. They could actually lose their independence and objectivities and then you get too complacent. [...] they don't look for better improvement because when you look for improvement, the management will look at you differently again. They said you are making trouble for them rather than helping them. So they all tend to - instead of creating any problem with the relationship, they probably don't want to do much more than what is required. And that is the danger.

In the AC participants' view, to maintain independence and objectivity of the IAF, they could easily rotate the out-sourced IAF by not renewing their engagement contract. However, they could not terminate the employment of in-house internal audit staff if the dismissal is not in accordance with the law. In addition, the majority of the

AC participants suggest that out-sourced IAF have to act professionally and independently as their reputation is at stake if they compromise on their professionalism and independence. This is reflected in the AC participant's statement below:

[AC#1] Because IA is also a professional. At the end of the day, he has to make a decision, which side shall I fall on. By the end of the day, he knows that if his reputation is on the line, he isn't going to piss about with his job. [...] they are not going to sit down there and put their profession, their rice bowl on the line and say I side manager, I lie to you, they're not. So if they are found out, in the whole market, they're dead. It's a small market. There aren't too many of them around and, basically, where are they? Basically in KL, Johor, Penang and it's a competitive market.

- *Fresh perspectives*

Several AC participants comment that out-sourced IAF are able to bring in fresh perspectives and ideas compared to the in-house IAF due to over-familiarity with their job. This is reflected in the AC participant's statement below:

[AC#10] It's because I think after some years, whatever they have seen is they have seen. If it's a new out-sourced IA come in, they may bring in a different perspective of things.

- *Specialised skill sets*

Several AC participants posit that out-sourced IAF normally possess specialised skill sets (e.g. information technology, enterprise-wide risk management) compared to in-house IAF. Unless the listed issuers' operation is sizeable, it will be costly to maintain a team of specialised skilled internal audit staff. This is reflected in the AC participant's statement below:

[AC#12] I prefer to outsource to a good outsourcing firm because, one, they have the experience in sharing, they look at things, very independently. They are not myopic. In-house auditors may not have the kind of expertise and the research required. One area, for example, is if you're in-house, very difficult to find someone with an IT background. To me, internal auditors nowadays not just purely on manual, you must also have computer audit skills.

#### **6.2.4.2 Selection criteria for out-sourced IAF**

The discussion with the AC participants also reveal that the AC participants have considered a number of criteria in the selection of out-sourced IAF that in their view would enhance IAF effectiveness. The criteria includes relevant industry experience and qualifications of the principal/audit partners, adequacy of resources (competent

staff to undertake the audit assignments etc.), audit fee and audit methodologies. For renewal of the IAF engagement, the AC participants will assess, amongst others, the quality (i.e. report presentation and depth of audit findings) and timeliness of the delivery of audit reports.

- ***Relevant industry experience and qualifications***

A majority of AC participants comment that relevant industry experience and qualifications of the audit partners/principals are crucial in their selection of out-sourced IAF. This is reflected in the AC participant's statement below:

[AC#13] We look at their related industry experience, we look at their resources, we look at their qualification. See whether they have internal audit experience then we also look at their methodology. See whether their methodology because now it need to be risk based. If it's not risk based, basically, do not fulfil what we required.

- ***Adequate resources***

The consistent sentiment among AC participants is that even if the partners, executive directors or principals of the out-sourced internal audit firms are well-qualified, if their firms lack the necessary human resources to undertake the IAF engagement it is not going to contribute to the effectiveness of the IAF. The adequacy of human resources includes staff with the right professional qualifications, skill sets and experience. This is highlighted in the AC participant's statement below:

[AC#11] [...] many of these firms, the people are not - they're overworked, not very well-experienced because the experienced ones are running around so they never spend enough time in the company so they will let their juniors just go through the motion of - I get the feeling - doing what is supposed to be done in a particular area, highlight a few issues and make recommendations and that's it. And I find it is very disappointing because very often when I query them on why do you say this is a medium risk and why do you say this is a high risk, they don't really know.

Several AC participants highlight people management skills as a critical attribute of out-sourced internal audit staff. Since the out-sourced internal audit staff are not from the same organisation, it is more challenging for them to garner information from their auditees. Accordingly, it is crucial for them to possess exceptional interpersonal skills

for them to entice their auditees to open up and share sensitive information within a relatively shorter timeframe<sup>111</sup> as reflected in the statement below:

[AC#1] [...] the person who's managing the job must have the temperament and personality to do an internal audit function. It's very difficult to get the cooperation of the employees, the staff and management unless you have a personality which is able to get along or 'coax' - get information out of them. It's a skill. It's an intrusive job. [...] the person who does it has to have that personality to be able to get as much out as quickly as possible from management without being at logged heads, fighting, fighting, fighting.

- ***Audit fee consideration***

Audit fee is a key consideration for a majority of the AC participants in the selection of the out-sourced internal audit firms. This practice is not beyond market norm since it is the duty of the AC to get the best value internal audit services in terms of monetary value and quality. This is reflected in the AC participant's statement below:

[AC#7] Basically we will ask for a quotation from about three firms, review them and then look at their capability. Of course this is the cost to the organisation so these are to be dealt with properly.

- ***Quality and timeliness of audit report***

Besides fee, another key consideration in the renewal of an out-sourced IAF is the quality and timeliness of the audit report. The AC participants' views are reflected in the following statements:

[AC#4] We look at quality of the IA reporting on certain item whether it is superficial, adequate or in-depth for our purpose. However, cost plays an important factor as well.

[AC#10] Of course, the kind of quality of the report. What do they look at, what kind of things that they are suggesting and they have highlighted?

[AC#3] It's no use when you did at Chinese New Year period and you're giving me the report today<sup>112</sup> because things would have changed. Even those guys could have rectified a new system completely.

A summary of the influences of the 'organisational support' on IAF effectiveness, based on the AC participants' perspectives, is presented in Table 6.4.

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<sup>111</sup> Compared to the in-house IAF, out-sourced IAF are required to complete the audit within a stipulated timeframe for each engagement.

<sup>112</sup> The AC interview was conducted in early October 2014 and the Chinese New Year was in February of the same year. Approximately nine months apart.

**Table 6.4: Key comments on IAF resources (under second component)**

<b>Internal audit resources</b>	<b>AC (n=14)*</b>	<b>AC key comments</b>
Investment in IAF (section 6.2.3.1)	13	Investment in IAF is crucial to enhance its effectiveness. However, ‘big is not necessarily beautiful’. The AC must decide on the appropriate level of IAF investment which could assure the directors that the organisation has a sound control system. IAF investment should commensurate with the size and complexity of the organisation’s operations.
<b>Core internal audit attributes (section 6.2.3)</b>		
Independence and objectivity (section 6.2.3.2 (i))	12	Independence and objectivity is dependent on individual’s personality and integrity. However, objectivity may be compromised if the internal audit staff perceive senior management has significant control or influences over IAF resources (e.g. hiring and firing, remuneration and career progression) vis-à-vis the AC.
Competency and proficiency (section 6.2.3.2 (ii))	10	Varied industries require different skill sets. CIA qualification is not the only measurement to proxy competency of internal audit staff. For IAF effectiveness, the AC look for a mix of skill sets on a group basis (i.e. internal audit team) rather than individual basis.
<b>Specific attributes of CAE (section 6.2.3.2 (iii))</b> AC participants (n=6)^		
Integrity, professionalism and assertiveness	8^	Integrity and strong personality of CAE are critical as it will propel CAE to act objectively and assertively.
People management skills	6^	Good people management skills (e.g. interpersonal, negotiation and communication skills) enable CAEs to deliberate and resolve tough audit findings without antagonising and causing conflicts with other senior management (e.g. other departmental heads)
‘Seniority’	7^	‘Seniority’ will accord the CAE with the confidence and assertiveness to deal with



<b>Internal audit resources</b>	<b>AC (n=14)*</b>	<b>AC key comments</b>
		other senior management on challenging audit issues.
Leadership	3^	Leadership is assumed if CAE can be appointed to this position.
<b>Special attributes of in-house internal audit staff (section 6.2.3.2 (iv))</b> AC participants (n=6)^		
Audit mindset	4^	They must possess inquisitive mindset and be able to highlight a problem when they 'see' it. They must have the urge to find an end and not an easy closure (i.e. passionate about their job)
People management skills	5^	They must possess interpersonal skills and not antagonise the auditee as they need to get their cooperation and support.
Communication skills	3^	The junior internal audit staff possess poor oral presentation skills and poor report writing skill.
<b>Out-sourced IAF (new emerging theme) (section 6.2.4)</b> AC participants (n=10)#		
<b>6.4.2.1 Rationale for out-sourcing</b>		
<i>Budget constraints</i>	6#	Due to budget constraints or size of operation, it is not economical for the smaller listed issuers to maintain an in-house IAF.
<i>Human resource management</i>	8#	Human resource management (e.g. to recruit/retain internal audit staff, training etc.) has been cited as the main reason for listed issuers to opt for out-sourcing arrangement.
<i>Independence and objectivity</i>	8#	Mixed views in respect of whether out-sourced IAF is more independent than in-house IAF. AC who support (that out-sourced IAF is more independent) posit that since they are not employees of the organisation, the issue of being 'overly friendly' with staff of other departments will not arise. However,

<b>Internal audit resources</b>	<b>AC (n=14)*</b>	<b>AC key comments</b>
		AC who view otherwise, suggest that the out-sourced IAF may compromise with senior management in order to secure the new mandate or to be retained in the job.
<i>Fresh perspectives</i>	4#	Out-sourced IAF are envisaged to give fresh perspectives due to their wider exposures vis-a-vis in-house IAF who could be too familiar with the job.
<i>Possession of specialised skill sets (e.g. IT)</i>	4#	Out-sourced IAF possess specialised skill sets (e.g. IT, ERM). It is difficult to maintain an in-house IAF with such specialised skill sets due to cost factor.
<b>6.2.4.2 Selection criteria for out-sourced IAF</b>		
<i>Relevant industry experience and qualifications</i>	5#	Out-sourced IAF need to possess industry experience that is related to listed issuers' industry.
<i>Adequate resources</i>	8#	Out-sourced IAF need to have adequate internal audit staff with the right qualifications, skill sets, experience and people management skills to undertake the monitoring role.
<i>Audit fee consideration</i>	6#	This is not to reduce IAF investment but merely to get the best value for organisations (in terms of monetary value and IAF quality)
<i>Quality and timeliness of audit report</i>	6#	Scope and depth of the internal audit findings and timeliness of internal audit report are critical in ascertaining effectiveness of the out-sourced IAF.

\* (n=14) represents the total number of AC participants who participated in this study. The number in each column below represents the number of AC participants who responded that particular item/question.

^Out of the 14 AC participants, only six AC participants have listed issuers that maintain an in-house IAF. They have responded constructively to interview questions pertaining to in-house IAF. Some AC participants whose listed issuers out-source their IAF have refrained or randomly contributed to interview questions on in-house IAF.

# Out of the 14 AC participants, eight AC participants' listed issuers outsource their IAF. Another two AC participants have co-sourced IAF arrangement; they have also contributed to this section of the interview questions.

### 6.2.5 Summary

Following the discussions in the foregoing sections, a summary of the main constructs of the internal enabling factors (second component) with their corresponding facts are presented in Table 6.5.

**Table 6 5: Summary of findings of internal enabling factors (second component)**

Constructs	Key interview questions	ACs' expectation	In practice
AC Support (section 6.2.1)	What are the AC attributes in your view are critical to enhance the IAF effectiveness?	<p><b>AC attributes</b> cited are: independence, financial expertise, diligence and commitment, industry experience and business acumen, judgemental skills, AC chair and AC members' assertiveness and people management skill.</p> <p><b>AC influences/support</b> cited are: AC's control over the IAF resources and AC's support and empowerment and close rapport with the IAF</p>	<p><b>AC attributes:</b> The main concern is the 'true' independence of AC appointees. It is a common practice that ex-government, nominees of ruling political parties and confidantes of controlling shareholders are appointed as independent directors (or AC) of listed issuers. These AC appointees normally lack the expertise and corporate experience to discharge their role diligently. These AC appointees are alleged to be less proactive during board deliberation and are subversive to owner-managers' demand. Asian culture could have also attributed to certain AC less provocative during board deliberation and less willing to stand-up and confront top management's decision.</p> <p><b>AC influence/support:</b> Although the regulators require the IAF to report directly to the AC, 'dual reporting' is a common practice in Malaysia. However, listed issuers do not adhere strictly to the 'dual reporting' structure as proposed in IPPF. The AC do not have full control over the IAF resources. For instance, remuneration and career progression of the CAE (representing in-house IAF) and professional fee of out-sourced IAF still lie in the hand of top management. This could affect effective monitoring of AC over the IAF.</p>
	How could AC contribute to enhance	AC should have control or more significant influence over the IAF matters (e.g.	In practice, since 'dual reporting' structure is being adopted, top management is 'perceived' to have

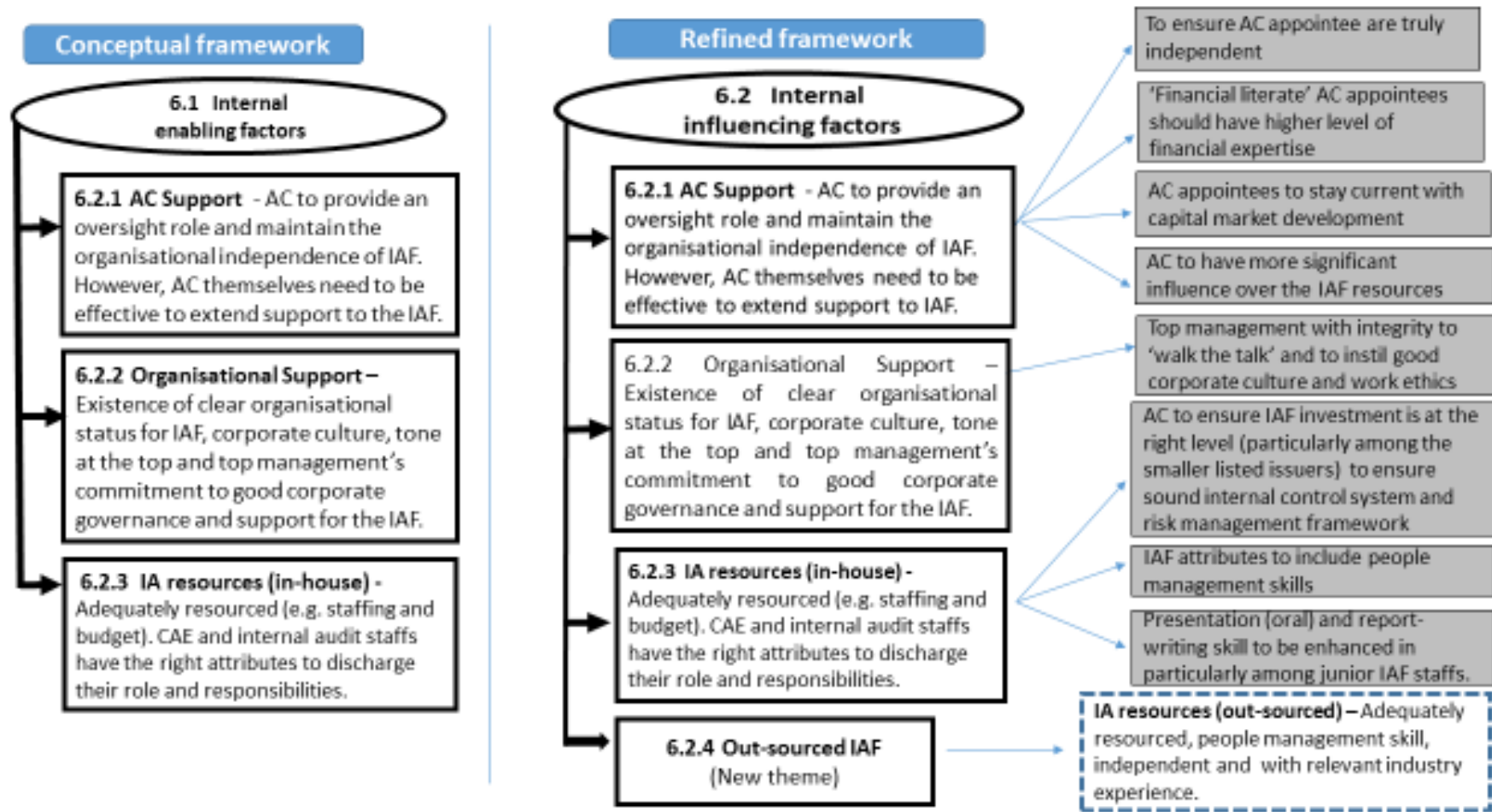
Constructs	Key interview questions	ACs' expectation	In practice
	organisational independence of the IAF and consequently its effectiveness?	the IAF resources) in addition to internal audit activities.	more significant influence over the IAF resources (performance appraisal and remuneration package of the CAE, the budget etc.). This may compromise on objectivity of the IAF.
Organisational support (section 6.2.2)	Do you agree that CAE should be placed high up in the organisational chart for them to function effectively? Why?	A majority of the AC perceive otherwise. The AC posit that by virtue of the IAF reporting directly to the AC, their organisational status is inferred.	This is due to the fact that majority of the listed issuers out-sourced their IAF. Even for listed issuers that maintain an in-house IAF, the internal audit staff who heads the in-house IAF team may not be 'senior' enough to be placed high up in organisation chart.
	Who do you think should be the party to set the 'tone at the top'? Why?	The top management should be the party to set the 'right tone' since they are the most influential within the organisation. Integrity of top management is critical as it is the compass of how corporate governance of the organisation is heading.	The AC acknowledge the significant influence top management have over the organisation (including the IAF resources). In their view, without top management's support, all good governance effort will just be an academic exercise. This include effective practice of the IAF.
The IAF resources (in-house) (section 6.2.3)	Investment in IAF	Investment in IAF is critical but 'big is not necessarily beautiful'. The IAF investment should commensurate with the 'needs' and size of operation of the respective listed issuers. An effective AC should decide on what is the optimal level of IAF investment for the listed issuers.	In practice, listed issuers are not prepared to spend significant amount on the IAF as top management are sceptical over the IAF's true value contribution to governance. Certain listed issuers (mainly smaller listed issuers) have limited budget for IAF. They either out-source their IAF or maintain a one-man internal audit team (with a relatively junior staff). Their main objective is to conform to the mandatory IAF ruling and stay legitimate.
	What are the attributes which must be possessed by CAE/internal audit staff to ensure their effectiveness?	<p><b>Core internal audit attributes</b> are: independence and objectivity, and competency and proficiency.</p> <p>Independence and objectivity is dependent on individuals' integrity and personality.</p>	Top management has relatively more significant influence over the IAF resources (e.g. CAE's remuneration and performance appraisal) vis-a-vis the AC. This may have impact on the independence and objectivity of the CAE.

Constructs	Key interview questions	ACs' expectation	In practice
	Core internal audit attributes	Competency and audit skill sets vary depending on industry of auditees' business operations. AC's perception of competency is based on group's (i.e. internal audit team) mixed skill sets rather on individual basis.	The CIA qualification is not a 'must-have' professional qualification for CAEs to be considered as effective. Rather, the CAEs' competency are assessed based on their industry-relevant qualifications and experience and their analytical skills. At junior IAF staff level, a bachelor degree in accounting and finance suffice.
	Specific attributes – CAE	<b>Attributes</b> cited are: integrity and assertiveness, people management skills, 'seniority' of CAE	In the AC perspective, CAE's soft skill set (e.g. people management skills, negotiation skills, interpersonal skills) takes precedence over their technical skill sets.  The AC participants inform that a majority of the CAE or heads of internal audit are pretty 'junior' in terms of their industry and work experience.
	Specific attributes – internal audit staff	<b>Attributes</b> cited are: audit mindset and skill sets, people management skills, communication skills (oral and written)	Poor communication skills is a major concern of the AC. In their view, it will affect the ability of the internal audit staff in presenting their audit findings thus compromising on their effectiveness. The poor command of English is particularly apparent among the younger generation. This is attributable to a policy change by the Malaysian government where the medium of teaching was switched from English language to Malay language in the early 1970s.
<i>Out-sourced IAF (section 6.2.4)</i>	What is/are the main driver(s) that encourage listed issuers to out-source their IAF?	<b>Rationale for out-sourcing arrangement cited are:</b> Budget constraint (particularly for smaller listed issuers), absolve listed issuers from human resource management problem, independence consideration, fresh perspective and specialised skill set (e.g. IT) of out-sourced IAF.	Consistent with expectation of the AC participants.

<b>Constructs</b>	<b>Key interview questions</b>	<b>ACs' expectation</b>	<b>In practice</b>
		<p><b>Selection criteria for Outsourced IAF:</b>                      Audit fee consideration,                      audit partners/ principals' industry-relevant qualification and experience,                      adequate resources and quality and timeliness of the internal audit report.</p>	

Following the discussions in the earlier sections, the second component of the conceptual framework is refined to incorporate the AC participants' expectation. It is presented in Figure 6.5.

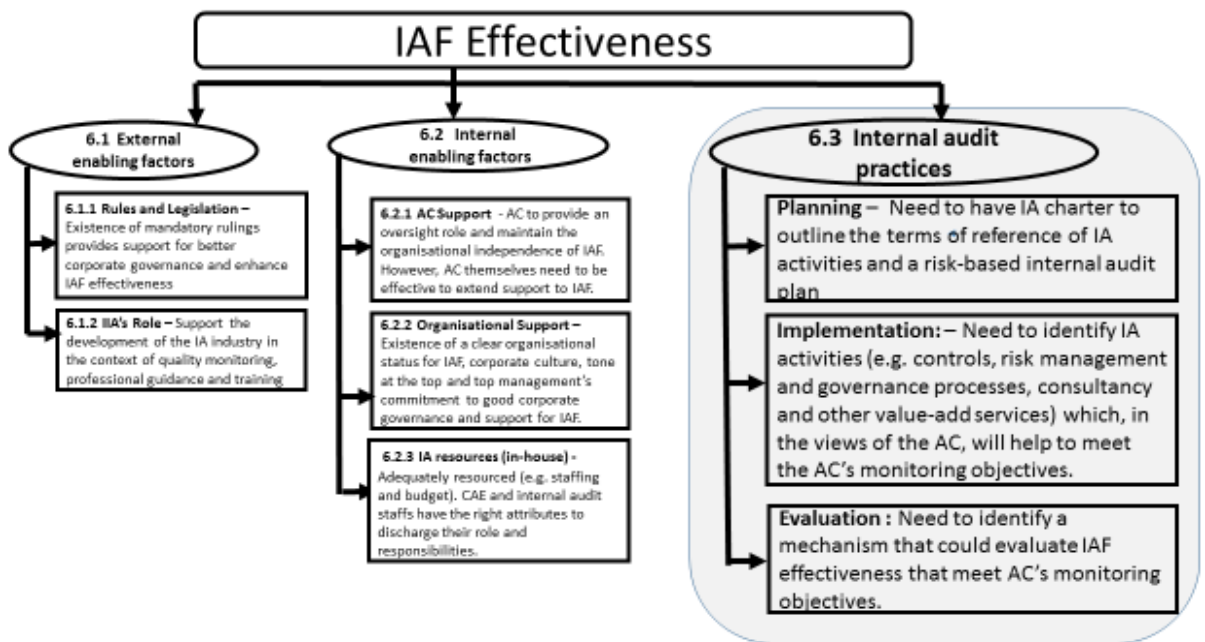
Figure 6.5: Refined internal enabling factors (second component)



### 6.3 Internal Audit Practices (Third Component)

The third component of the conceptual IAF effectiveness framework is the ‘internal audit practices’ and is presented in Figure 6.6. The AC participants’ comments on each of the three constructs are presented in section 6.3.1 (Planning: internal audit planning), section 6.3.2 (Implementation: nature of internal audit activities) and section 6.3.3 (Evaluation: IAF performance evaluation). Following these discussions, a summary of the key findings and the refined framework of this section is presented in section 6.3.4.

**Figure 6.6: Conceptual IAF effectiveness framework (third component – internal audit practices)**



#### 6.3.1 Planning: internal audit planning

Under this section, the AC participants’ views are presented under two sub-sections: IA charter and internal audit planning (risk-based approach).



### 6.3.1.1 IA charter

To ensure clarity of the IAF role and responsibilities, the IIA (2013a) suggests that the purpose, authority and responsibility of the internal audit activity must be formally defined in an IA charter.<sup>113</sup> Lack of role clarity has resulted in the IAF not able to meet the expectation of either of its ‘masters’, i.e. the senior management or the AC (Lenz and Sarens 2012; Abbott, Parker and Peters 2010). The AC participants are not all familiar with the concept and purpose of the IA charter. After clarification by the researcher, several AC participants confirm that their listed issuers maintain the IA charter; however, they generally do not view the IA charter as having any significant impact on enhancement of IAF effectiveness. In their view, most of the important provisions of the IA charter (terms of reference and scope of audit work etc.) would have been captured in documents such as the engagement letter (for the out-sourced IAF) as well as employment letter and internal audit plan (for the on-house IAF). Accordingly, in the AC participants’ view, the preparation of IA charter is a mere formality that may not have much value-add to the effectiveness of the IAF. This sentiment is best reflected in the AC participant’s statement below:

[AC#2] The internal audit charter is just theory. To me, its theory. Good to have but is it necessary? I don’t know.

The findings clearly signify a lack of professional influence from the internal audit service providers (either the in-house or out-sourced IAF) over the key IAF stakeholders (i.e. the AC). They have not adequately, or have failed, in ‘educating’ the AC of the purpose and significance of the IA charter. This further reaffirms prior discussion on the weak normative isomorphism (via professional influences) in supporting effective practice of the IAF in Malaysia.

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<sup>113</sup> The IIA requires the IAF to present the IA charter which stipulates the purpose, authority and responsibility of IAF consistent with the Definition of Internal Auditing, the Code of ethics and the Standards for the board (including the AC)’s approval. (See the Standard 1000 –Purpose, Authority and Responsibility and the Practice Advisory 1000-1)

### 6.3.1.2 Internal audit planning (risk-based approach)

The Malaysian regulators require the IAF to report directly to the AC. However, the regulators are less explicit in relation to the operation of the IAF in listed issuers; they merely suggest for listed issuers to follow ‘the standards of the internationally recognized professional bodies’.<sup>114</sup> In relation to the development of an internal audit plan, the AC participants are consistent in their view that the CAEs or head of internal audit (for the in-house IAF), or partners or executive directors (for the out-sourced IAF) should be responsible for preparing and presenting the internal audit plan for the AC’s deliberation and approval. This is reflected in the AC participant’s statement below:

[AC#2] CAE will, of course - he being on the field and as I said we are not fulltime, he should give us a proposal. There are times when the AC chip in to consider - why don’t you look at this one, that angle and that one. Also we work hand-in-hand with the management. The management will also tell us their views what the key area is.

The last quote also suggests that the AC participant views the senior management’s involvement at the planning stage of IAF as crucial. It also infers the AC participants acknowledge that senior management have more extensive knowledge in the business operations and risk environment surrounding the organisation. This sentiment is also echoed in another AC participant’s statement below:

[AC#11] Recently we had an audit committee meeting and the internal audit manager presented his plans and the CEO said - actually I’d rather you look at payroll because that is a big part of our organisation and I just want to make sure that’s okay. And we talked about it and we agreed that if that’s what the CEO wants and it makes sense, why don’t we do that first? So in that sense, we work very closely with our senior management. I’ve got to agree with it. And it’s always driven by where do you think the risk areas are? Where do you think things can go wrong? Where are the ‘black-holes’ that you need to dig into? And sometimes you do need senior management to tell you a little bit about that. That’s why a strong senior management is very important. That’s your internal support.

Besides reaffirming that top management’s support and involvement is crucial at the audit planning stage, the last quote also confirms that a risk-based audit approach is being adopted in the development of internal audit plan. Below is the illustration of how a risk-based internal audit plan is being developed.

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<sup>114</sup> See commentary of Recommendation 6.2, Principle 6 of the CG Code (2012)

[AC#2] The management will chart the risk profile of the company on the quadrant like - most likely but low impact, most likely and high impact, then high risk, extreme quadrant. So once you have charted the risk quadrant then we will get the internal audit to tailor the internal audit plan according to the risk profile of the company. When we think an element has the highest risk, we don't visit them once a year. We want to visit them two or three times a year because the occurrence is high and the exposure to financial damages is also very high, therefore, you must take more time to monitor it. Don't spend time looking at stationery where total budget for the whole year is only \$5,000, \$10,000 or \$50,000.

On clarification, the AC participant confirmed that the risk register (including information such as risk identification, risk profiling and charting etc.) is prepared by the respective departmental heads with input from their operational units (i.e. the risk-owners). The IAF's role is to conduct an independent assessment of the potential risk areas as identified in the risk register and to ensure that the risks are adequately evaluated, managed and controlled. The risk assessment is conducted in conjunction with the development of the audit plan by the IAF as reflected in the statement below:

[AC#6] Once you have that in place and your risks are understood and accordingly managed; then you have the internal audit to assess the risks then also do an audit which is more risk-based. [...] And then it's all pulled together so that the AC can see a cohesive approach to the whole matter of audit and the risk management.

This approach is consistent with the risk-based audit approach as recommended by the IIA.<sup>115</sup>

In practice, the AC participants inform that internal audit activities are being conducted based on a pre-determined number of audit cycles within a financial year. From the interviews, it is apparent that most listed issuers would adopt a four-cycle audit<sup>116</sup> in each financial year. These four cycles coincide with the AC's quarterly meetings.<sup>117</sup> The internal audit report will be presented to the AC for their deliberation and approval at each quarterly AC meeting as reflected in the statement below:

[AC#4] Our audit plan was prepared by the out-sourced IA and approved by the AC. For our company, we have identified twelve core areas by function (e.g. human resources, purchasing, sales etc.) that need to be audited by IA. Each of this aspect will take a cycle of about three (3) months to be completed. However, if the AC feel that certain item need

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<sup>115</sup> Practice Advisory 2200-2, IPPF, 2013, p159

<sup>116</sup> Four-cycle audit means the listed issuers will have four internal audits in one financial year.

<sup>117</sup> Under the paragraph 15.12(1)(g) of the Listing Requirements, the AC is required to meet every quarter to discuss the quarterly result and year-end financial statements. During this quarterly meeting, the AC will also review the IA report. The quarterly result and IA report will then be presented to the full board of directors for their consideration and final approval. This procedure is necessary prior to the release of the quarterly or year-end results to the stock exchange.

more vigorous audit or to be revisited in a shorter time-frame, the IAF will have to incorporate that in their audit plan to meet our requirements.

Normally internal audit plan is approved at the beginning of each financial year. However, the IAF might be required to perform other ad hoc assignments if there is any drastic change in business environment (enactment of a new law, such as GST,<sup>118</sup> or acquisitions of new subsidiaries/investments etc.) or any potential fraud investigations as illustrated in the statement below:

[AC#5] Beginning of the year we go through a list but then it is not an exhaustive list. Because what we suggest is a skeletal only if you come across some issues, then you (refer to the IAF) prompt the AC. [...] The other day we find out that on the foreign workers, it's an issue – because the Malaysian government changed their regulation. That will affect the cost, compliance issues and then the levy things. So, we send our IA to study the compliance issues and financial impact.

Some AC participants comment that whilst more audit cycles per financial year will accord greater assurance to the AC, they must also weigh the costs and benefits so as not to unnecessarily burden the listed issuers financially. This reaffirms the previous discussion that investment in IAF has to be commensurate with the 'needs' requirement of the respective listed issuers.

### **6.3.2 Implementation: nature of internal audit activities**

The establishment of the IAF in listed issuers is mandatory in Malaysia. However, the regulators are less explicit in the operation of IAF in Malaysia. This has accorded listed issuers the flexibility in the structural and functional set-up of their IAF. In this thesis, the researcher seeks to establish whether the Malaysian listed issuers have fulfilled their 'theoretical role' as depicted in the IIA's new *Definition for Internal Auditing* (IIA 1999). In defining the 'theoretical role', the researcher has relied on the three core internal audit activities of controls, risk management and governance as well as the value-add activities (consultancy etc.) as defined in the *Definition of Internal Auditing* (IIA 1999). Accordingly, the discussion is structured around these four internal audit activities and presented in the following sections.

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<sup>118</sup> The first introduction of GST for Malaysian effective from 1 April 2015.

### 6.3.2.1 Controls

All AC participants acknowledge that internal audit activities should adopt a risk-based audit approach as risks are ‘[i]n every elements of the business’ [AC#1]. The controls process to be undertaken by the IAF should support the organisation in the management of the identified risks. This is reflected in the AC participants’ statements below:

[AC#1] There’s risk in every element of the business. For instance, for a manufacturing operation, if your waste discharge is not properly treated, it is a risk to us because we have a liability and compliance requirements and my factory certification is dependent on how we discharge waste. It’s a risk to me. If the government authority shuts the factory down, we are dead. That’s a risk to us. If it’s an employee who’s stealing company information because he can access the server, it’s a risk to us also. If the finance side is not managing the purchase orders properly, we may have an issue where stuff is not accounted for - a risk to us also. So, to me, the internal audit function is also the risk management function.

[AC#3] As a good internal auditor, if they’re looking at system control weaknesses, invariably they are going to come up with recommendations which is going to transgress on risk areas too. They would alert the risk guys, who will then revisit their risk profile for credit risk, liquidity risk and then you delve down deeper. [...] Risk manager who’s usually the front end people, they do not do the testing so they don’t do the compliance. They reassess positions at any periodic time, be it at least once a year. It could be six monthly. It depends on how robust your organization is. The IA has to do the compliance.

The last quote suggests that internal auditing and risk management function complement each other, which confirms the IIA’s stipulation that the three core internal audit activities of risk management, controls and governance are interrelated (see Practice Advisory 2110-2, IPPF p. 131). In addition, the last two quotes also confirm that operational control and compliance audits form the major part of the risk-based control audit.

Although the AC participants are unable to provide estimated man-hours incurred for each of the three core internal audit activities, the consistent sentiment is that the internal audit activities focus predominantly on risk-based control audit (including operational control and compliance audit). This is reflected in the AC participant’s statement below:

[AC#10] For the IA function, I would say 80% actually is on internal controls and then 10% on risk management and then another 10% on something else. I would think that in a normal cycle, they are doing all on internal control, 100% of internal control but there is expectation for them to also recommend on improvements that are very operational. But we do not carry a message to them that your focus is only the operational audit but

their focus is still the internal controls but, in addition to that, we would also want to hear something on risk review.

The last quote suggests that a significant amount of the IAF resources is being tied up in risk-based control audit (including operational controls and compliance audit) with a relatively small amount of IAF resources is being channelled into risk management and governance. This is consistent with prior studies conducted by the Big Four audit firms, which comment that the IAF has overly focused on operational and control risks (PwC 2009; Ernst & Young 2008;) at the expense of strategic and business risks (PwC 2009). Besides highlighting on controls or systems weakness, the AC participants also expect the IAF to provide value-add advice such as how to improve on the systems or operational controls weaknesses. It is interesting to note that despite the IIA's effort in transforming the internal audit profession (as depicted in the *Definition of Internal Auditing* (IIA 1999)), the IAF in Malaysia is still very much confined to its traditional role (i.e. operational control audit). The only difference is that the prevailing internal audit activities are structured around identified risks (i.e. risk-based approach) as opposed to the control-orientated approach as in the past.

Interestingly, the last AC participant mentions the terminology 'operational audit'. Further clarification with the AC participant reveals that the term is used to literally mean '[a]uditing of an organization's operations' [AC#2] without any reference to the 3E-based operational auditing (i.e. efficiency, effectiveness and economy) as advocated by researchers such as Chambers and Rand (2011), Flesher and Zarzeski (2002) and Cadmus (1964).

The findings reveal that none of the AC participants has a clear understanding of the '3E-based operational auditing'. The terminology 'operational auditing' has been used loosely by the AC participants to mean 'audit of an organization's operations'. During the AC interview, the 3E-based operational auditing was briefly explained to the AC participants to gauge their views on whether this auditing approach would enhance effectiveness of the IAF. Several AC participants refrained from commenting due to lack of in-depth knowledge of this new auditing activity. Several ACs steadfastly comment that the IAF's role should be confined strictly to financial, operational control and compliance audit. They are sceptical that the internal audit professionals

are able to deliver beyond risk-based controls audit (i.e. operational controls and compliance audit).

Although unfamiliar with the 3E-based operational auditing, two AC participants however, suggest that it is a value-add service to organisations if the IAF is capable to deliver such service. This is reflected in one AC participant's statement below:

[AC#12] I always tell my internal auditors to look not just at whether they complied, you have to look at what they are complying with, not in terms of having a process but in terms of efficiency as well. The need for such a process, is it a duplication? Is it something that is nice to have but serve no purpose? So their role is - it has to go beyond that, to see that we can have a company that runs efficiently so that we don't want to have a lot of staff doing things that are just mere duplication and had no added value.

The unfamiliarity of ACs with this terminology (i.e. 3E-based operational auditing) is understandable considering the IIA is in the midst of providing a clearer guidance on this auditing concept. In addition, it is also unfair to expect the AC, who are not professional internal auditors, to comprehend the technical jargon and methodologies of internal auditing in great depth. Having said that, it is also inappropriate to conclude that 3E-based operational auditing is not being practised by listed issuers in Malaysia.

Several AC participants suggest that to ensure integrity of financial reporting an effective IAF should work beyond an operational controls audit. The IAF scope of work should, amongst others, include analytical review of financial statements and fraud prone areas, such as journal adjustments. This sentiment is reflected in the AC participant's statement below:

[AC#12] I prefer internal auditors who undertake financial analysis as well. Helping management and audit committees to see the numbers, whether the numbers make sense. Be able to analyse financial information whether we are on the right track, whether the company is doing well or not. Very simple things like ratios, for example. It's important. A lot of people - internal auditors they don't look at those. They are very process driven. So I like to steer a bit more. Using the management information system to analyse financial information for the AC.

The comments of the AC participants are understandable considering the majority of them are from external audit background. This further reaffirms the earlier discussion that the IIAM has to be more proactive in 'educating' the key IAF stakeholders of the internal audit role and function. This will ensure more effective monitoring by the AC over the IAF.

### 6.3.2.2 Risk management

A majority of the AC participants acknowledge that the IAF's involvement in risk management should be confined to independent risk assessment (i.e. at the internal audit planning stage) and monitoring. They should not assume an active frontline role in risk management, which is allegedly the responsibility of the management. This understanding is consistent with the provision of the IIA (2013b). The AC participants' view on IAF role in risk management is best illustrated in the following statement:

[AC#6] I don't agree that the IAF focus only on internal control and not risk management. [...] we have put it to the management that they are responsible for managing the risk. And internal audit's role is not to be at the frontline. But we've also asked the internal audit, in both cases, to also have the risk management covered within their quarterly report. Not as the driver in terms of - but actually collating the summary and presenting what management has done in updating their risk reporting framework.

This AC participant continues:

They will give the quarterly update in terms of what has changed in terms of risks. Are there any new risks that have come in the picture? Are there any risks which have increased or decreased? The identified risks. Or which have remained the same? We've got that every quarter and there is a snapshot of the top 10 or 20 risks for the company with some sort of quantification and, of course, the important thing being the direction. So on that chart, where it has moved in terms of the axis. I think that's very useful. So we've emphasized to both management and internal audit that it's all interlinked. You're not just looking at things in isolation. So that's where AC has got to also be looking at risk and getting not just a report on risk from management but also internal audit looking at it for us, the AC.

Because internal audit sits in the risk management [committee], whatever you call it [...] But internal audit sits in more as an observer - management runs it. So internal audit can also give their input in terms of do they agree, don't agree. And that's where the quarterly updates come up for the AC.

The last quote informs that the IAF's involvement in risk management is mainly focusing on facilitating the risk management process, collate risk information from the respective department or operational unit (i.e. the risk owners) and report to the AC the decision of the executive risk management committee<sup>119</sup> ('ERMC') on matters pertaining to risk profiling, charting and mitigation/action plans. This is a common

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<sup>119</sup> Comprising the head of departments and operational unit (i.e. the risk-owners). They are deemed the first line of defence in the Three-line of Defence in Effective Risk Management and Controls (IIA 2013b)



practice among listed issuers that maintain an in-house IAF, as confirmed by other AC participants.

For listed issuers that engage out-source IAF, the AC participants confirm that the out-sourced IAF are normally not involved in the facilitation of risk management process due to cost factors. The standard engagement is confined predominantly to a risk-based control audit (includes operational control and compliance audit). The fees are normally agreed upfront. Hence, any engagements outside this standard scope of work, such as, engagement to develop and/or review the risk management framework or corporate governance framework is considered a separate engagement, therefore an additional cost to the listed issuers. Having said that, the out-sourced IAF has free access to information pertaining to risk management (risk registers, the ERMC's minutes and risk management action plan etc.) of the listed issuers. This is reflected in the AC participant's statement below:

[AC#12] Most out-sourced parties are focusing on risk-based control audit. They don't want to go beyond that because of cost factor. Although we - on an ad hoc basis requiring them to come in, to look at governance, look at some of the risk factors. It's always a challenge for AC, as we have to look at the costs to the company and how much the IA can do. In our company we use co-sourcing. Most compliance and controls jobs are with the external party. The in-house IA, a lady, an ex-EY [refers to Ernst & Yong] external auditor, is in the risk management committee, focusing more on risk management controls. And, this out-sourced party also look at part of the risk management controls - it's mostly covering the business risk /operational risk. If not of cost issue, I would want them to be more involved in other aspects of risk management - risk management framework, corporate governance framework.

It is apparent that cost factors play a significant role in determining the job scope of the IAF, particularly for the out-sourced IAF. This has resulted in a differentiation in the internal audit activities being undertaken by an in-house IAF and out-sourced IAF in Malaysia.

The IIA's position paper *Three-Line of Defence in Effective Risk Management and Controls* (IIA 2013b) outlines the role of the IAF in risk management. In Malaysia, the regulators are not explicit in the operation of the risk management function. This has accorded the listed issuers flexibility in the functional and structural make-up of

the risk management function. The findings reveal that some larger listed issuers<sup>120</sup> (in terms of market capitalisation) adopt the *three-line of defence* approach in risk management and controls, while the smaller listed issuers (in terms of market capitalisation) adopt an approach which is more akin to a ‘two-line of defence’ approach.

The findings reveal that the larger listed issuers normally maintain a risk management department headed by a Chief Risk Officer or Risk Controller (who serves as the second line of defence) who facilitate the risk management process. The risk management department will collate risk information from the respective departments or operational unit, evaluate the identified risks and compile them into a risk report/register (with the risk profiling, risk quadrant charting, mitigation plan etc.). The risk information from the respective departments and operational units (i.e. the ‘risk owners’ who serve as the first line of defence), will be re-assessed and streamlined (based on their priorities) and compiled into a group risk register. Under this structure, the IAF serves as the third line of defence. Their role is to evaluate and ensure that significant risks are duly addressed, mitigated and monitored. This group risk register will then be presented to the risk management committee (‘RMC’) or the audit and risk management committee (‘ARMC’) for their deliberation before presenting to the main board of directors for their final endorsement. Both the RMC and ARMC are sub-committees of the main board.

At the other extreme, the smaller listed issuers do not normally maintain a separate risk management department. For smaller listed issuers that engage an out-sourced IAF, usually the senior management<sup>121</sup> are tasked with facilitating the risk management processes. Conversely, those with in-house IAF, this facilitation role will be assumed by the in-house IAF. Under this structure, the departments and operational units are the first line of defence and the IAF will be the other line of defence.

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<sup>120</sup> Particularly the financial institutions (e.g. banks and insurance companies)

<sup>121</sup> Unless the listed issuer has an In-house IAF, then the In-house IAF will normally task to facilitate the risk management processes.

From the discussions with the AC participants, it is apparent that there are two configurations of sub-committee appointed to oversee the risk management function and IAF of listed issuers in Malaysia. The first configuration is where a listed issuer maintains two separate sub-committees, namely, the RMC and the AC. Under this configuration, the risk management function is placed under the direct purview of the RMC and the IAF under the AC. Under the second configuration, both the risk management function and IAF are placed under the purview of the ARMC. A detailed discussion of the two sub-committee configurations is presented in Appendix 6.

A majority of the AC participants confirm that their listed issuers do not maintain a three-line of defence in risk management and controls. Instead, they maintain a structure which is more akin to a two-line of defence comprising only the risk owners (as the first line) and the IAF (as the second line), without the risk-controller.<sup>122</sup> Although some listed issuers maintain a three-line of defence structure, '[t]he MNC's<sup>123</sup> emphasis is much stronger' [AC#6] as compared to the local listed issuer. This is understandable since 'risk management' is a new concept to majority of the listed issuers in Malaysia. It was introduced in 2012 when all listed issuers are required to disclose the *Statement of Risk Management and Internal Control* in their annual report (the 'Statement') from financial year ended 2012 onwards.<sup>124</sup>

In summary, there is a gap in terms of scope of risk management involvement between an in-house IAF and an out-sourced IAF. The gap is mainly in the facilitation of the risk management process. The findings may warrant a separate study to investigate

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<sup>122</sup> This findings is expected since majority of the listed issuers which has well-established risk management operation are financial institutions (e.g. banks and insurance companies). And financial institutions have been excluded in this study due to they are under more stringent monitoring requirement under the Bank Negara Malaysia (or the Reserve Bank of Malaysia).

<sup>123</sup> Refers to listed issuer whose parent company is a multi-national corporation.

<sup>124</sup> This is a requirement pursuant to the paragraph 15.26(b) of the Listing Requirement (2013). In the Statement, the directors are required to report on the soundness of the risk management framework and internal control systems of the listed issuers. In turn, the senior management (e.g. CEO, CFO or MD) are to provide a back-to-back assurance to the directors that the risk management and internal control systems of the listed issuers are operating effectively. The external auditors are also required to comment on the Statement. The key corporate governance stakeholders can seek guidance from the *Statement of Risk Management and Internal Control: Guidelines to directors of listed issuers* (the 'Guidelines') in the preparation of the Statement.

whether there is a differentiation in the level (robustness) of risk assessment and risk review between the in-house IAF and the out-sourced IAF.

### 6.3.2.3 Governance

The majority of the AC participants, who engage an in-house IAF,<sup>125</sup> do not perceive the IAF could play a significant role in governance activities. This is reflected in one of the AC participant's statement below:

[AC#2] In CG [refers to corporate governance, there's all those standard things which the company secretary has sufficient knowledge unless you have a different version of governance. Unless you tell me your governance involves another angle but your governance is all in the CG guidelines. I don't think they need the IA to look at it.

The last quote clearly reveals that the lack of publicity by the IIAM of their own professional standards has resulted in key IAF stakeholders unsure of the nature of governance activities<sup>126</sup> offered by the IAF. This AC participant's view is shared by many others.

In relation to promoting appropriate ethics and values within the organisation, a majority of the AC participants inform that their listed issuers have in place certain governance mechanisms, such as whistle-blower channel, code of ethics etc. These governance practices are a mandatory disclosure in the annual reports. However, further discussions with the AC participants reveal a lack of understanding and some AC participants are unable to elaborate on how these governance mechanisms operate within their listed issuers. In relation to the code of ethics, the findings reveal that there is an apparent lack of management's effort in educating the employees. Hence, this disclosure (of governance mechanism) in the annual report may suggest another boilerplate exercise merely to conform to the regulatory requirements. The lack of organisational support and the perceived lack of serious commitment by top management on these governance practices may render them ineffective (Rachagan and Kuppusamy 2013).

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<sup>125</sup> Out-sourced IAF are normally not involved in governance activities unless it is a separate engagement (e.g. fraud investigation, development of governance framework etc.).

<sup>126</sup> See Standard 2110 or Practice Advisory 2110 -1, IPPF. IIA (2013)

Risk management has also been used as an anti-fraud control. Interestingly, the AC participants are not keen to engage in discussion on fraud detection mechanisms in listed issuers, particularly on potential fraud involving top management. This could be due to the sensitivity of the subject matter. In Malaysia, a high concentration of listed issuers are family-owned or state-controlled, hence, the chance of employees to whistle-blow on any fraudulent activities involving top management is slim. This could be due to their Asian culture (i.e. less confrontational or provocative) or fear factor (fear for loss of jobs/career, punishment etc.) (Rachagan and Kuppusamy 2013).

In relation to ethics assessment on senior management,<sup>127</sup> all the AC participants confirm that none of their IAF perform such an assessment. Several AC participants cite ‘sensitivity’ and ‘maturity’ of the IAF service providers has resulted in them not suitable to undertake such exercise. This is reflected in the AC participant’s statement below:

[AC#2] No assessment on top management because this is very opinion driven and there’s no benchmark to say this person is good or not good [...] I don’t think Malaysia has reached that level because this become personal. In order to do that the person must be matured. If you are not matured, it’s difficult and you don’t find a lot of matured people around at that position. I think it’s tough.

In relation to communicating risk and control information to appropriate areas of the organisation, several AC participants acknowledge that ‘risk management’ is a relatively new concept to most listed issuers. Accordingly, the IAF has been entrusted the ‘educator’ role to guide the departmental and operational unit heads in the development of a risk management framework. These sentiments are reflected in the following AC participants’ statements:

[AC#4] [...] actually, risk is not something so easy for junior business unit heads to comprehend. This is reflected in their risk management report submitted to senior management for consideration.

[AC#10] When the company just started off with the risk management, actually the out-sourced internal auditor was engaged to conduct this training and also help setting up the risk management framework.

[AC#7] The IA head and group risk manager helped guiding them. You need the IA head to do this job. Only senior people can command respect. They first explained what risk

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<sup>127</sup> Another proposition of the IIA. Kindly refer to Standards #2110 or Practice Advisory 2110 -1, IPPF. IIA (2013)

management is to the operational people and then guide them how to identify the risk and then come up with the controls, the mitigating factors and all that.

This ‘educating’ exercise by the IAF is consistent with the governance activities as suggested in the Professional Standard 2110, IPPF IIA (2013a).

The AC participants also inform that on an ad hoc basis, the IAF are engaged to undertake some special assignments, such as related-party transaction, fraud investigations or whistle-blower cases. These are governance activities that are consistent with the IIA (2013a). This is reflected in the AC participant’s statement below:

[AC#2] Internal control is a very big word. We actually check into operations mainly. But when there is reported fraud, there’s some money being stolen, IA will be directed to go and check and give a report. And they are also involved in - RPT (refers to related-party transaction). When there’s a RPT transaction - why this car or why this building is given (disposed) to this fellow, director or whoever at this special price? They will check and report back to the AC whether the transaction is okay or not okay. Because one of our obligation is to clear RPT transaction. We don’t have time to go that. So, young man (refers to the IAF) will have to go and check for us.

In summary, although the majority of the AC participants believe the IAF are not competent to undertake governance activities, the in-house IAF actually have support in facilitating the risk management process (by ‘educating’ the department and operational unit heads) and undertaking some ad hoc assignments (e.g. related party transaction, fraud investigation). Due to cost factors, the out-sourced IAF’s involvement in governance activities is minimal, unless they are specifically engaged to undertake such special assignments.

#### **6.3.2.4 Value-add services**

The majority of the AC participants inform that the IAF should not assume a dual-role, i.e. assurance and consultancy, citing potential issues with independence and conflict of interest. This is reflected in the AC participants’ statements below:

[AC#4] But has to be very careful. CAE or IA can give general briefing on potential risk area for business unit. But not advise the business unit or department and provide detailed risk analysis and action plan. As this may compromise on their independence. They should not be advising and then performing audit on the same client.

[AC#13] That I don’t agree. If the company is getting bigger, there are so many consultancy firms in the market. Why should we use the IA and get into this conflict situation? Why don’t we leave them alone? [...] because we are setting bars based on guideline to make sure we don’t allow our EA (external auditors) to do work outside

external audit, not even GST<sup>128</sup> consultancy and tax. If we want IA to undertake this consultancy job, then we have to go through another procedure to make sure they comply and get the clearance from the audit committee, the board - why can't we find other alternatives?

This AC participant continues:

[...] there will be chances that the IA will get too involved and he got carried away. So you have to balance the risk. At the end of the day you have to weigh between the independence issue and their contribution. I would say at this moment, looking at this context, they may be doing too many things. [...] I think we would rather have them stick to internal controls.

Another AC participant informs that internal audit might lack competency in providing consultancy advice, such as strategic business risks in relation to business acquisition, new business ventures etc. This is due to their risk-averse mindset and lack of sound business judgement skills. This is reflected in the AC participant's statement below:

[AC#2] Depending on what consultancy. If it is about new business venture, new investment etc. - No! If before you set up a business, invite them in and they advise you to ensure that you have this controls, that controls, that's okay. Those are value-add things. No problem. But doing business is not only to ensure controls are in place. Doing business is to ensure making money and that involve risk-taking. Internal auditors don't have the mindset of businessmen and lack good business judgement skills, so, no I don't think I would want them in at that stage.

The consistent sentiment among the AC participants is that the in-house IAF are generally not competent enough to provide consultancy services due to their lack of relevant expertise and experience. As in most instances, due to limited budget allocation, the heads of internal audit or CAEs engaged by the small- or medium-sized listed issuers are relatively not that 'senior' in terms of industry experience. This is reflected in the following AC participant's statement:

[AC#4] Well, again, it voiced down to how much you are prepared to pay. If we were to get somebody who is able to possess good assurance knowledge on systems control and be able to advise on matters like risk management, we have to be prepared to pay.

Another AC participant suggests that it is overly ambitious for the IIA to claim that its members are able to undertake consultancy role in addition to the assurance role. This is highlighted in the AC participant's statement below:

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<sup>128</sup> GST – Goods sales and services tax. This is a new tax system just introduced and implemented effective 1 April 2015.

[AC#5] KPMG can do consultancy, it can do risk management, it can do corporate governance, all this but you can imagine they make up of how many departments? And now you expect one IA or CAE to undertake all these functions? No way. If your in-house IA team has so many different type of expertise, might as well you set up a consultancy company. Correct or not?

This AC participant continues:

IIA is trying very hard to bring up the profession. It's good. But no, because you must know what type of quality, their knowledge. Regardless of how knowledgeable you are, you need a team - and it's a very big team! It is very costly. But, the big PLCs, like Maybank, yes they can afford.

Despite the majority of the AC participants believing that the IAF should not (due to independence issues) or could not (due to capability issues) undertake consultancy services, several AC participants, however, perceive consultancy services as a value-add to the IAF services. This is as reflected in the AC participant's statement below:

[AC#12] Value-add, the view I hold there some people disagree because they say there's a bit of an independence issue. They say if you help, if you come out with this and that, you do this way or that way - then you're testing your own thing. Then where's your independence? It's just like external auditors who help the - sometimes it provides service on design or system and then you do a test on the system so where's the independence? So I guess that one is simple but, to me, it's more value-add rather than trying to play the role of I want to find something wrong. Rather I want to see how things are improved and therefore, I don't have to find anything wrong. Two different things. That's what I believe anyway.

This last quote reveals that the AC participants places greater emphasis on IAF's 'capability' to value-add over the 'independence' consideration. They also perceive the IAF as a 'business partner' to support operational units, as opposed to the traditional view of the IAF as a 'corporate police' whose focus is mainly to find fault in its auditees.

However, whilst some of the AC participants show support for the IAF to undertake a consultancy role, they are mindful of the cost factor, in particular if they have to engage the out-sourced IAF to extend their service beyond the standard risk-based control audit (i.e. operational control and compliance audit). These sentiments are reflected in the AC participants' statements below:

[AC#14] Yeah. I don't see much of a conflict issue. That will be ideal but because of cost factors, I don't think the management will want them to be involved in consulting as well.

[AC#1] We out-sourced our internal audit function. The job scope is agreed upfront at the beginning of the year. [...] But it will be separate charge. [...] Yes, agreed, there could be conflict of interest issues. But, it is okay. [...] Well, if they have the right skill sets to meet our needs, we are fine.



Having said that, the AC participants are generally unsure of the type of consultancy engagement that could be provided by the IAF, except for consultancy in development of a risk management framework, corporate governance framework and enterprise-wide risk management. The AC participants' confusion could probably be due to the lack of publicity of the IIA in regards to the IAF's role and function and vague provisions in the IIA's standards.<sup>129</sup>

In summary, 'independence' and 'conflict of interest' are cited as the two main reasons why the majority of the AC participants refrain from involving the IAF in providing consultancy services. However, it appears that 'costs' (or affordability) is the major concern for the both groups of AC participants (i.e. support or not support the IAF to assume dual-role).

Based on the foregoing discussions, there is an apparent gap in the internal audit activities being undertaken by the in-house IAF and the out-sourced IAF. The findings report that the in-house IAF has substantially fulfilled the 'theoretical role' as defined in the *Definition of Internal Auditing* (IIA 1999). They have undertaken relatively more of the core internal audit activities as defined under the theoretical role as compared to the out-sourced IAF. The out-sourced IAF's ability to fulfil their 'theoretical role' is impeded by their 'costs-conscious' auditees (i.e. listed issuers).

### **6.3.3 Evaluation: performance evaluation**

In the evaluation of the IAF performance, the IIA has suggested the IAF adopt the quality assurance and improvement program ('QAIP'),<sup>130</sup> which entails an ongoing internal assessment (by the CAE or other qualified party within the organisation) and external assessment (by an independent qualified external assessor) every five years. In this thesis, the researcher has also attempted to gauge the AC participants' views on

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<sup>129</sup> See standards 2210.C1 and 2210.C2, IPPF (2013) pertaining to 'consultancy' role

<sup>130</sup> QAIP suggests for internal and external assessment of the IAF performance. Internal assessment (Standard 1131, IPPF (2013)) suggests an on-going monitoring of the IAF performance based on CAE's self-assessment or by somebody within the organization with sufficient knowledge of the IAF (normally on annual basis). For external assessment (professional standard 1132) suggests for assessment by a qualified independent assessor outside the organization every five years.

whether it is a reasonable measure to evaluate IAF performance based on the ‘external auditors’ reliance on the IAF work, a popular proxy measurement for IAF quality or IAF effectiveness (see Pizzini, Lin and Ziegenfuss 2014; Munro and Stewart 2011; Desai and Desai 2010). Accordingly, the discussion in this section will be structured around: QAIP and external auditors’ reliance on the IAF work. The AC participants’ views are presented in the following sections.

### **6.3.3.1 QAIP: internal assessment and external assessment**

A majority of the AC participants are not aware of the QAIP as stipulated in the IIA (2013a). All AC participants acknowledge that their listed issuers do not adopt the QAIP in the evaluation of the IAF performance. This is interesting considering some of the out-sourced IAF are corporate members of the IIA and it is a requirement for all members to adhere to the provisions in the IPPF. Having said that, all AC participants are consistent in their sentiment that for the IAF to be considered ‘effective’, the IAF must be able to support the AC in achieving their governance mandates/objectives. The AC participants do not see full compliance with the IIA’s professional guidance as necessary to ensure effectiveness of the IAF. This is clearly reflected in the AC participant’s statement below:

[AC#10] Of course, we just look at our needs. We don’t really look at whether they have complied with certain standards of the IIA. We don’t need to. So what we could do is just to look at whether they meet our needs.

However, to ensure consistent monitoring of IAF across listed issuers, several AC participants have suggested the regulators provide a set of guidelines or framework that outlines the basic parameters to evaluate the IAF. This is reflected in the AC participant’s statement below:

[AC#13] As long as the IAF framework is there, the AC can assess IA performance based on the framework. [...] The only way to move toward is for Bursa to come up with a guideline [...] set out the basic parameters so that the industry can follow. [...] And the AC could evaluate the IAF performance based on those parameters.

It is interesting to reveal that the majority of the AC participants do not rely on a systematic and objective performance evaluation methodology (e.g. a pre-determined set of KPIs with objective measurements) in the evaluation of IAF performance. Instead, their evaluations are rather ‘subjective’. The AC participants inform that they

do not have an established checklist or criteria to benchmark, unlike the evaluation of the external auditors' performance, which is more systematic. The AC participants' views are reflected in the statements below:

[AC#7] [...] every year, we do an evaluation of the external auditor. There's a questionnaire, the list of matters and then we go through the checklist of their performance and all that feedback and then only we will recommend reappointment. Sadly, we do not have similar assessment for internal audit.

[AC#6] It's not so easy to - I mean apart from, the audit plan and percentage of completion in terms of the number of audits and maybe the timeliness of the reports which we get - every report has got to come out from completion of fieldwork, the period before it's presented to the AC. So apart from that, there's no real good KPI that have been used for internal audits. So unlike the other departments where sales department has got sales targets and all that, we've debated on this for internal audit. No-one can come up with any other measurement so it's very - it's, I guess, more subjective. [...] We don't want to give him a KPI and say how many items you must raise because then he will raise too many.

An AC participant whose listed issuer adopts an objective valuation approach (i.e. KPI-based) provides an account of how IAF performance is being evaluated in the listed issuer. This is presented in the statement below:

[AC#3] Basically, there are two - this comes back to matrix management. The organization has a departmental KPI. So usually there will be pre-set conditions which HR (refers to human resource department) would drive it with help from some huge HR firms like Towers, Watson or PA Consultants. So they would have done a group structure for all the divisions. So that KPI will also have to be met. But that is for the department. Then the individuals are already on a peer review basis with your colleagues, within your department. Up/down feedback, the 360° feedback is there. Then we ourselves do see you presence if you are the CAE at our quarterly meetings or any AC meetings. At the board meeting, sometimes you are also called to present some things, offsite meetings, et cetera, we watch how you speak, how focused you are and then you will do a self-assessment of yourself based on a career continuum plan - for your department, for yourself, et cetera. You will send it and I would, as a chairman of my audit committee, assessing you together with the three or four or five of us with you in one go. It gives you a fairer perspective rather than on one person deciding on your future. And in the process, we are supposed to come up with constructive criticisms, praises where praises are due and at the same time where there's improvements needed, we will advise you accordingly. And if there are training programs, there are a lot of other subsets into that evaluation criteria.

The 'subjective' performance evaluation measurements adopted by the majority of the AC participants include, amongst others, quality of the internal audit report (e.g. writing skill, report by exception, depth of the audit work) and timeliness of the report (e.g. turnaround time). This is reflected in the AC participants' statements below:

[AC#13] We look at delivery. We don't want them to present late reports because they have many assignments and we look at the quality of the issue they have recommended then we also look at the response of management. We also evaluate based on the audit plan whether they deliver what we want or not. So based on that, we do ask them to give

us their resource list to see how many people they have and to update us on the jobs they have done. So we will do it every year to see whether they comply.

[AC#3] Your report findings which you come up with recommendations must be business oriented. You don't recommend for the sake of this thing and you must be able to evaluate macro and micro points. That's where your review process, your manager in the internal audit, the senior managers or the CAE will know how it should be, table and escalate it to the full board, to the audit committee. [...] So when that comes up to me it must be very - either recommendation that's workable definitely -within the industry, not with exorbitant cost to rectify it but with no benefit. The worst thing that can happen is when senior management suddenly turns up and says that's rubbish, we do this thing in elsewhere you look at it and that test serves the same purpose. You have completely lost the plot.

When assessing the quality of the internal audit report, besides looking at their recommendations (i.e. whether they make any commercial sense and whether it is cost-beneficial), the AC participants also focus on the depth of their report. In the AC participants' perception this would reflect the experience and knowledge of the CAE. This is reflected in the AC participant's statement below:

[AC#11] I have two years of using external people so I have a way of comparing. For the internal guy to be deemed effective, he has to be telling me things that the others were not telling me. His ability to see things that others may not.

In summary, the consistent sentiment among the AC participants is that they do not perceive the necessity to adopt the IIA's QAIP. However, to ensure a more systematic and consistent evaluation practice across listed issuers, several AC participants have suggested the regulators provide a basic internal audit performance evaluation framework.

### **6.3.3.2 External auditors' reliance on the IAF work**

External auditors' reliance on IAF's work has been widely adopted as a proxy measurement for IAF effectiveness or IAF quality in prior research. It is interesting to note that none of the AC participants support this proposition. In fact, the consistent responses from the AC participants are that whilst external auditors request for internal audit reports, they do not reveal the extent to which they have relied on the IAF's work nor have they commented on the quality of the report. This is particularly so if the IAF work is undertaken by an out-sourced IAF. One AC participant commented that this could be due to the external auditors trying to refrain from commenting on another professionals' work. The AC participants' views are reflected in the statements below:

[AC#6] So how much reliance they place on internal audit, I'm not really sure. They don't quite - that's why I say they don't formally say okay, internal audit has done all this so we rely on that. [...] But what I've noticed is that, over the years we can see some shift. I think external auditors used to say that they rely on the internal audit work to do testing of controls and all this. It would appear now that I think the external auditors seem to be doing less and less of actual field testing. I don't know, this is my perception. They say they do it on their own so I don't know whether it's pressure in terms of fees and costs. Whilst they say that they do it on their own and maybe they have reduced in terms of their sample size or whatever because certainly I don't think they seem to spend much time but they do raise some control issues when in the course of their audit.

[AC#10] So far, no. They only look at the internal audit reports but not to review their work papers. Yeah. They do consider the internal audit reports [...] No. I think it's not a common practice here [...] I don't think any internal auditor will open the work files for review. [...] but in-house team I think it's fine. The external auditor will not rely on the IA work to reduce their work.

[AC#7] Of course in our discussion with the external auditor we do ask them of their view on the performance of our IA. So far, of course, it's a rather informal approach. [...] but not gone into a formal evaluation process.

This same AC participant comments that the group internal audit team from their parent company,<sup>131</sup> however, does comment on the work of their in-house IAF. This is reflected in the statement below:

[AC#7] In the MNC's case, there are comments from the group or regional audit team. In their assessment, if they feel there is deficiency, they would raise it – such as we don't have enough people or we are lacking quality in the internal audit. I mean that's something they will raise but not the external auditors.

In summary, the AC participants' evaluation of IAF performance is based on 'subjective' criteria such as timeliness of internal audit report, quality of the internal audit report (report-writing style, depth and coverage of the audit work, practicality of the audit recommendations etc.). These assessment criteria are consistent with the findings of a global study conducted by Ernst & Young (2008) which revealed that the commonly adopted measurement metrics for IAF effectiveness by corporations are: the completion of audit in comparison to its plan and the length of issuing of the audit report. The AC participants do not believe the necessity to adopt the QAIP as proposed by the IIA in the evaluation of the IAF performance. In their view, the ultimate objective of the performance evaluation is to gauge whether the IAF could deliver what they are asked to perform and support the AC in meeting their governance mandates/obligations. The findings also negates the possibility for the AC

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<sup>131</sup> The parent company is a public company listed on the NYSE.

participants to rely on the external auditors in providing their comments on the IAF work, particularly the out-sourced IAF. To ensure more consistent monitoring of IAF across listed issuers, some AC participants have proposed the regulators provide a framework or a set of guidelines that sets out the basic parameters for the AC to rely on in the evaluation of IAF performance.

### 6.3.4 Summary

A summary of the ACs' expectation for each of the main constructs for internal audit practices and the corresponding facts are presented in Table 6.6.

**Table 6 6: Summary findings on internal audit practices**

<b>Constructs</b>	<b>Key interview questions</b>	<b>ACs' expectation</b>	<b>In practice</b>
Planning: internal audit planning (section 6.3.1)	Does your company maintain an IA charter? Do you think it will help enhance the IAF effectiveness? (section 6.3.1.1)	There is no necessity to have an IA charter as most of the stipulations in the IA charter (terms of reference, scope of the IAF work etc.) would have been captured in the engagement letter (for out-sourced IAF) or employment letter and internal audit plan (for in-house IAF).	It is not a mandatory requirement for listed issuers to disclose the IA charter in annual reports of listed issuers. Only a small number of the AC participants informed that their listed issuers maintain an IA charter.
	Who is responsible for outlining the scope of internal audit plan? How is it done in your listed issuers? (section 6.3.1.2)	CAE (of the in-house IAF) or partner/executive director (of the out-sourced IAF) is responsible to prepare the internal audit plan for the AC's review and approval.  All AC confirm risk-based approach has been adopted in the development of internal audit plan. A majority of the AC participants view senior management's involvement at audit planning stage as crucial. As the senior management has extensive knowledge about the business operations and risk environment surrounding organisations.	Consistent with AC's expectation.

Constructs	Key interview questions	ACs' expectation	In practice
Implementation: nature of internal audit activities (section 6.3.2)	<p>What are the internal audit activities essential to support the AC in meeting their governance obligation? (To focus on: control, risk management, governance processes)</p> <p>section 6.3.2.1 – control</p> <p>section 6.3.2.2 – risk management</p> <p>section 6.3.2.3 – governance</p>	<p>Internal audit activities should be founded on risk-based audit approach as risks are in every aspects of business. Internal audit activities should focus on risk-based control audit (i.e. operational and compliance audit) although the IAF is also expected to play a role in risk management.</p> <p>The IAFs' role in risk management is to ensure that significant risks (operations, business and financial) are duly managed (i.e. identified, mitigated and monitored).</p> <p>The AC participants do not see the IAF could have significant role in governance activities as suggested by the IIA (2013).</p> <p>The AC participants do not think that it is not necessary for the IAF to fulfil the 'theoretical role' (as stipulated in the <i>Definition of Internal Auditing</i> (IIA 1999) for them to be considered as 'effective'.</p>	<p>There is an apparent gap in respect of job scope between the in-house IAF and out-sourced IAF. While the in-house IAF has substantially fulfilled the 'theoretical role' (as depicted in the <i>Definition of Internal Auditing</i> (1999)), out-sourced IAF's role is confined predominantly in risk-based control audit. The differentiation is not due to incapability of out-sourced IAF to undertake the additional internal audit activities but because of cost factor (i.e. cost consciousness of certain listed issuers).</p> <p>Having said that, a significant amount of the in-house IAF resources are still focusing on risk-based control audit (i.e. operational control audit and compliance audit), with a smaller percentage on risk management and governance activities (e.g. fraud investigations, related party transactions review).</p> <p>In-house IAF's involvement in risk management are mainly risk assessment at planning stage and as a facilitator of the risk management processes. Majority of the listed issuers (small and medium-sized) do not maintain a three line of defence for risk management and control as suggested by the IIA (2013b).</p> <p>Listed issuers disclose in annual reports that they maintain governance mechanisms (e.g. whistle-blower, work ethics). However, a majority of the AC participants are not familiar with the said governance</p>

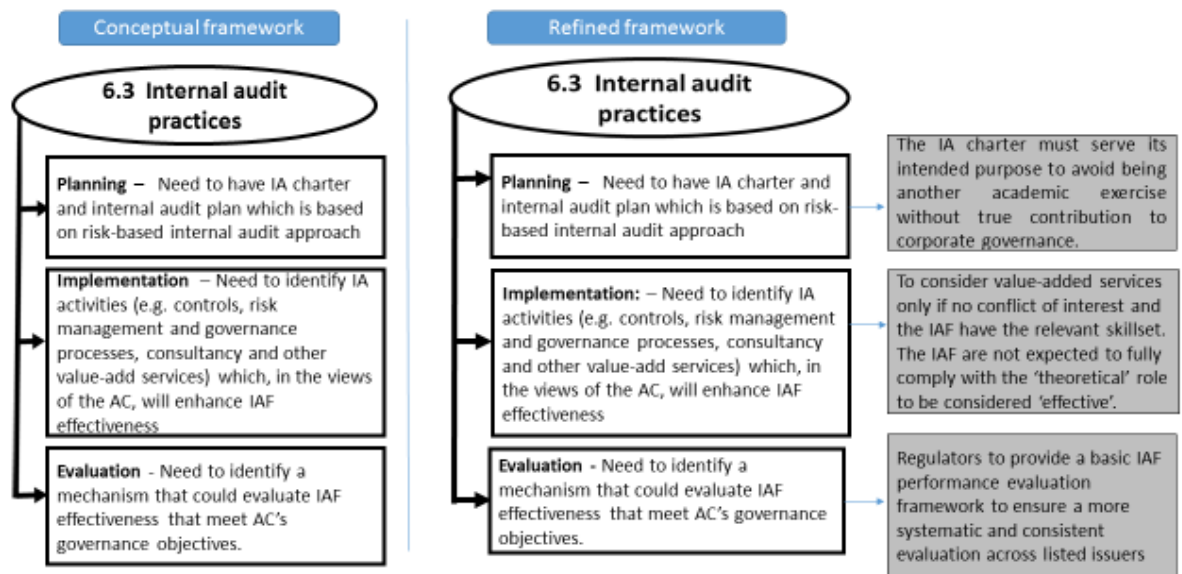
Constructs	Key interview questions	ACs' expectation	In practice
			mechanisms. Hence, it may infer that the disclosure in annual reports are a boilerplate exercise to decouple the regulatory requirements (institutional pressure).
	What are the value-add services undertaken by the IAF that will support you in meeting your governance obligations? (section 6.3.2.4)	The AC participants have mixed views in respect of whether IAF should assume consultancy role in addition to assurance role. The majority of them (10 out of 14) are against having the IAF undertaking consultancy role citing 'independence' and 'conflict of interest' issue. Some have cited cost factors (due to low IAF budget), particularly among the small- and medium-sized listed issuers and they believe the IAF should focus on risk-based controls audit. The few AC participants who are open to having IAF undertaking consultancy role weigh the capability of IAF to 'value-add' more than IAF's 'independence' may be compromised.	AC participants with an in-house IAF are more susceptible to having their IAF providing value-add services (i.e. consultancy) in addition to assurance as there would be no significant additional costs for this extra service. However, for out-sourced IAF, this extra service would mean a separate engagement, thus higher professional fees outlay.
	Does your IAF conduct 3E-based operational auditing? Do you think that to add value, the IAF should perform 3E-based operational auditing? (section 6.3.2.2)	A high majority of the AC participants confess that they have no knowledge of this new auditing concept. They are sceptical that the current pool of internal audit professionals have the necessary skill sets to undertake such activity. In their view it may be beyond the budget of a majority of the listed issuers (i.e. small- and medium-sized) to engage such qualified internal audit professionals.	A high majority of AC participants are not familiar with this new auditing concept. None of their listed issuers are involved in 3E-based operational auditing.



Constructs	Key interview questions	ACs' expectation	In practice
Evaluation: performance evaluation (section 6.3.3)	Does your listed issuer adopt the IIA's QAIP (i.e. internal and external assessment) on the IAF performance? (section 6.3.3.1)	The AC participants are consistent that it is not necessary to adopt the IIA's QAIP. In their view, an effective IAF is one who can support the AC in meeting their governance obligations. In their view, if the regulators could provide a basic IAF performance framework that sets out the basic evaluation parameter, they could monitor the IAF quality and performance more systematically across listed issuers. <i>[Note: The same AC view have been highlighted in section 6.1.3.2]</i>	None of the AC adopts the IIA's QAIP. A majority of the listed issuers do not maintain a systematic and objective evaluation measure (e.g. KPI). Except for one AC who informed that one of his listed issuer adopts a KPI and peer review approach in the evaluation of IAF performance (360° evaluation approach).  In evaluation of IAF performance, a majority of the AC participants employ subjective measurements, such as, timeliness of audit report (turnaround time), quality of the internal audit report (report-writing style, depth and coverage of the audit work, practicality of the audit recommendations etc.).
	Do you rely on external auditors' remark in your evaluation of IAF performance? (section 6.3.3.2)	All AC participants are consistent in their sentiments that they do not evaluate IAF quality based on external auditors' reliance on IAF work.	The AC inform they do not rely on the external auditors' evaluation of IAF work in their evaluation decision. As external auditors normally do not inform the extent to which they have relied on the IAF work and do not comment on the quality of the internal audit report.

Following the discussions in earlier sections, the third component of the conceptual framework is refined to incorporate the AC participants' expectations and is presented in Figure 6.7.

**Figure 6.7: Refined internal audit practices (third component)**



## 6.4 Refined IAF Effectiveness Framework

The conceptual IAF effectiveness framework that was developed in Chapter 5 comprises of three core components: the external enabling factors (first component), internal enabling factors (second component) and internal audit practices (third component). The purpose of this study is to investigate the prevailing internal audit practices in Malaysia and how the key contextual and environment factors could impact on effective practice of the IAF, from the lens of the AC.

Following the interviews with the AC participants, the external enabling factors (first component) have been refined to include a new emerging theme, that is the ‘internal audit industry readiness’, or readiness of the internal audit industry to meet the heightened market demand/expectation for internal audit professionals in the context of quantity and quality. In addition, the role of the IIAM as a professional body has also been refined. The refinement to external enabling factors (first component) is presented in Figure 6.2.

The internal enabling factors (second component) have also been refined to take into account the AC participants’ views on the AC support (effectiveness of the AC, AC

influences over IAF resources vis-a-vis top management etc.), organisational support (genuine commitment of top management to good corporate governance, integrity of top management etc.) and IAF resources. A new theme emerged during the AC interviews, that is, the out-sourced IAF, which was not previously captured in the conceptual IAF effectiveness framework. Following this development, the internal enabling factors (second component) are refined and presented in Figure 6.5.

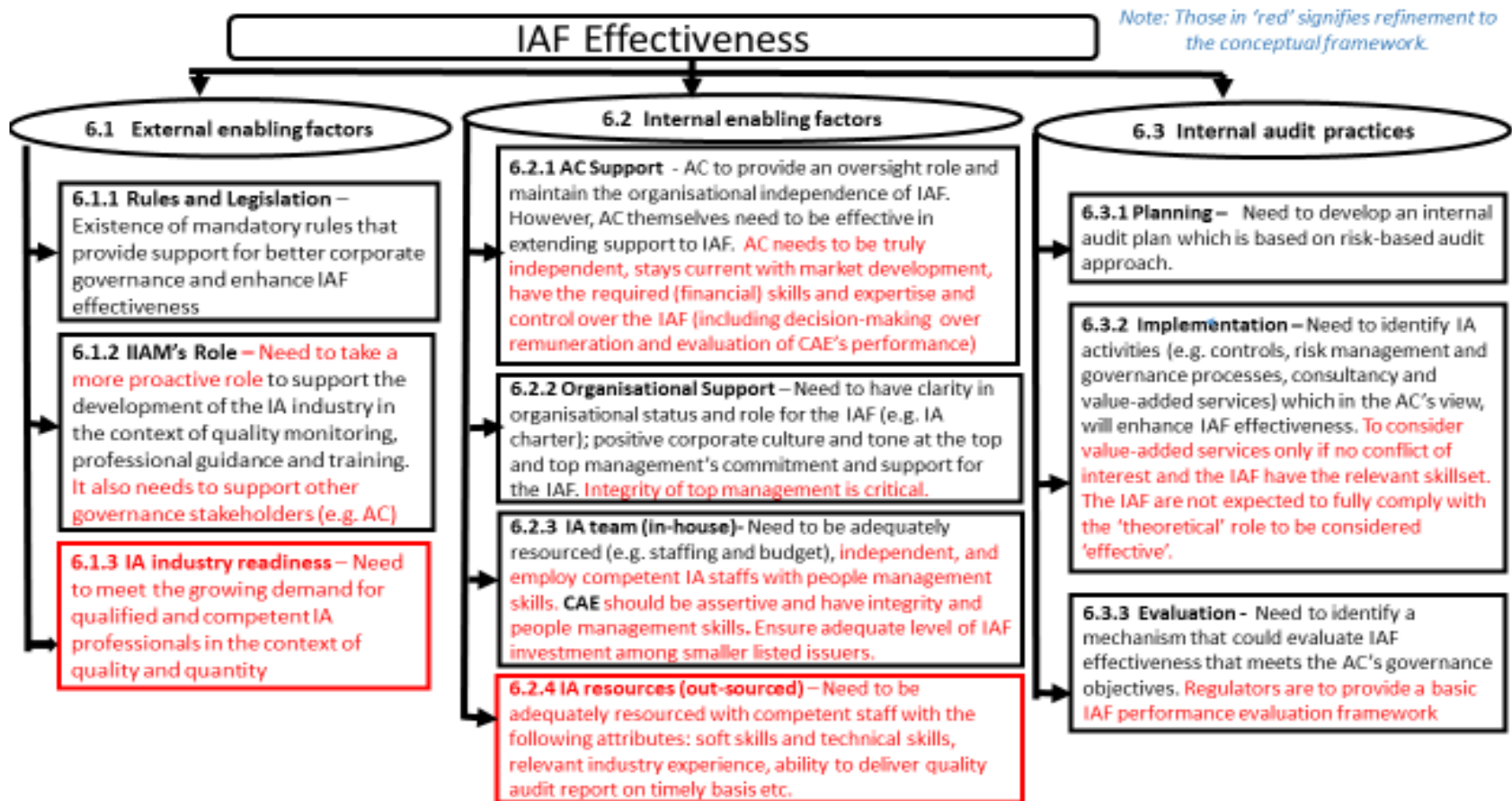
The internal audit practices (third component) have also been refined to take into account the AC participants' views. The refinement includes highlighting the internal audit activities, which in the AC participants' view are necessary to enhance IAF effectiveness (e.g. risk-based operational control audit) and which in their view are mere academic exercise or will not contribute to IAF effectiveness (IA charter, 3E-based operational audit, QAIP etc.). The refinements are captured in Figure 6.7.

Taking into account the refinements as presented in the preceding sections, the comprehensive refined IAF effectiveness framework is presented in Figure 6.8.

## **6.5 Chapter Summary**

This chapter has confirmed/negated and refined the constructs identified in the conceptual IAF effectiveness framework in Chapter 5 after incorporating the interview findings with fourteen AC chair and AC members of the Main Market listed issuers. Following this, a refined IAF effectiveness framework has been established and presented in Figure 6.8. The next chapter seeks to discuss the implications of the findings in this chapter. It also aims to examine the impact of the key contextual or enabling factors (internal and external to organisations) on internal audit practices in Malaysia by linking them to the multiple theories (i.e. agency, stakeholder and institutional theory) with particular focus on how the three isomorphism processes (under institutional theory) have influenced the effective practice of the IAF in Malaysia.

Figure 6.8: Refined IAF effectiveness framework



## **CHAPTER 7: DISCUSSION**

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### **7.0 Introduction**

Following the development of a conceptual IAF effectiveness framework in Chapter 5, a series of semi-structured, in-depth interviews were conducted with fourteen AC chair/members of Main Market listed issuers in Malaysia. The AC participants' views were sought mainly to confirm/negate or refine the constructs as identified in the conceptual IAF effectiveness framework. The AC participants' views and the refined IAF effectiveness framework were presented in Chapter 6. This chapter aims to discuss the key findings of this thesis. Section 7.1 discusses the importance of each component under the refined IAF effectiveness framework, with a particular emphasis on how the external enabling factors (first component) and internal enabling factors (second component) have impacted on the internal audit practices (third component) in Malaysia. Section 7.2 discusses the implications of this refined IAF effectiveness framework in the Malaysian context and relates the findings to the theories employed in this thesis. Section 7.3 presents the efficacy of the refined IAF effectiveness framework.

### **7.1 Importance of Each of the Components Identified Under the Refined IAF Effectiveness Framework**

All AC participants confirm that all the enabling factors identified are important to the internal audit practices in Malaysia although some may exert a greater influence than others over the operationalisation of IAF in Malaysia. The significance of each component is presented in the following sections.

### 7.1.1 External enabling factors (first component)

#### 7.1.1.1 Rules and legislation

The AC participants view the ruling that mandates the establishment of the IAF as important, as it has compelled all listed issuers to establish an IAF<sup>132</sup> in their corporations. This AC sentiment is not surprising, considering Malaysia is a highly regulated country. Corporations and the business community are used to the policy-makers taking leads in any major structural reforms to the corporate scene. The AC participants conjecture that with this new ruling, the market perception of the IAF role has changed. In their view, the IAF plays a significant support role not only to the AC but also the top management. This is particularly the case if the listed issuers have a complex group structure with widely diversified businesses where top management (particularly the owner-managers) have no direct control and supervision over them.

However, the AC participants are concerned over the lack of commitment among certain listed issuers (particularly the smaller listed issuers) in the practice of the IAF. The AC participants comment that these listed issuers are complying with the mandatory IAF ruling in ‘form’ rather than in ‘substance’ (i.e. form over substance).

On the requirement for the IAF to report directly to the AC, the majority of the AC participants support this ruling. They perceive ‘direct reporting’ to the AC will enhance organisational independence of the IAF and clear the predicament of ‘role ambiguity’ or ‘who is my master?’ (the AC or senior management), which has been haunting the IAF (see Lenz and Sarens 2012; Abbott, Parker and Peters 2010). However, the AC participants acknowledge that since the AC are not involved in the daily operations of the organisation, ‘dual-reporting’<sup>133</sup> is a more practical arrangement. All the AC participants confirm that there is no apparent conflict between the AC and top management over the ‘dual-reporting’ arrangement. However, their

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<sup>132</sup> In the AC participants’ view the establishment of IAF is important, as it is expected to enhance the controls and governance systems of corporations. However, without a mandatory requirement, many listed issuers may not have established an IAF due to cost factor.

<sup>133</sup> Report functionally to the AC and administratively to the senior management (e.g. CEO). Refer to Practice Advisory 1110 Organisational Independence, IPPF (IIA, 2013)

overwhelming support for the ‘direct reporting to AC’ ruling suggests that the AC participants themselves are seeking legislative empowerment to enhance their formal organisation power vis-a-vis senior management (see Kalbers and Fogarty 1993) on control over the monitoring mechanisms (e.g. internal and external audit).

From the perspective of institutional theory, coercive isomorphism (DiMaggio and Powell 1983) has compelled listed issuers to establish the IAF. However, the AC participants’ assertion reveals that smaller listed issuers could have just ‘ceremonially conformed’ (DiMaggio and Powell 1983; Meyer and Rowan 1977) with the mandatory IAF ruling. They decouple the institutional pressure by out-sourcing their IAF (with low fee budget) or establishing a ‘skeletal’ in-house IAF (with one or two relatively junior internal audit staff). On the ‘direct reporting to the AC’ ruling, listed issuers have again decoupled the institutional pressure. Mimicry isomorphism has resulted in the ‘dual-reporting’ arrangement becoming a common practice among listed issuers in Malaysia. This ceremonial conformance with mandatory rulings by certain listed issuers could impede the effective practice of the IAF in Malaysia.

#### **7.1.1.2 The role of the IIAM**

Being the sole professional body of internal auditing, the IIAM is expected to play a more significant role in supporting the market participants and regulators through professional guidance, quality monitoring and training. This effort is expected to raise the profile of the IIAM and the internal audit profession. Consequently, this will lead to greater diffusion of higher quality internal audit practices into organisations. Disappointingly, the AC participants are consistent in their sentiments that the IIAM has not done enough to support the business community. The AC participants also cast doubt over whether the IIAM has the capacity and capability to assume the quality monitoring role over the internal audit service providers in Malaysia, taking into account its relatively small membership base<sup>134</sup> and limited resources (i.e. manpower).

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<sup>134</sup> The IIAM has a membership base (corporate and individual) of more than 3,000 and about 800 CIA (Source: <http://www.iiam.com.my/index.php/profile/> Date downloaded: 8 February 2017). There are a total of 922 listed issuers (i.e. 807 Main Market and 115 ACE Market) on Bursa Malaysia (Source: <http://www.bursamalaysia.com/market/listed-companies/list-of-companies/>) (updated on 8 February

A majority of the AC participants are not familiar with the IIA's professional guidance and do not have a clear understanding of the 'theoretical role' of the IAF (as stipulated in the *Definition of Internal Auditing* (IIA 1999)). Their perception of the IAF's role is confined mainly to the traditional role - operational control auditing. Alzeban (2015) posits that an AC with the majority of its members independent, have expertise in auditing and accounting and regular meetings with the CIA are more likely to influence the IAF to conform with the professional guidance of the IIA (i.e. the IPPF). In this study, despite a significantly high number of the AC participants being independent with extensive accounting and auditing experience, they have limited knowledge of the IIA's professional guidance. The consistent sentiment among the AC participants is that the IIAM has not done enough to propagate their professional guidance and the new 'theoretical role' of the IAF. The perceived inactivity of the IIAM could also explain the lacklustre support from the AC on matters such as the IIAM assuming a more significant role in quality monitoring and regulating the internal audit industry in Malaysia.

It is believed that qualified professionals in an organisation could help 'internalise' the professional culture with that of the organisational culture and bring about a worthwhile contribution to the control environment of organisations (Abernethy and Stoelwinder 1995; Fogarty 1992). However, with a relatively small membership base (particularly the professional membership), the influence of normative isomorphism on listed issuers is expected to be minimal. The AC participants inform that the majority of the listed issuers out-source their IAF. This is expected to further weaken the influence of normative isomorphism on organisations. An in-house IAF is assumed to have a stronger influence than an out-sourced IAF as the out-sourced IAF's influence is constricted by their presence in auditees' office, which is dependent on the audit cycle. In most instances, it is confined to four audit cycles per financial year for most listed issuers. Consequently, the influence of normative isomorphism is negated

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2017). In addition, there are large private corporations (e.g. subsidiaries of multinational corporations) which engage IAF services. Hence, the IIAM's current membership is relatively small for it to exert any significant professional influence over the business community.



by the lack of presence of the IIAM as a professional body and weak infusion of qualified internal audit professionals (e.g. CIA) in listed issuers.

### **7.1.1.3 Internal audit industry readiness**

The majority of the AC participants suggest that the shortage of internal audit professionals has resulted in them not being able to fill the vacant positions in their in-house IAF. This is also partly the reason why some listed issuers out-source their IAF. The findings reveal that the inability of the internal audit industry to attract and retain professionals (particularly the young graduates) could be due to two reasons. First, the nature of the internal audit work. The AC participants cite stress, lonesome and boredom as the reasons that may have prompted the internal audit staff to quit the industry. Second, the prestige attached to the profession. The AC participants cite less glamorous jobs with limited career progression opportunities have resulted in the industry not being able to attract young graduates to join the internal audit profession. The AC participants lament that junior internal audit staff treat the job as a stepping stone for better future job opportunities.

The shortage of qualified internal audit professionals is not uncommon in other parts of the world. Some AC participants posit that the mandatory IAF ruling introduced at the end of 2007 caused a surge in market demand for the internal audit professionals, but the internal audit industry then was less ready to cope. However, close to a decade later, the shortage of qualified internal audit professionals still persists. In the AC participants' views, an adequate supply of internal audit professionals to meet the market demand is paramount; without a pool of competent and qualified internal audit professionals, any effort to enhance IAF effectiveness will merely be an academic exercise.

While the regulators have mandated the IAF, the internal audit industry is not regulated.<sup>135</sup> The AC participants are concerned over the quality of the internal audit

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<sup>135</sup> Anybody can establish an out-sourced IA firm in Malaysia. The operator requires no practising license nor membership certification with any professional bodies. This is a stark different from external audit firms which are required to obtain a practising license from the Ministry of Finance, Malaysia. Also, the external auditors' work is subject to monitoring by the PCAOB (Public Companies Audit

service providers, particularly the out-sourced IAF. Despite their concern over quality issues, the AC participants' views are mixed concerning whether the internal audit industry should be regulated and who should be entrusted with the monitoring role. However, they acknowledge that quality of internal audit service providers has a great impact on IAF effectiveness in Malaysia.

## **7.1.2 Internal enabling factors (second component)**

### **7.1.2.1 AC support**

All AC participants acknowledge that only an effective AC can augment IAF effectiveness. They confirm that AC attributes such as industry experience,<sup>136</sup> business acumen and judgemental skill<sup>137</sup> are important. However, they emphasise that AC attributes such as independence, financial expertise,<sup>138</sup> diligence and commitment<sup>139</sup> are crucial to an effective AC.<sup>140</sup> In their view, AC appointees who are ex-senior government servants, nominees of politicians/political parties, confidantes of controlling shareholders<sup>141</sup> or owner-managers (i.e. controlling shareholders who also assume executive managerial), are independent in 'form' but not 'substance'. These AC appointees normally lack the necessary corporate experience and financial expertise and are often succumb to pressure from owner-managers. This is consistent with Bruynseels and Cardinaels (2013)'s study, which posits that AC appointees who are appointed on 'social networks' instead of 'advice networks' are less effective in their oversight quality.

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Oversight Board) and/or their respective professional bodies (e.g. MIA and MICPA). For internal auditors, their works are not subject to evaluation by any independent parties/regulatory body.

<sup>136</sup> This is consistent with prior research (e.g. Cohen, Hoitash, Krishnamoorthy, & Wright, 2014; Hoitash, Hoitash, & Bedard, 2009; Olson, 1998)

<sup>137</sup> This is consistent with prior research (e.g. Naiker, Sharma and Sharma 2012; DeZoort and Salterio 2001)

<sup>138</sup> This is consistent with prior research (e.g. Seetharaman, Xu and Sanjian 2014; Dhaliwal, Naiker and Navissi 2010)

<sup>139</sup> This is consistent with prior research (e.g. Raghunandan and Rama 2007)

<sup>140</sup> This is consistent with prior research (see Seetharaman, Xu and Sanjian 2014; Gendron and Bédard 2006; Bedard, Chtourou and Courteau 2004; Turley and Zaman 2004; DeZoort, Hermanson, Archambeault, & Reed, 2002)

<sup>141</sup> This could include corporate shareholders, such as, state-owned investment arm of the Malaysia government (e.g. Khazanah) or other state-owned/controlled agencies (e.g. pension funds etc.)

The AC participants' remark on the appointment of political nominees as AC members is not surprising. 'Politics in business' is a common scene in Malaysia. The practice has been well-documented in prior research, which reports the significant influence and interference of ruling political parties in businesses in Malaysia (see Bliss, Gul and Majid 2011b; Adhikari, Derashid and Zhang 2006; White 2004; Yen 2002; Gomez and Sundaram 1999; Gale 1985). To overcome this, one AC participant suggests that the regulators<sup>142</sup> adopt the Bank Negara Malaysia's practice of requiring any prospective AC appointee to be recruited from the list of approved directors (i.e. candidates who have met the qualifying criteria of the regulators). In this AC participant's view, this will absolve listed issuers from appointing AC from 'social networks' of controlling shareholders or owner-managers, hence, mitigating the propensity of appointing a 'less' independent AC member to the board. Apart from that, the majority of the AC participants also suggest that the AC chair should have an assertive personality and preferably financial expertise since their role is to oversee the monitoring mechanisms (e.g. external and internal audit) of corporations.

The Listing Requirements (2011) have explicitly set out the qualifying criteria for 'independence' and 'financial literacy' for an AC member. However, it is apparent that some listed issuers have decoupled in their appointment of AC members and ceremonially conformed to the Listing Requirements (2011) by engaging AC members who are 'independent' in 'form' but not in 'substance'.

To ensure 'independence' of the independent directors, the regulators set a 'nine-year ruling'.<sup>143</sup> The majority of the AC participants query this ruling. They comment that independent directors need time to acquire company-specific knowledge of the listed issuers they serve. Setting a hypothetical timeframe will result in listed issuers losing the AC members who have just gained insights of the operations of the listed issuers. In their views, 'independence' is in a mental state of mind. Forcing these AC members to retire will lead to a waste of talent and experience. The AC participants' view are

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<sup>142</sup> Refer to jointly the Securities Commission of Malaysia and the Bursa Malaysia

<sup>143</sup> Independent directors can serve to a maximum cumulative tenure of nine years. After that, they can continue to serve on the same board but as non-independent directors; unless they are re-elected as an independent director at an annual general meeting. (Recommendation 3.2, CG Code (2012)).

consistent with *expertise* perspective as shown in prior literature (see Chan, Liu and Sun 2013; Vance 1983).

All the AC participants in this study are well-recognised professionals in their respective field (e.g. ex- or current partners of Big Four firms or medium-sized public accounting firms, ex-banker or partner of a legal practice), reputational risk is high stake to them (see Srinivasan 2005; Abbott and Parker 2000; Carcello and Neal 2000). As such, they value the contribution of IAF. They perceive a close working relationship with IAF will derive mutual benefits to both parties. In their view, the AC can gain insights into the operations and controls environment of the organisation and the IAF can enhance their organisational status by a closer working relationship with the AC and consequently support their organisational independence (Stewart and Subramaniam 2010; Arena and Azzone 2009). In enhancing organisational status of the IAF, the AC participants suggest that the AC could show their support to the IAF via various means, such as open support to the IAF in front of senior management, close rapport (see Stewart and Subramaniam 2010; Arena and Azzone 2009), private meetings outside the scheduled AC meetings (see Zaman and Sarens 2013; Arena and Azzone 2009; Turley and Zaman 2007) and active involvement in internal audit activities such as audit planning and findings (see Abbott, Parker and Peters 2004). The AC participants' remarks are consistent with prior literature as cited above.

The AC's support could also be reflected in the AC's authority over IAF resources. Although the regulators require the IAF to report directly to the AC, a 'dual reporting' arrangement is widely practised in Malaysia. The majority of the AC participants acknowledge that they have an active involvement and final authority over the hiring and firing of CAEs and out-sourced internal audit firms. However, the performance appraisal, remuneration and career progression of CAEs and the audit fee of out-sourced IAFs are normally decided by the senior management, although the final decisions may be presented to the AC participants for their endorsement as a formality exercise. This lack of active control over IAF resources is an indication of the AC's weaker organisational power or status vis-a-vis senior management, which could eventually affect AC effectiveness (see Badolato, Donelson and Ege 2014; Turley and Zaman 2007; Braiotta 2004; Raghunandan, Read and Rama 2001; McHugh and Raghunandan 1994). This is because if the IAF perceive senior management to have

more influence over their livelihood, they may have the tendency to align with senior management (see Salancik and Pfeffer 1977). The AC participants are aware of this zero-sum power play between them and the senior management, which is the reason why they strongly support the ‘direct reporting’ to the AC ruling despite the ‘dual reporting’ arrangement that is common practice in Malaysia as they are seeking the legislative endorsement to enhance their formal organisational power within the organisation (Kalbers and Fogarty 1993).

### 7.1.2.2 Organisational support

All AC participants perceive organisational support as crucial in enhancing IAF effectiveness. The majority of the AC participants, whose listed issuers engage in-house IAF, acknowledge that organisational status of CAEs<sup>144</sup> is important as it accords the CAE the confidence to handle a tough situation (sensitive audit findings etc.) and not succumb to pressure from other senior management (e.g. other department heads, CFO, CEO). This is consistent with Abbott, Parker and Peters (2012b)’s study, which suggests that the IAF’s objectivity is a direct function of its organisation status. Despite the AC participants conceding that the CAEs need to have a ‘senior’ managerial role for them to discharge their role effectively, they do not see the need to involve CAEs at strategic board or senior management meetings as proposed by the IIA (2013),<sup>145</sup> as in their view the CAE’s forte is in operational controls and not on strategic business development matters. Furthermore, the CAE’s risk-averse mentality and lack of business acumen may deter them from contributing constructively at high-level strategic meetings. The ACs’ perception could have two connotations. First, while according the CAEs with the organisational status, the board (including the AC) is still sceptical over the CAE’s capability to assume the ‘trusted advisor’ role to the board or senior management (see Hermanson, Ivancevich and

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<sup>144</sup> Such as C-suit managerial position and above.

<sup>145</sup> Practice Advisory 1111-1, Board interaction, IIA (2013) suggests, amongst others, for the CAE to attend Board meeting so that the CAE can appraise strategic business and operational development and raise high-level risk, system, procedures or control issues at an early stage.

Ivancevich 2008b). Second, it may also infer that the CAEs in Malaysia are relatively less ‘senior’ in terms of industry experience and exposure to assume the advisory role.

The organisational status of out-sourced IAF is not perceived by the AC participants as a contentious issue since they are not part of the organisation. The AC participants comment that requiring the out-sourced IAF to report directly to the AC is itself a clear indication of the IAF’s significant role within the organisation.

All AC participants acknowledge that top management should be the party to set the positive tone for the organisations as they are the most influential party over operations and stakeholders of organisations (Claybrook 2004; Clarkson 1995). They need to ‘walk-the-talk’ to ensure the message of strong ethical values and culture are filtered down across the organisation. This is consistent with the ‘top-down’ approach suggested by Chambers (2014). Nonetheless, the AC participants concur that the integrity of top management is of utmost importance in ensuring the right tone is set for the organisation. Without a genuine and serious commitment from the top management, any effort to implement any corporate governance measures (whistle-blower, fraud investigation etc.) will just be an academic exercise, that is, conforming in ‘form’ and not ‘substance’. The AC participants acknowledge that a positive corporate culture will ease the monitoring effort of the IAF and ensure its effectiveness. This view is consistent with Schwartz, Dunfee and Kline (2005).

On the same note, the AC participants view top management’s support for the IAF as critical in enhancing IAF effectiveness as a commitment to the IAF infers top management’s commitment to good corporate governance (Goodwin-Stewart and Kent 2006a). However, the majority of the AC participants acknowledge that top management of most listed issuers (particularly the smaller listed issuers) are not prepared to invest in the IAF. This could be due to either limited financial resources<sup>146</sup> or not seeing the value of the contribution from the IAF. Unwillingness to invest in the IAF has resulted in a significantly high number of smaller listed issuers in Malaysia

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<sup>146</sup> Limited financial resources may have caused smaller listed issuers to prioritise their limited financial resources to operations which can yield direct benefits or values (e.g. production, marketing).

out-sourcing their IAF.<sup>147</sup> If the low investment in the IAF by smaller listed issuers in Malaysia is not because the top management perceives the AC as an alternative monitoring mechanism (substitution effect) to IAF (see Barua, Rama and Sharma 2010), then it could infer a lack of top management's commitment to the IAF. This further reaffirms the earlier discussion suggesting that certain listed issuers (particularly the smaller listed issuers) ceremonially conform to the mandatory IAF ruling to stay legitimate.

### **7.1.2.3 IAF resources: in-house IAF**

All AC participants concur that the IAF resources are a critical contribution to IAF effectiveness. The IAF resources include investment in infrastructure (IT software, computer etc.) and human capital (skilled internal audit staff, continuing education etc.). Despite prior literature (see Anderson, Christ, Johnstone, & Rittenberg, 2012; Sarens and Abdolmohammadi 2011; Barua, Rama and Sharma 2010) suggesting that larger IAF investment or size of internal audit team signifies top management's commitment to better governance, the AC participants in Malaysia posit otherwise. The majority of them do not agree that 'big is beautiful'. They posit that IAF investment must be commensurate with the size and complexities of listed issuers' operations and financial affordability. The AC participants perceive an effective AC should be capable enough to decide on the appropriate level of IAF investment that could accord the assurance required by the board of directors while not unnecessarily straining the financial position of the listed issuers.

Regarding human capital investment, the AC participants acknowledge that continuing education, professional qualifications and on-the-job training are essential in enhancing the effectiveness of internal audit staff. They perceive attributes such as independence and objectivity (see Stewart and Subramaniam 2010; Christopher, Sarens and Leung 2009), and proficiency and competency (Bame-Aldred, Brandon, Messier, Rittenberg, & Stefaniak, 2013; Prawitt, Sharp and Wood 2011) as crucial.

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<sup>147</sup> This is consistent with Anderson, Christ, Johnstone, & Rittenberg (2012)'s study which suggests that out-sourced IAF costs relatively lower than to maintain than an in-house IAF.

However, it is interesting to reveal that the AC participants place a higher emphasis on ‘soft’ skill sets (people management skill, interpersonal skill etc.) over ‘technical’ skill sets of the IAF. Based on the AC participants’ responses, ‘soft’ skill sets includes how to create rapport with an auditee (but not compromising the IAF’s independence and objectivity) and how to entice an auditee to ‘open’ up and share sensitive information. The findings also reveal the AC participants’ great concern over the poor communication skills<sup>148</sup> (i.e. report writing and oral presentation) among internal audit staff. To the AC participants, poor communication skills could impede the effectiveness of the IAF. Prior literature on IAF effectiveness focuses primarily on internal audit attributes such as independence, proficiency and work performance, rarely have they examined the ‘soft’ skills aspect of the IAF. This may open up an avenue for future research. Furthermore, there is virtually no prior literature that focuses on the communication skill sets of the IAF. This could be an IAF attribute peculiar to Malaysia as the result of the change in their education system.<sup>149</sup>

The AC participants also place a high emphasis on ‘soft’ skill sets (people management skills, negotiation skills etc.) of the CAE. This is consistent with Boyle, Wilkins and Hermanson (2012) who accentuate that interpersonal skills are a paramount attribute of CAEs. Although the AC participants perceive ‘soft’ skill sets as critical for both the CAE and internal audit staff, the skill set requirements are expected to vary across different levels of management (see Abdolmohammadi 2012). At CAE level, as the head of IAF they are expected to report internal audit activities and findings. They may be required to ask difficult questions of an auditee who is more senior than them (e.g. managing directors, CEO). When confronted with such a challenging issue, an effective CAE, in the AC participants’ perspective, is one who is assertive and objective but able to pursue his/her cause ‘diplomatically’. This is consistent with Boyle, Wilkins and Hermanson (2012) who posit that the CAE should possess

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<sup>148</sup> The poor command of English language has been cited as the contributory factor of the poor communication skills. This is mainly due to the policy change whereby English language as the principal medium of teaching was repealed and replaced by the Malay language since the early 1970s.

<sup>149</sup> As suggested by one of the AC participants, ‘[t]here is a lost generation of English speaking’ (AC#2). The Malaysian government abolished the usage of English language as the medium of education and replaced it with the Malay language in the early 1970s. This has resulted in poorer command of English usage and articulation among the younger generation.



exceptional interpersonal skill in building an effective working relationship with people within and outside an organisation. Interestingly, there is limited empirical research that focuses on CAE attributes that could support IAF effectiveness. This may open up another avenue for future research.

#### **7.1.2.4 Out-sourced IAF**

This is a new theme that emerged during the field study. Different internal audit sourcing arrangements such as in-house, out-sourcing and co-sourcing have advanced in the US since the introduction of SAS No. 65 (Serafini, Sumners, Apostolou, & Lafleur, 2003). In the case of Malaysia, out-sourcing of the IAF probably happened at the same time as the IAF ruling was made effective at the end of 2007.

In Malaysia, the findings suggest that the common reasons for engaging an out-sourced or co-sourced IAF are to absolve the listed issuers from human resource issues (e.g. to recruit, retain and train internal audit staff), budget-constraints,<sup>150</sup> lack of particular expertise (e.g. IT, ERM)<sup>151</sup> and independence issues, although some AC participants disagree that an out-sourced IAF is more independent or objective than an in-house IAF. This is consistent with Ahlawat and Lowe (2004)'s study, which does not give an affirmative findings that an out-sourced IAF is more objective than an in-house IAF.

The findings reveal that the majority of the AC participants view possession of relevant industry experience (i.e. similar industry as auditees), adequate resources (e.g. adequate staffing with relevant skills and proficiency) and ability to deliver quality audit reports on time as critical attributes of out-sourced IAF. Some AC participants view people management skills as more critical for out-sourced IAFs than in-house IAFs. As cited by one AC participant, the IAF is an 'intrusive job' [AC#1], which requires cooperation and support of the auditee's staff to provide information that

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<sup>150</sup> This is consistent with Anderson, Christ, Johnstone, & Rittenberg (2012)'s study which suggests that the cost of maintain out-sourced IAF is relatively lower than in-house IAF as they cover mainly operational control audit and compliance audit. A lower level IAF.

<sup>151</sup> Several AC participants suggest that their listed issuers opt for co-sourcing arrangement as in-house staff lack specialised expertise (e.g. IT, ERM, etc.)

could at the time be sensitive. Accordingly, the out-sourced internal audit staff need to have exceptional interpersonal skills to gain confidence and rapport with the auditee staff in the shortest timeframe.

The literature on different IAF sourcing arrangement has gained momentum over the past decade. However, the findings are mixed on which sourcing arrangement is most superior in respect of its contribution to IAF effectiveness or quality. This is particularly the case for Malaysia. Although this study has attempted to garner the AC participants' view on their choice of sourcing arrangement and benefits of choosing one sourcing arrangement over another, due to the small sample size generalisation of findings is not possible. Hence, this may again open up another avenue for future empirical research.

### **7.1.3 Internal audit practices (third component)**

The mandatory IAF ruling was introduced at the end of 2007. However, there are virtually no prior studies that focus on internal audit practices in Malaysia under this new regulatory regime. Consistent with the IIA (2013) proposition, all AC participants acknowledge that their listed issuers employ a risk-based approach to internal auditing.<sup>152</sup> However, the findings suggest a significant gap about the scope and rigour of the internal audit activities being practised across listed issuers. This is because while the regulators have mandated IAF establishment, they are not explicit in the operationalisation of IAF. Consequently, this has accorded listed issuers flexibility regarding the structural and functional make-up of the IAF. This section seeks to compare and contrast the internal audit practices in Malaysia vis-a-vis its 'theoretical role' through the three aspects of internal auditing: planning, implementation and evaluation.

#### **7.1.3.1 Planning: internal audit planning**

Internal audit planning is essential before commencement of any audit assignments as it helps to organise the internal audit activities in achieving the desired goal or

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<sup>152</sup> See Griffiths (2006) and McNamee (1997)

objective, which is aligned with that of the organisation (IIA 2013a). In Malaysia, there is no exception. All AC participants expect the IAF, whether in-house or out-sourced, to develop an internal audit plan that addresses all critical risk aspects of listed issuers, i.e. a risk-based approach (Griffiths 2006; McNamee 1997), and present it to the AC for deliberation and final endorsement. This approach is consistent with the proposition of the IIA (2013a). Interestingly, the majority of the AC participants view senior management's involvement at this stage of auditing as crucial. In their views, senior management has extensive knowledge of the businesses and is familiar with the risk environment surrounding the business operations. This clearly signifies the AC participants' acknowledgement of their limitations on company-specific information, i.e. information asymmetry (Raghunandan, Read and Rama 2001). The AC participants' perspective supports the IIA (2013)'s proposition for a closer working relationship among senior management, the AC and the IAF.

The findings also reveal that there exists a gap concerning robustness of risk assessment conducted during the planning stage across listed issuers. It could range from a desktop review of the risk register and risk profiling (prepared by the risk management committee/team) to an independent and extensive assessment of potential risk areas (operational, business etc.) by the IAF. The findings also suggest that AC participants with an in-house IAF have more in-depth knowledge about the risk assessment processes undertaken by the IAF as compared to the AC participants with an out-sourced IAF. This could infer a more in-depth deliberation of risk assessment proceedings and findings during the AC meetings by the in-house IAF since the in-house IAF has less constraint on costs.

Interestingly, none of the AC participants views the maintenance of the IA charter as necessary in enhancing IAF effectiveness. In their view, the proposed stipulations in the IA charter (terms of reference, scope and responsibilities of the IAF etc.) have already been disclosed in other documents (e.g. letter of engagement for out-sourced IAF and letter of employment for in-house IAF). As one AC participant suggests, '[t]o me, its theory. Good to have but is it necessary?' [AC#2]. This further reaffirms that the IIAM has not done enough to 'educate' the market participants of the IIA's professional guidance and the role of the IAF.

### 7.1.3.2 Implementation: nature of internal audit activities

The findings reveal an apparent gap in the nature and robustness of internal audit activities undertaken across listed issuers. This could be due to a number of influencing factors, such as size of the group/companies, complexities of the operations (e.g. diversification in terms of business sectors or geographical locations), controlling shareholders' requirements<sup>153</sup> and the regulatory regime<sup>154</sup> their subsidiaries or investments (including foreign investments) operate in.

This gap is especially apparent between in-house and out-sourced IAFs. While in-house IAFs are reported to have substantially addressed the 'theoretical role' (as depicted in the *Definition of Internal Auditing* (IIA 1999)), the out-sourced IAF's role is confined predominantly to risk-based control audits (i.e. operational control and compliance audit). The in-house IAF is expected by the AC participants to perform more value-add services (coordination of risk management process, fraud investigation, related party transaction review, consultancy etc.). Conversely, the out-sourced IAF is expected to focus predominantly on risk-based control audit. This apparent gap in job scope between the out-sourced IAF and in-house IAF could be because the out-sourced IAF's professional fee is determined by the scope of their job engagement whereas the in-house IAF's costs are relatively fixed (except for overtime claims).

Accordingly, the ability of the out-sourced IAF to expand their work scope to include more value-add services is constricted by their 'fee-sensitive/budget-conscious' audit clients. This is consistent with Anderson, Christ, Johnstone, & Rittenberg (2012)'s study, which posits that corporations out-source their operational controls and compliance audits to outside internal audit firms to keep their costs low. Such cost-saving measures may compromise on the quality of the IAF deliverables and

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<sup>153</sup> If controlling shareholder is a multinational corporation, the Malaysian listed issuer may be subject to a more stringent monitoring requirement. If the controlling shareholder is a listed issuer of a foreign stock exchange, such as the NYSE, then the internal audit activities of the Malaysian-listed issuer may be structured to ensure SOX-compliant.

<sup>154</sup> If the subsidiary (local or foreign) or investment is operating in business sectors (e.g. power plant operator, highway construction builder, financial institutions) which are highly regulated, it may require a more extensive compliance audit to ensure conformance with the regulations.

consequently impact on IAF effectiveness (see Barua, Rama and Sharma 2010; Arena and Azzone 2009).

The findings also suggest that only the in-house IAF are involved in the coordination of risk management processes in listed issuers. The out-sourced IAF are not involved since it is not within the scope of their standard engagement. Accordingly, the involvement of out-sourced IAF in risk management is confined to risk assessment during the audit planning stage and the monitoring of such risks during the audit cycle. The IIA (2013b)'s proposed three-line of defence strategy in effective risk management and controls is not a concept familiar to the majority of the AC participants. Consequently, it is not widely adopted in listed issuers, particularly the smaller listed issuers. This is not surprising considering risk management was only introduced in late 2012.<sup>155</sup>

The majority of the AC participants felt strongly against the IAF assuming a 'dual-role' (i.e. assurance and consultancy). They perceive such practice will compromise the IAF's independence (see Stewart and Subramaniam 2010) unless the IAF team is sizable enough to warrant a firewall (i.e. separate teams to perform consultancy and assurance). This view is consistent with Kawashima (2007). However, some AC participants lament that that it will be very costly and beyond the budget of most listed issuers to maintain a sizable in-house IAF that could assume both roles of assurance and consultancy. This view of the AC participants is consistent with prior literature (see Kawashima 2007).

### **7.1.3.3 Evaluation: performance evaluation**

In the evaluation of IAF performance, a majority of the AC participants acknowledge that they have no knowledge of QAIP as proposed in the IIA (2013). None of their listed issuers has adopted QAIP in IAF performance evaluation. This further reaffirms

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<sup>155</sup> Kindly refer to paragraph 15.26(b) of the Listing Requirements (2011) and the Statement of Risk Management and Internal Control: Guidelines to directors of listed issuers.

the fact that the influence of the IIA through normative isomorphism (DiMaggio and Powell 1983) over the internal audit profession in Malaysia is lacking.

The findings also reveal the majority of the AC participants employ subjective measurements in the evaluation of IAF performance. These measurements include quality of the internal audit reports (e.g. depth and breadth of the audit work, report by exception, advisory on remedial plan for control weaknesses, clarity of written presentation), timeliness of the report (e.g. turnaround time), and oral presentation skill during the AC meetings and peer review<sup>156</sup> (i.e. review of the internal audit work by the auditee). Only one AC participant informs that one of his listed issuers adopts an objective measurement, i.e. KPI, in the evaluation of the IAF performance. This findings is consistent with a global survey by Ernst & Young (2008).

However, all AC participants are consistent in their sentiment that they evaluate IAF effectiveness based on their ability to support the AC in fulfilling the AC's governance obligations. This 'goal-oriented' perspective of the AC participants is consistent with the 'goal model' as suggested by Cameron (1983). To ensure a more systematic evaluation of IAF performance across listed issuers, some AC participants have suggested the regulators provide a guideline or framework that sets out the basic parameters for evaluation (audit methodologies, evaluation criteria etc.).

External auditors' reliance on IAF work has been widely adopted in prior literature as proxy for IAF effectiveness (see Prawitt, Smith and Wood 2009; Glover, Prawitt and Wood 2008; Krishnamoorthy 2002; Felix J and Juan Antonio 2001); ). Interestingly, this is not happening in Malaysia. The AC participants are consistent in their view that external auditors have not informed them of their reliance on IAF work nor have the external auditors commented on the quality of the IAF work. This could be partly due to the Asian culture resulting in them being less vocal in their approach or because the external auditors try not to comment on another professional firms' work. There has been limited research that focuses on the performance evaluation aspect of the IAF,

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<sup>156</sup> Peer review is one of the internal assessment approach under the QAIP as suggested in Professional Standard no. 1300, IIA (2013).

and there is virtually none based on the Malaysia dataset. Accordingly, this has opened up an avenue for future research.

In summary, the in-house IAF have substantially fulfilled the ‘theoretical role’ (as defined in the *Definition of Internal Auditing* (IIA 1999)) but the out-sourced IAF’s role is confined predominantly to risk-based control audit (i.e. operational controls and compliance audit). The findings suggest that in complying with the mandatory IAF ruling, certain listed issuers (the smaller listed issuers) have decoupled by out-sourcing their IAF and thereby partially fulfilling the ‘theoretical’ role of IAF. Their propensity to decouple the ruling could be explained by a number of factors. For instance, there is no independent monitoring by the regulators or professional bodies, and actual internal audit activities are not publicly disclosed to external stakeholders through, for example, annual reports.

## **7.2 Implication of the Findings**

Following the discussions above, it is apparent that although the AC participants confirm all the enabling factors in the conceptual IAF effectiveness framework are important, it is undeniable that certain enabling factors exert greater influence than others at the different stages of the IAF implementation process. Based on the multi-theoretical lens employed in this study, agency theory provides the broader governance process of organisations in general. Stakeholder theory highlights the need for the IAF to fulfil the needs of its key stakeholders or service users, such as the AC, senior management and external auditors. However, it is the institutional theory that has a greater bearing on this thesis due to the peculiar political, cultural and economic background of Malaysia. The first part of this section addresses the influences of the enabling factors from the three isomorphism, coercive, mimicry and normative, identified under institutional theory (DiMaggio and Powell 1983). The second part of this section seeks to highlight the AC expectation of the IAF effectiveness in Malaysia.

### **7.2.1 Influence of the enabling factors on different stages of operationalisation of the IAF: institutional theory perspective**

At the conception stage of the IAF, ‘rules and legislation’ (an external enabling factor) is the most significant enabling factor in establishing an IAF in listed issuers. As it moves to the implementation stage, organisation support (an internal enabling factor), which is significantly influenced by top management’s commitment to good corporate governance and ethical culture, gains prominence.

However, if the rules and regulation are less explicit and the top management lacks serious commitment, mimicry isomorphism will reign, resulting in listed issuers ‘ceremonially conforming’ to institutional pressure (regulations). To stay legitimate, they will mimic others through a process of ‘follow the leader’ regardless of whether the leader is proven to be effective. In the case of Malaysia, mimicry isomorphism has resulted in listed issuers (normally the smaller listed issuers) out-sourcing their IAF or establishing a ‘skeletal’ in-house IAF (with only one or two junior internal audit staff) to partially fulfil their ‘theoretical role’. The lack of monitoring effort over the IAF’s performance by regulators or an independent body affiliated to the regulators, equivalent to the Public Companies Audit Oversight Board (‘PCAOB’) to external auditors, or professional bodies, equivalent to MICPA or the Malaysian Institute of Accountants (‘MIA’) to external auditors, has further negated the influence of coercive isomorphism during the implementation and performance evaluation stage.

In the case of Malaysia, the influence of normative isomorphism is negated by the lack of significant presence of the IIAM in supporting the market participants (i.e. listed issuers) and key corporate governance stakeholders (the AC, senior management and external auditors). The IIAM’s relatively small professional membership base has also weakened their professional influence over organisations. The AC, which is entrusted to oversee the IAF, has not been able to exert their professional influence due to relatively weaker organisational power or status vis-a-vis top management since their appointment in most instances is dependent on the owner-managers. Also, the culture of appointing ‘friendly’ AC members or from ‘social networks’ (instead of from ‘advice networks’) has further weakened the AC’s professional influence via normative isomorphism. These implications are summarised in Table 7.1.



**Table 7.1: Influence of enabling factors over the stages of operationalisation of the IAF: institutional theory perspectives**

	Stages of operationalization of the IAF		
	Conception	Implementation	Performance evaluation
Coercive isomorphism (e.g. law, enforcement)	<i>Strong</i> – Mandatory IAF ruling	<i>Weak</i> – Ruling on operationalisation of the IAF is not explicit, resulting in flexibility in the structural and functional make-up of IAF among listed issuers	<i>Weak</i> – No independent monitoring by regulators.
Normative isomorphism (e.g. culture, professional body)	<p><i>Weak</i> – Professional body (e.g. IIAM) a less significant presence in supporting market participants. Professional membership base (i.e. CIA) is small – ability to ‘internalise’ professional culture with that of organisation culture is negated.</p> <p><i>Weak</i> – The AC’s oversight quality could be compromised if ‘friendly’ AC member or from ‘social network’ instead of ‘advice network’ are appointed to the board. Their relative organisational power/status vis-a-vis top management may further weaken their professional influence over the listed issuers.</p>		
Mimicry isomorphism (e.g. ‘follow the leader’)	<i>Weak</i> – Listed issuers ceremonially conform to mandatory IAF ruling.	<i>Strong</i> – Listed issuers (top management’s decision) out-source their IAF or set-up a ‘skeletal’ in-house IAF and partially fulfil the ‘theoretical role’ of IAF.	<i>Strong</i> – Listed issuers (top management’s decision) do not employ QAIP in the evaluation of IAF performance.

### 7.2.2 AC participants’ expectation of IAF effectiveness in Malaysia

The AC participants’ expectation of IAF effectiveness is ‘goal-oriented’ (see Cameron 1983), which means the IAF must be able to support the AC participants in meeting their governance obligations and the organisations’ goals. Due to the exploratory and investigative nature of this study, the AC participants were purportedly not asked to provide a definition of IAF effectiveness as this might derive a stereotypical response from the participants. Instead, they were asked to provide their views on how IAF performance is evaluated or assessed and what contextual or environmental factors could help contribute to IAF effectiveness.

From the findings, it is inferred that AC participants do not view conformance with all the IIA's professional guidance or fulfilling the 'theoretical role' of the IAF as crucial in determining IAF effectiveness. Their evaluation of IAF performance is based on subjective measurements and is 'outcome-orientated'. The findings also suggest that the AC participants' expectation of IAF effectiveness is not static. It is dependent on the contextual and environment factors (i.e. the internal and external enabling factors) surrounding the internal audit practices in Malaysia. The AC's expectation of IAF effectiveness may be heightened if the prevailing enabling factors become more encouraging. For instance, a ready supply of qualified internal audit professionals and the IIAM is likely to exert more significant professional influence and support to the business community.

### **7.3 Efficacy of the Refined IAF Effectiveness Framework**

The refined IAF effectiveness framework developed in Chapter 6 outlines the three core components, namely external enabling factors (first component), internal enabling factors (second component) and internal audit practices (third component). The AC participants, as the key IAF stakeholder, have considered the enabling factors embedded in each of these core components as important. The findings in Chapter 6 provide support for the appropriateness and coverage of the framework.

The framework does not intend to provide a measurement for 'IAF effectiveness'. It aims to expand the horizon for future researchers on the topic of IAF effectiveness to go beyond the widely adopted 'IAF attributes fit' approach (Sawyer 1988) in most prior IAF-related literature to a 'key users' perspectives' approach (Albrecht, Howe, Schueler, & Stocks, 1988). Besides presenting the enabling factors (internal and external to organisations) that could significantly impact the effectiveness of internal audit practices in Malaysia, these findings also reveal that the AC's expectation of the IAF effectiveness is not static. It is dependent on the contextual and environmental factors (i.e. internal and external enabling factors) surrounding the internal audit practices in Malaysia. These findings are expected to provide a rich source of reference for future research. Overall, the findings support the efficacy of the conceptual IAF effectiveness framework developed in Chapter 5.

## **7.4 Chapter Summary**

This chapter discussed the importance of each of the enabling factors embedded in the three core components as identified in the refined IAF effectiveness framework. It also deliberated how the various enabling factors exert their influence during the operationalisation of IAF from the institutional theory perspectives, one of the theories employed in this thesis. This chapter ended by confirming the efficacy of the refined IAF framework and its contribution as a rich source of reference for future IAF research, policy and practice. The next chapter concludes this study with a summary of the main findings as well as its contribution to theory, policy and practice. The next chapter also highlights the study's limitations and presents avenues for future research.

## CHAPTER 8: CONCLUSION

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### 8.0 Introduction

This thesis aims to investigate and explore the contextual and environmental factors (i.e. the internal and external enabling factors) that impact on effective operationalisation of internal audit practices in Malaysia. A qualitative research approach has been employed to collect and analyse the data. In response to the overarching question of the thesis ‘What constitutes an effective IAF from the lens of the AC?’, three research questions have been addressed in this thesis:

*RQ1: What constitutes an IAF effectiveness framework taking into account the contextual factors that appear to inhibit and/or encourage the internal audit practices of the Main Market listed issuers in Malaysia?*

*RQ2: To what extent does the IAF effectiveness framework meet the AC’s expectation in fulfilling their governance obligations?*

*RQ3: To what extent is the IAF effectiveness framework practised by the IAFs of the Main Market listed issuers in Malaysia?*

Chapter 7 provided a discussion of the key findings in this thesis. This chapter aims to provide a summary of the key findings, discuss the contribution of this thesis to theory, policy and practice along with the limitations of the study and suggestions for future research.

### 8.1 Summary of Key Findings

In this thesis, the responses of the fourteen AC participants are used to confirm/negate and refine the conceptual IAF effectiveness framework in order to develop a refined IAF effectiveness framework. Developed from prior literature (academic and professional), professional guidance and rules and regulations, this thesis is structured around the three core components, namely, external enabling factors, internal enabling factors and internal audit practices, as presented in the conceptual IAF effectiveness

framework developed in this thesis (see Figure 5.5 in Chapter 5) and addressing RQ1. In response to RQ2, the AC participants' views on the conceptual framework support a refined framework as summarised in Table 8.1. In addressing RQ3, the AC participants' responses on the actual internal audit practices are also presented in Table 8.1, which summarises the key findings as presented earlier in Chapter 6.

**Table 8.1: The key interview findings**

<b>Interview findings (for RQ3)</b> <b>In practice</b>		<b>Interview findings (for RQ2)</b> <b>AC's expectation</b>	
<b>Enabling factors</b>	<b>Framework level</b>	<b>Enabling factors</b>	<b>Findings</b>
<u>Rules and legislation</u>  Certain listed issuers decouple the regulations to stay legitimate. They out-source their IAF with low fee budget or maintain a 'skeletal' in-house IAF (with one or two junior internal audit staff) and undertake limited scope internal audit. 'Dual reporting' is commonly in practice as opposed to the 'direct reporting' to the AC requirement by the policy-makers.	External	<u>Rules and legislation</u>  Need for mandatory rulings to support better corporate governance and enhance IAF effectiveness	Supported
<u>IIA's role</u>  The IIAM's role is perceived as less proactive in engaging the governance stakeholders resulting in the AC not familiar with their professional guidance as well as the role and function of IAF as stipulated in the IPPF (IIA 2013a).		<u>IIA's role</u>  Need to be more proactive in supporting the development of the internal audit industry in the context of quality monitoring, professional guidance and training. Also to support other governance stakeholders.	Refined
<u>Internal audit industry readiness</u>  There is a shortage of internal audit professionals. The internal audit industry is unable to attract and retain staff partly due to problems inherent in the profession. This includes nature of the job (boredom, lonesome, stressful etc.) and prestige attached to the profession (e.g. lack of career advancement opportunities). Also, the internal audit industry is not regulated. This may have resulted in a diverse range of performance quality among internal audit services providers (particularly the out-sourced IAF),		<u>Internal audit industry readiness</u>  Need for the internal audit industry to work towards meeting the growing market demand/ expectation for internal audit professions in the context of quantity and quality.	New emerging theme

<b>Interview findings (for RQ3)</b> <b>In practice</b>		<b>Interview findings (for RQ2)</b> <b>AC's expectation</b>	
<b>Enabling factors</b>	<b>Framework level</b>	<b>Enabling factors</b>	<b>Findings</b>
which may impact on IAF effectiveness.			
<u>AC support</u>  In practice, certain AC members are not truly independent. They are political nominees, ex-government servants or confidantes of controlling shareholders. They normally lack the necessary skill sets of an effective AC; thus negate their effective support and monitoring over the IAF. Also, their inability to have full control over the IAF resources may result in the IAF perceive the AC has 'weaker' organisational power vis-a-vis senior management. This may result in IAF align themselves to senior management, the party who could decide their livelihood.	Internal	<u>AC support</u>  Need for AC to be effective to extend support to IAF. For that, AC themselves need to be a financial expert (especially the AC chair), 'truly' independent, diligent and have real/perceived control over IAF resources vis-a-vis top management in order to gain loyalty of the IAF.	Refined
<u>Organisational support</u>  A majority of top management (particularly from the smaller listed issuers) are sceptical over the true value contribution of the IAF. Hence they are reluctant to invest in the IAF. Governance mechanisms (whistle-blower mechanism, code of ethics etc.) as disclosed in annual reports are merely boilerplate disclosure which could implicate a 'form' over 'substance' practice among certain listed issuers.		<u>Organisational support</u>  Need to have a clear organisational status for the IAF (to avoid role ambiguity), positive corporate culture and top management's commitment to good corporate governance (including support to the IAF).	Refined
<u>Adequacy of internal audit resources (in-house IAF)</u>  The shortage of qualified internal audit professionals has resulted in recruitment and retention of qualified internal audit professional tough for even large listed issuers. Poor language skill among the younger generation has also affected the quality of the IAF.		<u>Adequacy of internal audit resources (In-house IAF)</u>  Need to be adequately resourced (staffing and budget etc.) with independent and competent internal audit staff with both soft skill sets (e.g. interpersonal skills, communication skills) and technical skill sets. CAE is capable to lead the change.	Refined

<b>Interview findings (for RQ3)</b> <b>In practice</b>		<b>Interview findings (for RQ2)</b> <b>AC's expectation</b>	
<b>Enabling factors</b>	<b>Framework level</b>	<b>Enabling factors</b>	<b>Findings</b>
<u>Out-sourced IAF</u>  In practice, the AC engage out-sourced IAF with relevant industry, the right skill sets (e.g. soft skill sets) and ability to deliver quality and on-time internal audit report.		<u>Out-sourced IAF</u>  Need to be adequately resourced (e.g. staff with relevant skill sets), with relevant industry experience, timely delivery of audit report and quality of the audit report.	New emerging theme
<u>Planning</u>  The AC participants do not view IA charter crucial in enhancing IAF effectiveness but they concur that risk-based internal audit plan is adopted in internal audit planning.	Internal audit practices	<u>Planning</u>  Need to develop a risk-based internal audit plan.	Supported
<u>Implementation</u>  While in-house IAF has significantly fulfilled the 'theoretical' role of IAF (as stipulated in the <i>Definition of Internal Auditing</i> (IIA 1999)), the out-sourced IAF's role are confined mainly to operational control audit. The differentiation is mainly due to a majority of smaller listed issuers out-source their IAF with minimal fee budget and engage limited scope audit.		<u>Implementation</u>  Need to conduct internal audit activities commensurate with the 'need' requirement of the respective organisations. It is not necessary for the IAF to fully fulfil the 'theoretical' role (as stipulated in the <i>Definition of Internal Auditing</i> (IIA 1999)) to be considered 'effective'.	Refined
<u>Evaluation</u>  The QAIP (IIA 2013a) is not widely adopted in the evaluation of IAF performance. Subjective evaluation method is widely adopted instead of objective measures (e.g. KPI) by the AC in the evaluation of IAF performance.		<u>Evaluation</u>  Need to identify a mechanism that could evaluate IAF effectiveness that meet the AC's governance obligations. It is not necessary to fully comply with the IIA's provision on IAF evaluation (i.e. QAIP).	Refined

A detailed discussion of the above findings and implication has been presented in Chapter 7.

## **8.2 Contribution of this Thesis**

The contributions made by this thesis to theory, policy and practice are presented as follows.

### **8.2.1 Contribution to theory**

This thesis makes four specific contributions to theory. First, an IAF effectiveness framework has been developed for the first time in this thesis, at both theoretical and conceptual levels. This framework can be used as a basis for future studies. This is a major contribution of this thesis since a framework of this nature has not previously been developed in other studies. The framework consists of three main components that address the key enabling factors (internal and external to organisations) that could impact on internal audit practices.

Second, this thesis expands the existing literature relating to IAF. Although IAF effectiveness has attracted much research interest in the past two decades, prior studies tend to employ deductive inquiry approaches (e.g. archival or survey) and rely on the CAE (i.e. the IAF service providers) to evaluate their own effectiveness. This thesis expands the horizon of IAF effectiveness beyond the narrowly prescribed IAF attributes within the external audit standards (ISA 2013; AICPA 1990) and employs an inductive inquiry approach (i.e. semi-structured, in-depth interviews) to garner the AC chair/members' (i.e. the key IAF service users) views on how they perceive IAF effectiveness and what factors could encourage/inhibit the effective practice of the IAF. The results of the thesis provide a comprehensive understanding of challenges confronting effective practices of IAF in listed issuers. The findings indicate that top management's scepticism over the true value contribution of the IAF could result in their lacklustre support of the IAF. However, an effective and supportive AC and a proactive professional body (e.g. the IIAM) can 'internalise' the professional culture with that of the organisation culture and consequently bring about a conducive environment for the practice of the IAF.

Third, the findings extend the literature around the concept of IAF effectiveness. The results indicate that the AC (the key IAF service users) employ a 'goal-oriented' approach in their evaluation of IAF effectiveness. They perceive an 'effective' IAF as



one that is likely to support the AC in fulfilling their governance objectives rather than solely to conform to the ‘theoretical role’. Also, the findings reveal that there is no uniform measurement for IAF effectiveness. The AC evaluate IAF effectiveness based on subjective criteria (high quality audit recommendation, timely internal audit reports etc.).

Fourth, unlike prior studies, which have largely relied on agency theory to explain the IAF’s role in an organisation, this thesis adopts a multi-theoretical theories that includes agency, stakeholder and institutional theory to inform the role, function and practices of the IAF in Malaysia. The discussion of the implication of these multiple theories on effective practice of the IAF is presented in section 7.2 of this thesis.

The findings of this thesis provide a richer base of reference for future IAF-related research not only for Malaysia but also for emerging markets with similar economic and political backgrounds. It also contributes to the growing literature on IAF, specifically in the Asia-Pacific region.

### **8.2.2 Contribution to policy**

Although the regulators have mandated the establishment of IAF in listed issuers, the actual practice of the IAF in listed issuers is little known to outside stakeholders or other market participants as the internal audit activities are not well documented in published documents such as the annual reports. Most of the IAF-related disclosures in the annual report are standard (Bursa Malaysia 2014) and prepared to conform to the Listing Requirements (Johl, Johl, Subramaniam and Cooper 2013; Haron, Daing Nasir Ibrahim, Jeyaraman and Hock Chye 2010).

The findings in this thesis highlight to the policymakers some of the practical issues surrounding the implementation of the mandatory IAF ruling in Malaysia. It enables the policymakers to consider ways they could help ensure effectiveness of internal audit practices in listed issuers. For instance, certain listed issuers decouple by engaging ‘skeletal’ in-house IAF (with one or two junior staff) or engaging out-sourced IAF to conduct a limited scope audit. This may negate the purpose of requiring listed issuers to establish an IAF. To overcome this, the findings suggest the regulators (or a governmental agency like PCAOB to external auditors) to monitor the quality

and work performance of internal audit service providers (particularly the out-sourced IAF). Further, the AC participants indicate that to facilitate a more systematic monitoring over the IAF by the AC, the policymakers should consider issuing an IAF performance evaluation framework that sets out the basic evaluation parameters/criteria in collaboration with the IIAM.

### **8.2.3 Contribution to practice**

This study makes two main contributions to practice. First, at a professional level, this study provides insights into the AC's expectations of the IAF in supporting the organisation's governance mechanism as well as the AC capacity to meet their governance obligations. A clear understanding of the expectation of the ACs will minimise expectation gaps between service users and service providers. The AC's perspective on how a particular enabling factor (e.g. organisational support) could impact on IAF effectiveness will assist senior management to better structure their governance mechanisms. This understanding could also alleviate the tension between the AC and senior management who are alleged to have competing demands for IAF resources (Abbott, Parker, & Peters, 2010).

Second, at the professional body level, this study provides insights into the AC's perception of how a professional body (such as the IIAM) could play a more significant role in supporting its various stakeholders, including its members (individual or corporate), other corporate governance stakeholders (e.g. the AC and senior management) and policymakers/regulators. In the AC participants' view, the IIAM's active engagement with its stakeholders will gain the IIAM more support for its program and activities, for example, CIA professional examinations and continuing education program, professional training. This will eventually enhance the profile of the internal audit profession and convince the stakeholders of the value contribution of the IAF.

## **8.3 Limitations**

This thesis contains some limitations that must be considered when interpreting the results. The first limitation is the size of the sample. Semi-structured, in-depth

interviews provide a very rich source of data; however, this approach results in a smaller sample size. In this thesis, the sample consists of fourteen AC participants (comprising AC chair and AC members of the Main Market listed issuers in Malaysia). Sandelowski (1998) posits that the interviewing process can stop once data saturation has been reached, i.e. where there is no more new insights from the respondents. This author's view is supported by many other researchers (Saunders, Lewis, & Thornhill, 2011; Guest, Bunce and Johnson 2006). Guest, Bunce and Johnson (2006) suggest that for studies which aim to understand commonalities within a fairly homogeneous group of participants, twelve personal interviews suffice.

In this study, all the AC participants are well-recognised professionals in their respective fields. Their inputs are insightful and rich. As several earlier AC participants were very candid and provided in-depth sharing of their views, this resulted in no significant new data being introduced after the twelfth AC participant had been interviewed, i.e. the data saturation point had been reached. Accordingly, the researcher views fourteen participants as the right sample size for this research. Compared to archival and experimental research, the sample size in this thesis may be small; however, due to the exploratory and investigative nature of this research, the employment of a semi-structured, in-depth interview approach is the most appropriate even if there is a need to compromise on smaller sample size.

Secondly, purposeful sampling was adopted in the selection of the AC participants. As it is a non-random sampling method, this limits the generalisability of the results to the broader population of the AC. The selection of AC participants in this study is biased towards AC members who are 'financial literate'<sup>157</sup>. This selection strategy may compromise on 'representativeness' of the research findings as views of the 'non-financial literate' AC members are under-represented in this study. However, the researcher is mindful that this is an exploratory study which aims to develop an IAF effectiveness framework. Accordingly, the researcher has weighed the ability to garner

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<sup>157</sup> 'Financial literate' AC members are assumed to have more in-depth knowledge on corporate governance practices and control mechanisms (specifically the internal audit practices) of listed issuers than 'non-financial literate' AC members.

insightful views of ‘financial literate’ AC participants who are assumed to have solid governance knowledge and experience (including monitoring over the IAF) over ‘representativeness’ of the research findings.

Thirdly, this is an exploratory study which attempts to develop a framework that identifies the key enabling factors (both internal and external) that could impact on effective practice of IAF. No framework of this nature has previously been developed. Hence, it is important to accentuate that the key enabling factors identified in the IAF effectiveness framework in this study is by no means exhaustive nor conclusive. However, this framework will form the basis for future studies of similar nature.

Forthly, the thesis does not aim to provide any measurement for IAF effectiveness. Instead the study seeks to establish that the study of IAF effectiveness should expand beyond narrowly defined internal audit attributes within the control of IAF. However, future research could be employed to develop an IAF effectiveness index by relying on multiple enabling factors established under the conceptual IAF effectiveness framework. Considering the limitations as highlighted above, caution should be placed when interpreting the findings in this thesis.

#### **8.4 Future Research Opportunities**

The richness of the data collected for this thesis raises many ideas and opportunities for future research into internal audit practices and IAF effectiveness studies. This section highlights some of the potential research opportunities. Firstly, it is suggested that researchers use alternative research methods such as a deductive inquiry approach (e.g. questionnaire survey) to corroborate the findings of this thesis. Also, researchers from countries with similar cultural, political and economic background as Malaysia may conduct a similar study to build a body of evidence to support a broader-based conclusion on the refined IAF effectiveness framework.

The findings in this study reveal that the enabling factors of IAF effectiveness are more complex than the narrowly defined IAF resources (e.g. IAF attributes) within the control of IAF. IAF effectiveness appears to be influenced by a broader dimension of contextual or enabling factors as identified in the refined IAF effectiveness framework.

Using this framework as a starting point, an opportunity exists to develop a comprehensive model of IAF relying on a multi-stakeholder model, by including views of the owner-manager, the IIAM and regulators. The various stakeholders' views will be important for building a comprehensive conclusion to address IAF effectiveness in Malaysia.

The findings of this thesis also reveal that while in-house IAF has substantially fulfilled their theoretical role, out-sourced IAF's activities are confined predominantly to risk-based control audit (operational control and compliance audit). This apparent gap is not due to out-sourced IAF being incapable of fulfilling their theoretical role, but the budget-conscious auditees' have restricted their audit job scope. It is interesting to reveal that a high proportion of smaller listed issuers out-sourced their IAF to reduce their IAF outlay. Future research may conduct an empirical study to confirm whether size of listed issuers or controlling shareholders of listed issuers has any bearing on its choice of IAF engagement (i.e. in-house, out-sourced or co-sourced) and their scope of internal audit activities.

## **8.5 Chapter Summary**

In summary, this thesis explores the AC participants' expectation of IAF effectiveness by conducting semi-structured, in-depth interviews with fourteen experienced AC chair and AC members. Following the interviews, the conceptual IAF effectiveness framework was refined to capture the AC participants' perspectives. It highlights the internal audit currently in practice as well as the multiple enabling factors (internal and external to organisations) that encourage or inhibit effective operation of the IAF in Malaysia. The findings confirm that IAF effectiveness should not be conceptualised based on narrowly defined internal audit attributes within the control of the IAF. It also reveals that the ACs' expectation of IAF effectiveness is not founded on whether the IAF fulfil the 'theoretical role', but whether it assists the AC meet their governance obligations and objectives. Also, the ACs are practical in that any investment in the IAF has to be commensurate with the needs and affordability of the listed issuers. As a concluding note, the AC's expectation of IAF effectiveness is not static but dependent on enabling factors (internal and external to organisations) surrounding the internal audit practices in Malaysia.

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## Information kit

**Research Title:****Audit Committee perception on effectiveness of Internal Audit****Function: A Malaysian's perspective**

This Informed Consent Form has two parts:

- Part I: Information Sheet - to share information about the study with you
- Part II: Certificate of Consent - for signatures if you choose to participate

**Part I: Information Sheet****Introduction**

My name is Soo Sin LEE, a PhD candidate at Curtin Business School, Curtin University, Australia. I am currently conducting a research on drivers that encourage or inhibit the effectiveness of internal audit function (“IAF”), from the Malaysian audit committees’ perspectives. I sincerely hope that you will accept my invitation to participate in this study. Before you decide, you can talk to anyone you feel comfortable with about the research. This research project is being overseen by Dr. Joe Christopher and Dr. Gordon Woodbine of Curtin Business School and has been approved by the University’s Human Research Ethics Committee (Approval No. AC-14-11).

**Purpose of the research**

This study involves a three-pronged objective. Firstly, it aims to explore *what* drivers and *how* such drivers encourage/inhibit the effective operation of IAF in Malaysia. Next, to develop an IAF effectiveness framework based on the audit committees’ perspective that will enhance governance of corporations. Finally, it also aims to present the extent to which the IAF effectiveness framework is being applied in IAF of public listed companies in Malaysia.

**Type of Research Intervention**

This phase of the doctoral study will involve your participation in a personal interview of approximately one (1) hour.

**Participant Selection**

You are being invited to take part in this research because of your extensive industry experience, professional credentials, commitment to corporate governance, to name a few. Also, I believe that you are willing to share your vast corporate experiences and governance knowledge which will add depth to my study and consequently support the development of an IAF effectiveness framework. Your participation will also contribute to the growing literatures on IAF; specifically the Asia-Pacific region (which is alleged still at its infancy stage).

### **Voluntary Participation**

You are under no obligation to take part in this research and may withdraw your consent at any time during the tenure of this study. There will be no consequence for refusing or withdrawing.

### **Procedure**

If you accept my invitation, you will be asked to participate in an interview with myself. During the interview, I will sit down with you in a comfortable venue of your choosing. If you do not wish to answer any of the questions during the interview, you may say so and I will move on to the next question. No one else but the interviewer will be present unless you would like someone else to be there. The interview will be recorded by audio-recording and note-taking. The recorded interview will be transcribed. All information recorded and transcribed is confidential, and no one else except the interviewer and supervisors (as named below) will have access to the audio recording. The transcribed interview is confidential and anonymized.

### **Confidentiality**

The interviewer undertakes not to share information gathered other than with the supervisors. Any information about you will be anonymized. Only the interviewer will know the correlation to your name and your anonymized number/code. It will not be shared with or given to anyone. You will not be identified in any of the reporting of the data.

### **Who to Contact**

This study has been authorized by the Curtin University Human Research Ethics Committee (Approval No.: AC-14-11). Complaints on ethical grounds can be address to the Secretary (details below). If you have any queries or concerns about any part of the research study, please do not hesitate to contact my supervisors, Dr. Joe Christopher /Dr. Gordon Woodbine (as named below) or myself. Thank you very much for your participation and interest in this study.

Supervisors	
Dr. Joe Christopher Senior Lecturer School of Accounting Curtin Business School Curtin University, Australia Phone: +618 9266 2006 J.Christopher@curtin.edu.au	Dr. Gordon Woodbine Senior Lecturer School of Accounting Curtin Business School Curtin University, Australia Phone: +618 9288 2426 Gordon.Woodbine@cbs.curtin.edu.au
Secretary of Human Research Ethics Committee Curtin University GPO Box U1987, Perth WA 6845 Phone: +618 9266 2784 hrec@curtin.edu.au	

**Part II: Letter of Consent**

- I, the undersigned, voluntarily agree to take part in the study “Audit Committee perception on effectiveness of Internal Audit Function: A Malaysian’s perspective”
- I have read and understood the Information Sheet provided. I have been given a full explanation by the researcher of the nature, purpose and likely duration of the interview, and of what I will be expected to do. I have been given the opportunity to ask questions on all aspects of the study and have understood the advice and information given as a result.
- I understand that all personal data relating to research participants is held and processed in the strictest confidence and that any information that might potentially identify me will not be used in any publication resulting from this study.
- I understand that I am free to withdraw from the study at any time without needing to justify my decision and without prejudice.
- I confirm that I have read and understood the above and freely consent to participating in this study. I have been given adequate time to consider my participation.

Kindly tick ✓ in the relevant

YES  NO  I agree to this interview being audio taped

YES  NO  I would like a copy of the transcribed interview with me.

YES  NO  I agree to a subsequent short discussion to clarify my views (if required)

I prefer to be contacted by:

mobile phone ☎: \_\_\_\_\_  office ☎ : \_\_\_\_\_

email: \_\_\_\_\_

Name of participant  
(BLOCK CAPITALS):

Signed:

---

Date:

## Appendix 2

### Cover letter



Curtin University  
GPO Box U1987  
Perth Western Australia 6845  
Soosin.lee@postgrad.curtin.edu.au

[ ] September, 2014

Dear Mr/Mrs/Ms \_\_\_\_\_

RE: Invitation to participate in research interview on “Audit Committee perception on effectiveness of Internal Audit Function (“IAF”): A Malaysian’s perspective”

I am a Doctoral student at Curtin Business School, Curtin University, Australia. I would like to invite you to participate in the research I am undertaking as part of my PhD study. My research project aims to explore *what* factors and *how* such factors impact on effectiveness of IAF in Malaysia from the perspective of the audit committee. The ultimate objective of this doctoral study is to develop an IAF effectiveness framework. This PhD study is being overseen by Dr Joe Christopher and Dr Gordon Woodbine of Curtin Business School and has been approved by the University’s Human Research Ethics Committee (Approval No: AC-14-11).

Your participation in this research will be in the form of an interview. Your participation in the interview will not only contribute to the development of an IAF effectiveness framework specifically for Malaysia business community but also to the corporate governance literature. As an appreciation of your participation, an executive summary of the results of this study will be sent to you. An information sheet is attached with further details about this research project.

If you are willing to participate, please sign the attached Consent Form to confirm your consent. This will be collected when we meet and prior to the interview. All information you provide to us will be kept confidential.

Participation in this research is entirely voluntary. Therefore, should you wish to withdraw prior to commencement of interview, kindly contact me via email: [soosin.lee@postgrad.curtin.edu.au](mailto:soosin.lee@postgrad.curtin.edu.au). No explanation is necessary. Thank you in anticipation.

Yours sincerely,

Soo Sin LEE  
Doctoral Candidate  
School of Accounting,  
Curtin Business School, Curtin University

## Interview Guide

### Key interview questions

#### **First component: external enabling factors**

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(a) *The Malaysian regulators have mandated the establishment of IAF in Malaysia and required the IAF to report directly to the AC*

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#### Q1

In your view as an AC member, do you think that the mandatory IAF ruling has helped to enhance effectiveness of IAF in Malaysia? If yes, how? If no, why?

Do you encounter any problem(s) in the implementation of the mandatory IAF ruling? If yes, what are the problems?

#### Q2

In your view as an AC member, do you think that the ‘direct reporting to the AC’ ruling has helped to enhance the IAF’s organisational independence? If yes, how? If no, why?

Do you encounter any problem(s) in the implementation of the ‘direct reporting to the AC’ ruling? If yes, what are the problems?

Can you briefly explain the hiring and firing policies and procedures for the CAE in your listed issuers? Who decide on the performance appraisal, remuneration package, career progression of the CAE and internal audit staff in your listed issuer(s)?

Do you encounter any resistance from (or conflict with) the senior management in the implementation of the ‘direct reporting to the AC’ ruling? If yes, how?

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(II) *The IIAM’s role to exert professional influence (e.g. professional guidance, quality monitoring, support the regulators) over the internal audit profession in Malaysia.*

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#### Q3

Do you rely on the IIA’s professional guidance/framework in your monitoring over the IAF? If not, why? What alternative measures have you undertaken in your monitoring effort over the IAF? [Note: A more in-depth inquiry on the evaluation of IAF performance is found in third component – internal audit practices]

Does your IAF adopt the IIA’s standards/framework in the conduct of their work? If not, why? And, what (professional bodies’) standards/framework have they relied on in performing their work?

In your view, should the IIAM be accorded with the legislative backing to monitor the performance or work of internal audit service providers (like the PCAOB to external auditors)? If yes, how? If no, why?

If the IIAM is not the appropriate party, who do you think should be entrusted with the independent monitoring role over the performance or work of internal audit service providers besides the AC?

Do you think that the internal audit industry need to be regulated to ensure certain quality of IAF is maintained? How do you propose the internal audit industry to be monitored/regulated?

Q4 (a new theme emerged during field study)

Certain AC participants have informed that there is a shortage of internal audit professionals in meeting the market demand. In your view, what are the reason(s) behind this human resource shortage? What is its impact on IAF effectiveness? In your view, how could we overcome this problem?

Second component: internal enabling factors

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*(III) The AC's support*

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Q5

In your view, what is /are the AC attribute(s) that will support the IAF in enhancing their effectiveness in the Malaysian context? In your view, which are the most critical attributes?

[Probe: AC's independence, financial literacy/expertise, AC resources, AC's control over IAF resources and AC's diligence.]

Q6<sup>158</sup> [*This question was added during field study*]

In your view do you think that for the IAF to report administratively to the senior management and functionally to the AC (i.e. the dual-reporting structure) will compromise on their organisational independence? If yes, how? If not, why? In this respect, how could the AC help to enhance the organisational independence of the IAF?

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<sup>158</sup> This question was added during field study after some earlier AC participants informed that 'dual-reporting' structure (instead of 'direct reporting to the AC') has being widely practised in Malaysia.

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*(IV) Organisational support - Role ambiguity and organisational hierarchy*

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Q7

Do you agree that the CAE should be placed high up in the organisational hierarchy for them to function effectively? If yes, what level should they be placed? If no, why?

Do you involve your CAE at senior management or board's strategic management meeting? If no, why? If yes, why?

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*(V) 'Tone at the top', good corporate culture and work ethics*

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Q8

In your view, who should be the party responsible for setting the 'tone at the top' for the organisation? Why do you think so? [Probe: How do you propose to enhance the positive 'tone' at the top?]

What are the corporate governance mechanisms you have in place in your listed issuer? [Probe: Code of ethics for all level of employees, whistle blower mechanism, etc.]

Do you think that company with good corporate culture, positive work ethics will ease IAF's monitoring activities? If yes, how? If no, why?

In your view, what should top management do to enhance positive work culture within the organisation?

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*(VI) Adequacy of IAF resources (e.g. IAF budget allocation, competent staffs, etc.)*

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Q9

Can you briefly tell me how does the internal audit budget determine in your listed issuer(s)? [Probe: top-down or bottom-up approach? Relativity with turnover/revenue?]

Who has the final decision over the IAF budget for your listed issuers? [Probe: Board of directors, AC, CEO, CFO, or joint effort.]

Have you (as an AC) been confronted with any issues with the senior management on IAF resources /budget allocation ?

Q10

In your view, what is/are the attribute(s) which must be possessed by internal audit staffs to ensure their effectiveness in the Malaysian context? [Note: Similar question is asked to gauge the attributes for CAEs]

In your view, which are the most critical IA attributes to ensure their effectiveness? [Note: Similar question is asked to gauge the attributes for CAEs]

[Probe: Independence and objectivity, proficiency and competency, qualification (academic, professional), past external/ internal audit experience, soft skills (e.g. people management skill, negotiation skills), leadership etc.]

Q11 (a new theme emerged during field study)

In your view, what is/are the main driver(s) that encourage listed issuers to out-source their IAF? What are the pros and cons of out-sourcing vis-a-vis the in-house sourcing arrangement?

In your view, what is/are the attribute(s) must be possessed by the out-sourced IA firms to ensure their effectiveness in the Malaysian context?

Third component: internal audit practices

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*(VII) Planning: internal audit charter and internal audit planning*

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Q12

Does your listed issuer maintain an IA charter? If no, why? Do you think it will help to enhance IAF effectiveness?

Can you briefly explain how is the internal audit plan developed in your listed issuers? Who should be responsible for preparing the internal audit plan? What is the role of senior management in internal audit planning?

Do you review the internal audit plan mid-stream? If yes, under what circumstances?

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*(VIII) Implementation: nature of IA activities (theoretical role – control, risk-management, governance and value-add services)*

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Q13

What are the IA activities that in your view are essential to support you in meeting your governance objectives? [Probe: control, risk management and governance]

Please briefly explain the internal audit activities being undertaken by the IAF in your listed issuers. Do you think that the scope of controls audit that are conducted by the IAF is adequate to meet your governance obligations? If not, what they to meet your expectation? [Probe: Financial review, operational control audit, compliance audit, IT audit, strategic risk assessment/ERM, etc]

What is the role of IAF in risk management in your listed issuers? In your view, what should be the extent of the IAF's involvement in risk management? Does your listed issuer maintain the *three-line of defence* to risk management and control? If yes, can you briefly explain? If not, why?



## Appendix

What is the role of IAF in governance activities in your listed issuers? In your view, what is your expectation of the IAF's involvement in governance activities? [Probe: ethics assessment, coordination of information flow among key corporate governance stakeholders etc.]

### Q14

What are the value-added services (e.g. consultancy) being undertaken by the IAF in your listed issuer? What is your expectation of the IAF's involvement in value added services to support you in meeting your governance obligations? [Probe: IT/ERM, risk management framework?]

Does your IAF provide 3E-based operational auditing services? Do you think the IAF should offer such service to listed issuers?

In order to add value, do you expect the IAF to assume dual role (i.e. assurance and consulting role)? If not, why? If yes, why?

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### *(IX) Evaluation: IAF's performance assessment*

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### Q15

Does your listed issuer adopt the IIA's Quality Assurance and Improvement Program (internal and external assessment)? If no, why? If yes, how is it conducted?

Do you rely on the external auditors' evaluation of the IAF's work in your assessment of IAF performance? Does your external auditor rely on the IAF work in the conduct of their audit work? Briefly explain.

What criteria do you adopt in the evaluation of the IAF's effectiveness or performance quality?

[Probe: Quantitative evaluation measure (e.g. KPI) or qualitative/subjective evaluation, effectiveness, efficiency or both]

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### Concluding questions

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### Q16

In your view, do you think that there are any other factors which are critical to address IAF effectiveness which have not been covered in this conceptual framework? [Note: The researcher will walk-through the conceptual IAF effectiveness framework to ensure all constructs are duly covered during the interview].

In your view, what are the critical factors that will encourage or inhibit IAF effectiveness in Malaysia?

**Code Book**

<b>Constructs</b>		<b>Description</b>
First component: External enabling factors		
<i>Rules and Legislation</i>		<i>The Malaysian code of corporate governance and Listing Requirements (collectively the “Rules”) which are related to the IAF and its nexus with the AC</i>
	Mandatory IAF establishment	The Rules require all listed issuers in Malaysia to establish an IAF
	Direct reporting to the AC	The Rules require all IAF to report directly to the AC
<i>The role of IIAM</i>		<i>This is mainly to gauge the professional influence of the IIAM on the internal audit industry in Malaysia</i>
	IIA’s professional guidance	To gauge the extent to which the IIA’s professional standards/framework are being adopted in practice (by the AC and the internal audit professionals in Malaysia)
	IIAM as a monitoring agent	To gauge the perspective of the AC participants whether the IIAM should be given the legislative backing to assume the independent quality monitoring role over the IAF service providers in Malaysia.
<i>Internal audit industry readiness: quantity and quality</i>		<i>To gauge the readiness of the internal audit industry to meet the market demand for internal audit professionals from two perspectives: quantity and quality</i>
	Human resource shortage	Difficult to recruit and retain internal audit staff in the industry due to: the nature of internal audit job (e.g. boring, lonesome, stressful); and the prestige attached to the profession (e.g. lack of career progression opportunities, less glamorous job)
	Quality of internal audit service providers	The internal audit industry is not regulated. There is no independent monitoring over work performance of internal audit service providers. This may result in mixed quality of the internal audit deliveries among the internal audit service providers.
2 <sup>nd</sup> component : Internal enabling factors		
<i>AC support</i>		<i>Only an effective AC can augment IAF effectiveness. AC supports include: an effective AC (based on specific AC attributes); and AC influence</i>
<i>AC attributes</i>		
	Assertive AC chair and members	This includes AC chair/members who are willing to speak up, prepared to challenge top management (if necessary) and not succumb to top management’s pressure.
	Diligent and commitment	This includes active participation during board deliberation, stay current with market development (e.g. capital market rulings, audit & accounting standards) and diligently spend time to understand the businesses of the listed issuers.
	Financial expertise	The Listing Requirements (2011) requires at least one member of the AC to be a financial literate (e.g. a member of the MICPA, MIA, CAANZ).
	Financial stability and reputation	AC chair/members must be financially well off and have high social status (e.g. ex or current audit partners or partners of legal practices). They do not become AC because of the director’s fee.
	Independence	This includes truly independence of the AC members.

Constructs		Description
	Industry experience and business acumen	Industry experience includes: audit experience or possess industry experience which is related to the listed issuers. Business acumen includes business knowledge and exposure.
	Judgemental skills	This includes good analytical skills and ability to make sound decision for the listed issuers.
	People management skills	This includes soft skills such as interpersonal skill, negotiation skills, etc.
	Team work & diversity	AC effectiveness is not only on ‘individual’ basis but also on ‘group’ basis. A team of AC with diversified professional background (e.g. lawyer, accountant, actuaries) and experience will enhance the AC’s overall effectiveness.
<i>AC influences</i>		
	AC’s open support and close rapport with the IAF	Open support includes open declaration in front of senior management (e.g. that the IAF is the “AC’s men”). Close rapport includes private meetings between AC and the CAE and engaging partner (of out-sourced IAF). Also, the internal audit service providers have direct access (e.g. phone) to the AC chair/member.
	AC’s control over IAF resources	This includes the AC has control over hiring/firing, remuneration, performance appraisal, career progression of the CAE (in-house IAF). Also, the AC has control over the engagement/termination, scope of internal audit work and audit fee of out-sourced IAF.
<i>Organisational supports</i>		
	CAE’s involvement at strategic business meeting	This includes CAE’s participation at senior management meetings and to provide advice on risk or controls-related matters relating to strategic business decisions (e.g. new business ventures).
	Integrity of top management	This refers to personality of top management: honesty, sincerity and genuine commitment to uphold good corporate governance
	Investment in IAF	This refers to top management’s commitment to invest in IAF (i.e. budget allocation)
	Organisational hierarchy/status of the IAF	This includes CAE or head of internal audit to be accorded with senior position (e.g. senior manager and above) within the organisation.
	Tone at the top – corporate culture	This includes top management’s support for corporate governance and IAF. They are prepared to ‘walk-the-talk’ and instilling good corporate culture, work ethics and maintaining corporate governance mechanism (e.g. whistle blower).
<i>In-house IAF</i>		
	Adequacy of IAF resources	This includes how the IAF budget is determined and adequacy of the IAF budget/spending to meet the governance obligations of the AC and IAF.
<i>Attributes of in-house IAF</i>		
• Core attributes		
	Independence and objectivity	This includes internal audit staff are objective in discharging their duty - without fear or favour.
	Proficiency and competency	This includes the relevant academic or professional qualifications, relevant industry experience and work experience.
• Special attributes of internal audit staffs		
	Audit mindset	This includes inquisitive mindset, ability to “see” issues, critical analytical skill, and passion to dig deep into matters.

Constructs		Description
	Communication skill	This includes oral presentation skill and report-writing skill (e.g. command of English as well as report-writing approach – ‘report by exception’).
	People management skill	This includes soft skill set such as interpersonal skills and ability to garner cooperation of auditees.
<ul style="list-style-type: none"> <li>Special attributes of the CAE</li> </ul>		
	‘Seniority’	This includes a combination of high organisation hierarchical status, respectable qualifications, industry experience and age. In brief, the CAE must be able to command respect from other senior staff members (e.g. other department heads, CFO, CEO) within the organisation.
	People management skills	This refers to a higher level of soft skill set compared to junior internal audit staffs. This includes interpersonal skill, negotiation skill and ability to gain the confidence of peers and board of directors to enable the CAE to lead the change.
	Leadership	This refers to the ability to lead and gain support of their subordinates.
	Industry-related experience	This refers to the CAE must have industry experience in company which operates in similar or related industry as the listed issuer.
	Business acumen	This refers to the ability to look beyond risk and control (i.e. not too risk-averse) and able to weigh in from a business perspective.
	Assertiveness and professionalism	This includes the willingness to speak up and act professionally against other more senior staff members (e.g. CEO, CFO) within the organisation.
<i>Out-sourced IAF</i>		
<i>Rationale to out-source IAF</i>		
	Bring in fresh perspectives	Out-sourced IAF are expected to bring in fresh perspectives.
	Human resource management issues	This refers to listed issuers out-source their IAF as they do not want to be tied down with recruiting or retaining and training of internal audit staffs.
	Independence and professionalism	Independence and objectivity of out-sourced IAF and ability to act professionally.
	Limited fee budget	Listed issuers are better able to control their fee budget if out-source their IAF.
	Possession of specialised skills	This specialised skills include IT, ERM, risk management etc.
<i>Criteria of out-sourced IAF</i>		
	Audit fee	This includes indication of comparison of fee quote from several IA firms
	Adequate resources	This includes adequate staffing with relevant qualifications, audit experience and technical skill sets to undertake the audit assignments.
	Related industry experience	The engaging partner or the senior-in-charge of the job must have related audit experience as the listed issuers.
	Quality of audit report	This includes the audit methodologies, scope of audit work, depth of the audit findings, report by exception, writing skills etc.

Constructs		Description
	Timely delivery of audit report	This refers to turnaround time of the internal audit report.
Third component : internal audit practices		
<i>Planning: internal audit planning</i>		
	Internal audit Charter	This refers to the formal written document that stipulates the role and responsibilities of the IAF and the internal audit activity. This is to gauge whether the AC participants view this document will enhance effectiveness of IAF. Also, whether their listed issuers maintain an internal audit charter.
	Internal audit planning-risk-based approach	This includes adoption of a risk-based approach audit, development of internal audit plan and risk assessment in conjunction with the development of the audit plan, etc.
<i>Implementation: nature of IA activities</i>		
	Control	This includes discussion of internal audit activities being undertaken by the IAF (e.g. operational control or compliance audit, financial reviews) and the AC participants' view of each of the internal audit activities.
	Risk management	This includes discussion on the role and responsibilities of IAF in risk management, the adoption of three-line of defence in listed issuers, the reporting structure of IAF to the risk management committee and the AC, etc.
	Governance	This includes coordination of risk management process within the organisation by the IAF, educating role (e.g. three-line of defence, code of ethics), ethics assessment, fraud investigation, related-party transaction investigation, etc.
	Dual role	This refers to whether the AC believes the IAF could assume dual role (i.e. assurance and consultancy) as part of the value-add services to the organisations.
	Value-add service: Operational audit or performance audit	This refers to whether the AC believe that to be effective the IAF should perform value add services such as 3E-based operational audit, consultancy role.
<i>Evaluation: performance evaluation</i>		
	Adoption of the QAIP	This refers to the AC's perception on whether the adoption of the QAIP will enhance IAF effectiveness.
	Evaluation of IAF performance based on subjective measurements	The subjective measurements include timely delivery of IA report, quality of audit report, quality of audit report (e.g. depth of audit scope and recommendation of audit findings) and etc.
	Evaluation of IAF performance based on objective measurements	This objective measurements include KPI and other quantifiable measurements.
	Reliance on external auditors to evaluate IA work	This refers to whether the AC rely on external auditor's formal assessment of the quality of internal audit work or the external auditors' reliance on IAF work (a proxy of IAF quality)

## Appendix 5

**NODE SUMMARY REPORT**

Node names		Sources	References
<b><i>First component: external enabling factors</i></b>		-	-
	Rules & legislation	-	-
	Mandatory IAF establishment	14	47
	Direct reporting to the AC	14	83
IIAM's role		-	-
	IIA professional guidance in practice	9	38
	IIAM's as monitoring agent	11	49
	IA industry readiness: supply and quality	9	69
<b><i>Second component: internal enabling factors</i></b>		-	-
AC attributes		-	-
	Assertive AC chairmen and AC members	6	22
	Diligent and commitment	14	67
	Financial expertise	10	50
	Financial stability and reputation	2	2
	Independence	14	69
	Industry experience & business acumen	8	27
	Judgemental skill	3	5
	People management skill	1	2
	Team work & diversity	5	16
AC influences		-	-
	AC's open support and close rapport with the IAF	12	40
	AC's control over IAF resources	9	21
Organisational supports		-	-
	CAE's involvement at strategic meeting	3	4
	Integrity of top management	5	13
	Investment in IAF	11	46
	Organisation hierarchy/status of the IAF	9	35
	Tone at the top - corporate culture	14	63
	Adequacy of IAF resources	13	49
Attributes of in-house IAF		-	-
	Core attributes - Independence & objectivity	12	53
	Core attributes - Proficiency & competency	10	55
	Specific attributes of IA staffs – Audit mindset	4	7
	Specific attributes of IA staffs – Communication skill	5	25
	Specific attributes of IA staffs - People management skill	3	20
	Specific attributes of CAE – 'Seniority'	7	20

Appendices

Node names		Sources	References
	Specific attributes of CAE – people management skills	6	30
	Specific attributes of CAE – leadership	3	4
	Specific attributes of CAE – Competency (e.g. Industry-related experience)	6	11
	Specific attributes of CAE - assertiveness and professionalism	8	20
<b>Rationale to out-source the IAF</b>		-	-
	Limited fee budget	6	11
	Human resource management issues	8	11
	Independence & professionalism	8	11
	Fresh perspectives	4	7
	Possession of specialised skills (e.g. IT)	4	9
<b>Selection criteria for out-sourced IAF</b>		-	-
	Audit fee	6	9
	Adequate resources (e.g. staffing, relevant qualification)	8	19
	Related industry experience	5	15
	Quality of audit report	6	12
	Timely delivery of audit report	3	5
<b>Third component: internal audit practices</b>		-	-
<i>Planning : internal audit planning</i>		-	-
	IA charter – negative response	12	37
	Internal audit planning –risk-based approach	14	58
<i>Implementation: nature of internal audit activities (theoretical role)</i>		-	-
	Controls	14	95
	Risk management – adopted three line of defence	3	21
	Risk management – adopted two line of defence	11	78
	Governance – educating role	4	8
	Governance – coordinate risk management process	7	7
	Dual role – negative response	9	36
	Value add services – 3E operational audit	5	8
<i>Evaluation: performance evaluation</i>		-	-
	Adoption of the QAIP – negative response	14	14
	Evaluate IAF performance based on subjective measurements	13	60
	Evaluate IAF performance based on objective measurements	2	3
	Reliance on EA to evaluate IAF work – negative response	9	51

\*AC#6 represented his listed issuers – in-house and outsourced used KPI and subjective measurements

## Appendix 6

### **Risk Management Committee versus Audit and Risk**

#### **Management Committee**

Since December 2000, the board of directors was required to report the effectiveness of listed issuers' internal control system in a statement, known as the *Statement of Internal Control*<sup>159</sup> in annual reports of listed issuers. Interestingly, senior management who managed listed issuers on daily basis was not a party to provide such assurance to the investing public.

With effect from 31 December 2012, board of directors are required to report on organisation's risk management policies in addition to internal control. However, under the new requirements - *Statement of Risk Management and Internal Control – Guidelines for Directors of Listed Issuers* ("RMIC Guidelines")<sup>160</sup>, CEOs and CFOs are now required to give assurance to the board (a back-to-back assurance) on whether the companies' risk management and internal control system are operating adequately and effectively. This is a significant milestone that marked the change in regulators' stance pursuant to who should be responsible for the risk management and internal control systems of listed issuers.

In addressing the requirements of the RMIC Guidelines, two composition of board structure are commonly adopted by listed issuers. The first board structure which is more widely adopted by listed issuers in Malaysia is when a risk management committee ("RMC"), a sub-committee of the board, is established to oversee risk management function. Under this structure, the IAF reports directly to the AC on matters pertaining to internal controls whereby the executive risk management committee ("ERMC") (comprising predominantly the heads of operation unit

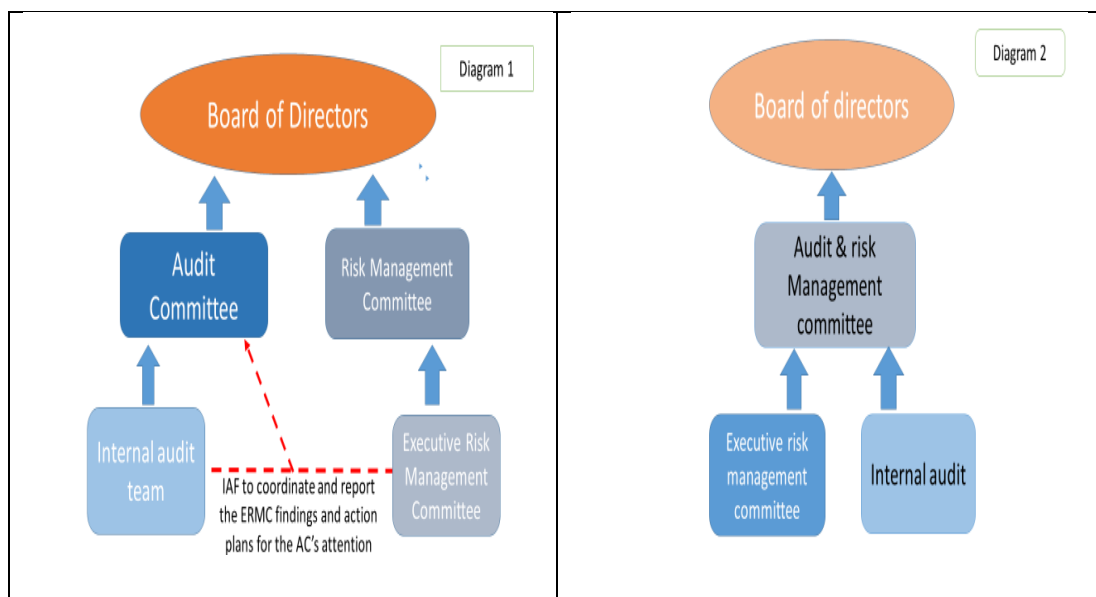
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<sup>159</sup> The requirement was stipulated in Paragraph 15.26(b) of Listing Requirements (2007). Listed issuers could seek guidance from the Bursa Malaysia's pronouncement - *Statement of Internal Control – Guidance for Directors of Public Listed Companies* (released in December 2000)

<sup>160</sup> Statement of Risk Management and Internal Control – Guidance for Directors of Public Listed Companies was issued on 31/12/2012 and came into immediate effect. It was prepared by a special task comprised predominantly the IIA(M), other professional accounting bodies (e.g. the MIA, the MICPA) and representative of both Bursa Malaysia and the Securities Commission Malaysia.



/departments, e.g. marketing, production, purchasing) reports directly to the RMC on risk management matters. Under this structure, the IAF’s role is confined to a coordinator, a go-between party between the ERMC and AC. Although the IAF is a member of the ERMC, they are not expected to assume an active role during the ERMC meeting. Its responsibility is merely to coordinate the ERMC meeting, record the discussions which entails the ERMC’s deliberation on potential risk areas, risk profiling, action plans, etc. and present them to the AC for their attention and consideration while discharging their governance duty. This board composition is best illustrated in Diagram 1 below.



The second board structure is, instead of setting up a separate sub-committee, the board of directors redefine the role of AC to include risk management function and rename the sub-committee as the Audit & Risk Management Committee (“ARMC”). Under this ‘combined role’ set-up, both IAF and ERMC will report directly to the ARMC. This structure is not so widely adopted compared to the earlier structure. This is best illustrated in the Diagram 2 above.