

**INTERNAL AUDITING PRACTICES AND PERFORMANCE OF
INTERNAL AUDIT DEPARTMENT**

FAUDZIAH HANIM BT HJ. FADZIL

UNIVERSITI SAINS MALAYSIA

2003

**Research report in partial fulfillment of the requirements for the degree of
Doctor of Business Administration**

**INTERNAL AUDITING PRACTICES AND PERFORMANCE OF INTERNAL
AUDIT DEPARTMENT**

FAUDZIAH HANIM BT HJ. FADZIL

UNIVERSITI SAINS MALAYSIA

2003

ACKNOWLEDGEMENT

In the name of Allah, Most Beneficent and Most Merciful. Praise and thanks to Allah, first and last, Lord and Cherisher of the all the words who taught humankind everything they knew not. May His blessings and His mercy is upon the Holy Prophet Muhammad S.A.W., the best of mankind.

I am very grateful to my main supervisor, Associate Professor Dr. Hasnah Haron and co-supervisor, Professor Dr. Muhamad Jantan for their guidance, patience, understanding, insight, knowledge, attention, kindness and encouragement throughout my Doctor of Business Administration program in Universiti Sains Malaysia. Words alone cannot express my greatest appreciation and gratitude to them. InsyaAllah, Allah will reward both of them abundantly.

My sincere appreciation and thanks also goes to members of staff of the School of Management, Universiti Sains Malaysia especially Professor Dato' Dr. Daing Nasir Ibrahim, Associate Professor Dr. Zainal Abidin Ahmad, Dr. Yuserrie Zainuddin, Professor Dr. Mahfooz, Associate Professor Dr. Ishak Ismail, Associate Professor Dr. Fauziah Md Taib, Dr. Nabihah and Mr. T. Ramayah.

My thanks of appreciation also go to all the students of the Doctor of Business Administration program and my colleagues who always give me support and encouragement during my study. I also wish to express my appreciation to the respondents who participated in this study. Without their assistance and data provided, this study obviously could not been performed.

My deepest gratitude also goes to Universiti Utara Malaysia for the financial scholarship and the Dean of Faculty of Accountancy, Universiti Utara Malaysia for his consent to pursue my study.

Last but not least, my very deepest gratitude and appreciation to my husband, Syed Soffian Syed Ismail, who is very patient and supported me all the way, my daughters Sharifah Saffinas and Sharifah Sakinah and my mother, Hajjah Rohani Darus. Their love, understanding and encouragement were certainly very important input in completing this study.

TABLE OF CONTENTS

	Page
ACKNOWLEDGMENT	i
TABLE OF CONTENTS	iii
LIST OF TABLES	vi
LIST OF FIGURES	vii
LIST OF ABBREVIATIONS	Viii
LIST OF APPENDICES	ix
ABSTRAK (MALAY)	x
ABSTRACT	xii
 Chapter 1 INTRODUCTION	
1.0 Introduction	1
1.1 Background of The Study	1
1.2 Problem Statement	6
1.3 Research Questions	7
1.4 Research Objectives	8
1.5 Research Significance	9
1.6 Definitions of Terms	10
1.7 Organisation of the Study	13
 Chapter 2 LITERATURE REVIEW	
2.0 Introduction	15
2.1 Overview of Internal Auditing	15
2.2 The History and Evolution of Internal Auditing	18
2.3 The Roles Of Internal Auditors	20
2.4 The Roles Of Audit Committee	25
2.5 Development of Standards for The Professional Practice of Internal Auditing	28
2.6 Agency Theory and the Internal Audit	29
2.7 Previous Literatures on Internal Auditing Practices	31
2.7.1 Internal – External Auditor Relationships	31
2.7.2 Perception of the Importance of the Internal Audit Department	32
2.7.3 The Extent of Compliance of SPPIA	35
2.7.4 Measure of Effectiveness of Internal Audit Department	35
2.8 Elements of SPPIA	40
2.8.1 Independence and Objectivity	40
2.8.2 Professional Proficiency	45
2.8.3 Scope of Work	47
2.8.4 Performance of Audit Work	49
2.8.5 Management of the Internal Auditing Department	49
2.9 Internal Control System	50
2.9.1 Risk Assessment	52
2.9.2 Control Environment	53
2.9.3 Control Activities	54
2.9.4 Information and Communication	54
2.9.5 Monitoring	56
2.10 Performance of Internal Audit Department	56
2.10.1 External Audit Fees	57

2.11 Chapter Summary	58
Chapter 3 RESEARCH FRAMEWORK AND METHODOLOGY	
3.0 Introduction	60
3.1 Research Framework	60
3.2 Hypotheses	61
3.2.1 Internal Auditing Practices	62
3.2.2 Internal Control System and Performance of Internal Audit Department	69 71
3.2.3 Internal Auditing Practices and Performance of Internal Audit Department	
3.3 Methodology	72
3.3.1 Research Design	72
3.3.2 Sample and Data Collection	72
3.3.3 Research Instrument	74
3.3.4 Operational Definition and Measurement of the variables	76
3.3.5 Method of Data Analysis	80
3.3.5.1 Descriptive Analysis	80
3.3.5.2 Inferential Analyses	80
3.4 Chapter Summary	84
Chapter 4 ANALYSIS AND FINDINGS	
4.0 Introduction	86
4.1 Responses	86
4.2 Goodness of Data	91
4.2.1 Factor Analysis	91
4.2.1.1 Internal Auditing Practices	91
4.2.1.2 Quality of the Internal Control System	97
4.3 Test of Reliability of the Instrument	101
4.3.1 Internal Auditing Practices	101
4.3.2 Quality of the Internal Control System	102
4.4 Descriptive Statistics	103
4.4.1 The Extent of Internal Auditing Practices	103
4.4.2 The Extent of Existence of the Quality of the Internal Control System	107 111
4.5 Diagnostic Test	111
4.5.1 Internal Auditing Practices	113
4.5.2 Quality of the Internal Control System	114
4.6 Hypotheses Testing	115
4.6.1 Hypothesis 1	127
4.6.2 Hypothesis 2	129
4.6.3 Hypothesis 3	
4.6.3.1 Quality of the Internal Control System on Performance of Internal Audit Department	129 130
4.6.3.2 Internal Control Systems on Performance of Internal Audit Department	130 132
4.6.3.3 Internal Auditing Practices, Quality of the Internal Control System and Performance of the Internal Audit Department	
	135

4.7 Chapter Summary	135
	137
Chapter 5 DISCUSSIONS AND CONCLUSIONS	138
5.1 Introduction	141
5.2 Recapitulation of Major Findings	
5.3 Discussion	145
5.3.1 The Extent of Internal Auditing Practices	145
5.3.2 Internal Auditing Practices and the Quality of the Internal Control System	146
5.3.3 The Quality of the Internal Control Systems and Performance of Internal Audit Department (External Audit Fees)	147
5.3.4 Internal Auditing Practices and Performance of Internal Audit Department	151
5.3.5 Mediating Effects	153
5.4 Implications of the Study	156
5.4.1 Theoretical Implications	163
5.4.2 Practical Implications	173
5.5 Limitations of the Study	
5.6 Suggestions for Future Research	
5.7 Concluding Remarks	
5.8 Chapter Summary	
 Bibliography	
Appendix A Questionnaire to Internal Auditors	
Appendix B Questionnaire to Audit Committees	
Appendix C Factor Analysis	
Appendix D Reliability	
Appendix E Regression Analysis	
Appendix F Graphs	

LIST OF TABLES

Table No.	Title of Table	Page
2.1	Summary of Research Concerning The Internal Audit Practices.	38
4.1a	Summary of Response Rates	87
4.1b	Summary of Demographic Data on Respondents – Internal Audit Department	88
4.1c	Summary of Demographic Data on Respondents – Audit Committees	90
4.2a	Principal-Components Analysis for Internal Auditing Practice	92
4.2b	Factor Loading of Internal Auditing Practice	92
4.2c	Principal-Components Analysis for the Quality of Internal Control System Initial Statistics	98
4.2d	Factor Loadings for the Quality of Internal Control System	98
4.3a	Test of Reliability of Data Internal Auditing Practices	102
4.3b	Test of Reliability of Data Internal Control System	102
4.4a	Means Scores of the Extent of the Internal Auditing Practices (Internal Auditor's Perspectives)	103
4.4b	Means Scores of the 35 Most Compliance Internal Auditing Practices (Internal Auditor's Perspective)	104
4.4c	Means Scores of the Extent of Existence of the Internal Control Systems	108
4.4d	Means Scores of the Internal Control System Items	108
4.5a	Test for Goodness of the Model	112
4.5b	Regression Coefficient and Test for Multicollinearity Coefficients ^a	113
4.5c	Test for Goodness of the Model	114
4.5d	Regression Coefficient and Test for Multicollinearity Coefficient ^a	114
4.6a	Results of Hypothesis 1 _a	117
4.6b	Results of Hypothesis 1 _b	119
4.6c	Results of Hypothesis 1 _c	122
4.6d	Results of Hypothesis 1 _d	124
4.6e	Results of Hypothesis 1 _e	127
4.6f	Results of Hypothesis 2	128
4.6h	Results of Internal Auditing Practices, Quality of the Internal Control Systems on Performance of the Internal Audit Department	131

LIST OF FIGURES

Figure No.	Title of Figure	Page
2.1	Internal Auditor's Role	25
3.1	Theoretical Framework	61

LIST OF ABBREVIATIONS

Abb.	Full Lists
AICPA	American Institute of Certified Public Accountants
CAE	Chief Audit Executives
CIA	Certified Internal Auditor
COSO	Committee of Sponsoring Organisations
IIA	Institute of Internal Auditors
KLSE	Kuala Lumpur Stock Exchange
MACPA	Malaysian Association of Certified Public Accountant (Malaysian
(MICPA)	Institute of Certified Public Accountants
MIA	Malaysian Institute of Accountants
PLCs	Public listed companies
SPPIA	The Standards for the Professional Practice of Internal Auditors
TRI	Technology Resource Industries Berhad

LIST OF APPENDICES

Appendix No.	Title of Appendix
A	Questionnaire to Internal Auditor
B	Questionnaire to Audit Committee
C	Factor Analysis Results
D	Reliability Analysis
E	Regression Analysis Results
F	Graphs

ABSTRAK

Kejayaan jabatan audit dalaman mestilah berfungsi mengikut amalan Standard untuk Praktis Professional Audit Dalaman (SPPIA, 2000) dan kualiti sistem kawalan dalaman. Mengikut senario perniagaan masa kini, kajian ini melihat kepada praktis audit dalaman dan kejayaan jabatan audit dalaman. Dengan menggunakan data daripada 250 pengamal audit dari syarikat yang tersenarai di Bursa Saham Kuala Lumpur, kajian ini mencadangkan bahawa kebebasan, skop kerja audit, laporan audit, program audit, pengurusan jabatan audit dalaman, persembahan kerja audit, pemeriksaan audit, objektiviti dan kecekapan profesional adalah penting dalam amalan audit dalaman mengikut persepsi juruaudit dalaman. Kajian ini juga mencadangkan bahawa penilaian risiko, kawalan aktiviti, kawalan persekitaran, maklumat dan komunikasi serta pengawasan merupakan kualiti yang penting dalam sistem kawalan dalaman dari pandangan jawatankuasa audit. Kajian ini juga menyelidik pengaruh amalan audit dalaman ke atas kualiti sistem kawalan dalaman. Pengurusan jabatan audit dalaman, kecekapan profesional, objektiviti dan pemeriksaan audit dalam amalan audit dalaman dan ia menunjukkan pengaruh yang signifikan ke atas pengawasan dari aspek kualiti sistem kawalan dalaman. Skop kerja audit dan persembahan kerja audit mempengaruhi maklumat dan komunikasi dari aspek kualiti sistem kawalan dalaman manakala persembahan kerja audit, kecekapan profesional dan objektiviti pula mempengaruhi kawalan persekitaran dari aspek kualiti sistem kawalan dalaman. Kajian ini juga menunjukkan pengurusan jabatan audit dalaman, persembahan kerja audit, program audit dan laporan audit mempengaruhi penilaian risiko dari aspek kualiti sistem kawalan dalaman sementara persembahan kerja audit dan laporan audit secara signifikan mempengaruhi kawalan aktiviti dari aspek kualiti sistem kawalan dalaman. Maklumat dan komunikasi serta penilaian risiko mempengaruhi persembahan jabatan audit

dalaman. Kajian ini juga menunjukkan skop kerja audit, kecekapan profesional, kebebasan dan laporan audit dalam amalan audit dalaman mempengaruhi secara signifikan persembahan jabatan audit dalaman. Akhir sekali, kajian ini menunjukkan bahawa penilaian risiko dan aspek kualiti sistem kawalan dalaman merupakan perantara di antara laporan audit dalaman dalam amalan audit dalaman.

0

ABSTRACT

The performance of an internal audit department must function in a manner that is in accordance with applicable professional standards such as Standards for the Professional Practice of Internal Auditing (SPPIA, 2000) and the quality of the internal control systems. Given the current business scenario, this study looks at the internal auditing practices and performance of internal audit departments. Using data from 250 auditing practitioners in KLSE-listed companies, this study suggests that independence, scope of audit work, audit reporting, audit programs, management of internal audit department, performance of audit work, audit reviews, objectivity and professional proficiency are important internal auditing practices from the perception of internal auditors. This study also suggests that risk assessment, control activities, control environment, information and communication and monitoring are important quality of internal control system from the perception of audit committee. This study also examines the influence of internal auditing practices on the quality of internal control system. Management of internal audit department, professional proficiency, objectivity and audit review significantly influence the monitoring of the quality of the internal control system. Scope of work and performance of audit work significantly influences the information and communication of the quality of the internal control system while performance of audit work, professional proficiency and objectivity significantly influence the control environment of the quality of the internal control systems. The study also shows that the management of internal audit department, performance of audit work, audit program and audit reporting significantly influences the risk assessment of the quality of the internal control system. On the other hand, performance of audit work and audit reporting significantly influences the control activities of the quality of the internal control system. Information and communication and risk assessment of the quality of the internal control systems do

significantly influence the performance of the internal audit department. This study further shows that scope of audit work, professional proficiency, independence and audit reporting of the internal auditing practices significantly influence the performance of the internal audit department. Finally, the study shows that risk assessment of the quality of the internal control system partially mediates the audit reporting of the internal auditing practices and the performance of the internal audit department.

Chapter 1

INTRODUCTION

1.0 Introduction

This chapter introduces the research agenda of this study. This chapter outlines the background of the study, statement of the problem, research questions, research objectives, research significance, definitions of terms and organisation of the remaining chapters.

1.1 Background of The Study

Auditing has a significant role in the management of most organizations. It has become increasingly varied, both in scope and objective to assist all levels of management in assuring internal and external constituencies that financial resources are being properly managed and accounted for.

Internal auditing has undergone dramatic changes that have expanded its scope in a way that allows it to make greater contributions to the organization it serves. Internal auditing is also performed in diverse legal and cultural environments; within organizations that vary in purpose, size, and structure; and also by persons within or outside the organization. Furthermore, the internal auditing profession also walks a tightrope between serving as a management consultant and an independent professional. A survey done by the Malaysian Institute of Corporate Governance (MICG), The Institute of

Internal Auditors Malaysia (IIAM) and Ernst & Young concluded that internal auditors are best placed to understand and appreciate the business processes of a company and they act as management consultant to reduce risks. Internal auditors also help run a company more efficiently and effectively to increase shareholders' value. To accomplish this, internal auditing must function in a manner that is in accordance with applicable professional standards such as the Standards for the Professional Practice of Internal Auditing (SPPIA). By complying with the SPPIA, the responsibilities of internal auditors can be met. This is because SPPIA requires that the chief audit executive (CAE) to report to a level within the organisation that allows the internal audit activity to fulfil its responsibilities. The purpose of the SPPIA is to delineate basic principles that represent the practice of internal auditing, as it should be, provide a framework for performing and promoting a broad range of value added internal audit activities, establish the basis for the measurement of internal audit performance and foster improved organisational processes and operations (IIA, 2000). By having these responsibilities, the internal auditing department can assist management to identify and solve problems at the initial stage and not wait until it is too late to be solved.

As this is the case, internal auditors need to be out in front, leading the business units with regards to the internal control system and also focusing on strategic business objectives. The internal auditors also need to establish themselves as vital cogs in their organizations, rather than as observers who watch from the periphery and wait for events to impact them (Sawyers, 1996).

Over the past several years, internal auditing practices have become a subject of interest in the internal auditing literature. One issue that has emerged related to the internal auditing practices is; “what is proper and sound measurement of the internal auditing practices?” Before proper and sound measurement of the internal auditing practices can be done, we have to have a clear understanding of the roles expected of internal auditing and its impact on the internal auditing practices or on the internal audit effectiveness (Barrett, 1986). However, Barrett notes, “effectiveness can be described, but it is difficult to quantify and in the final analysis, effectiveness is determined by the perception of auditees.” In the company environment, the management is the most important auditee of the internal audit department since effectiveness of the internal auditing practices can be described through the expectations of the management with regard to the internal auditing practices. The management will expect the internal auditors to perform their internal auditing practices to a certain level that is complying with the SPPIA since it can be easily described. Included in the SPPIA (2000) are five elements that are independence and objectivity, professional proficiency, scope of work, performance of audit work and management of internal audit department. Therefore, the CAE and internal auditors need to meet or exceed these expectations to be effective. With the ever-changing business environment, the effectiveness and credibility of the internal audit function is crucial.

It is also the internal auditor’s task to operate within the framework of professionalism to assist the company in achieving the highest-quality results and long-term objectives.

Because the scope of work performed by today's practitioners is so broad, there is an expanded need for clear and concise guidance that can be readily adopted and followed, regardless of the industry, audit speciality or sector. However, over the years, there have been dramatic changes in the internal audit environment and these will affect the internal auditing practices. Today's businesses rely on sophisticated electronic technology in every aspect of their operations and require timely information to make decisions regarding global operations. Therefore, the internal audit department must operate to achieve the highest results. To accomplish this, the internal auditing practices must function in a manner that is in accordance with the applicable professional standards and organisational's goals.

The internal control system plays an important role in the internal auditing practices since the internal auditors might be considered as being specialists in management control (Chambers, Selim & Vinten, 1987). Internal auditing practices appraise the effectiveness of internal control systems, which is a definition of internal auditing and which also includes an appraisal of the actions by management to correct situations, which are at variance with planned outcomes. The definition of internal control systems reveals that it is not fundamentally different from management control, which has an essential component of control such as planning, organising, staffing and directing (Chambers et al., 1987). Senior management and the audit committee normally expect that the CAE will perform sufficient audit work and gather other available information during the year so as to form a judgement about the adequacy and effectiveness of the control processes.

The CAE should then communicate that overall judgement about the organisation's system of controls to the senior management and the audit committee. This is necessary since internal auditors play an intermediary role and assist in the discharge of the oversight function of audit committee. If the above internal audit function is not available, the management needs to apply other monitoring processes in order to assure itself and the board that the system of internal control system is functioning as intended. In these circumstances, the board of the company will need to assess whether such processes provide sufficient and objective assurance or regular review and appraisal of the adequacy and the integrity of the internal control systems in the company.

KLSE has established industry taskforce which formulated the "Statement on Internal Control: Guidance For Directors of Public Listed Companies" to fulfil the above circumstances. The aim of this guidance is to assist listed companies in making disclosures in their annual reports on the state of internal control, in compliance with the Listing Requirements of the KLSE. Pursuant to the requirements of the Code in relation to the Internal Audit Function, in May 2001, the Securities Commission appointed the Institute of Internal Auditors Malaysia to establish a separate industry taskforce to formulate these Guidelines to assist the board of public listed companies in effectively discharging their responsibilities in relation to establishing an Internal Audit Function. Risk assessment, control environment, control activities, information and communication and monitoring are five important characteristics in this guideline.

Performance of the internal audit department is measured through lower external audit fees. Reckers et al. (1997) and Felix et al. (2001) in their studies found that internal control system has a significant impact on reducing the external audit fees. This is because internal auditors can provide information about the internal control system of the firm and the level of compliance with it, about specific firm accounting practices, industry conditions, firm management, and performance problems that could result in pressure to manipulate results. However, current management literature makes virtually no reference to internal auditing practices as a potentially powerful tool for meeting the management objectives of lowering external audit fees. Therefore this study intends to find out whether the internal auditing practices have a significant impact on the external audit fees.

1.2 Problem Statement

Previous studies have not examined the relationship between the internal auditing practices, internal control systems and performance of the internal audit department. To our knowledge, none of the studies have examined internal auditing practices, quality of the internal control system and performance of the internal audit department. Studies have only focussed on the elements of the internal auditing practices. To date there has been no study to examine the relationship of adherence of SPPIA to the performance of internal audit department. The auditing profession, both internal and external has come under increasing scrutiny since the highly publicised collapse of energy trader, Enron in the USA last year. The uncovering of alleged irregularities at Technology Resources

Industries Berhad (TRI) has highlighted the need for greater corporate governance in Malaysia. The importance of internal audit function and internal controls are only recognised and emphasized after irregularities are discovered. Adherence to established auditing standards and increasing corporate governance awareness, having effective internal audit functions would lead to an improved internal control system and better performance of internal audit department. Adherence to this, the greater the extent of internal auditing practices, the better will the internal control system be, leading to better performance of the internal audit department. Accordingly, the following research questions are posed.

1.3 Research Questions

On the basis of the research background, this study will be guided by three major research questions:

1. What is the extent of the internal audit practices in Malaysian listed companies?
2. How do internal audit practices adherence to SPPIA (2000) affect the internal control system?
3. How is the impact of the quality of the internal control systems on the performance of internal audit department?

1.4 Research Objectives

The profession of internal auditing walks a fine line between the roles of a business partner with client management and an independent reviewer of company operations. These dual roles may explain the fact that internal auditors are often described as both a business partner and a policeman. As a business partner, the internal auditor is thought to provide expertise to assist an organization in meeting its objectives while as a policeman, an internal auditor is often thought of as an adversary looking for flaws. As such the extent of the internal auditing practices play an important factor on these roles by providing empirical evidence to the profession.

This study will examine the relationship between the internal auditing practices and the performance of the internal audit department. That is, the greater the extent of internal auditing practices, the better will be the internal control system, leading to a better performance of the internal audit department.

In summary, the objectives of the study are as follows:

1. To identify internal audit compliance to SPPIA of Internal Audit Department of Malaysian Public Listed Companies.
2. To determine whether internal audit practices will affect the internal control system of the company.
3. To examine the relationship between internal control system and the performance

of the internal audit department.

1.5 Research Significance

The significance of the study can be seen from both theoretical and practical perspectives. From a theoretical perspective, this study supported how agency theory provides the internal auditing discipline based on the monitoring expenditure incurred by the principal and the agent.

This study provides empirical evidence as to the extent of the internal auditing practices adherence to SPPIA (2000) amongst Kuala Lumpur Stock Exchange listed companies.

It also provides evidence to the linkage between internal auditing practices, internal control system and performance of internal audit department. This is because internal auditors will be presented with important attributes of internal auditing practices stated in the SPPIA (2000) towards making quality internal control systems leading to a better performance of the internal audit department.

To the practitioners, the study informs them of which SPPIAs (2000) are not being adhered to. The study also establishes the extent of SPPIAs (2000) that contribute to the quality of internal control systems. The results will prove useful to internal auditing professionals and professional organizations entrusted with the responsibility for formulating new standards for internal auditors in an effort to help them improve the

focus and deliver their services to auditees and customers.

1.6 Definitions of Terms

For the purposes of this research study, the following terms will be utilized:

- 1. Internal Auditing:** “Internal auditing is an independent, objective assurance and consulting activity designed to add value and improve an organisation’s operations. It helps an organization accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control, and governance processes” (IIA, 1999)
- 2. Internal Auditing Practices:** Internal auditing practices refer to the compliance to Standards for the Professional Practice of Internal Auditing (SPPIA)(2000), which is undertaken to represent the practice of internal auditing.
- 3. Independence and objectivity:** Independence refers to whether internal auditors are free from interference in determining the scope of internal auditing while objectivity is an unbiased attitude and the avoidance of conflicts of interest.
- 4. Professional Proficiency:** Professional proficiency refers to knowledge, skills, and other competencies of the internal auditors to perform their

individual responsibilities.

5. **Scope of work:** The scope of work refers to relevant systems, records, personnel, and physical properties, including those under the control of third parties.
6. **Performance of Audit Work:** Performance of audit work refers to identifying, analysing, evaluating and recording sufficient information to achieve the engagement's objectives.
7. **Managing the Internal Audit Department:** This refers to the responsibility of the CAE for properly managing the internal audit activity to ensure it adds value to the organisation.
8. **Internal Control Systems:** Internal control system is assessing the adequacy of the organisation's risk management, control processes and monitoring to "provide reasonable assurance that the organisation's objectives and goals will be met efficiently and economically."
9. **Risk Assessment:** This refers to the uncertainty of an event occurring that could have an impact on the achievement of the company's objectives.

10. Control Environment: Control environment refers to any action taken by the company to enhance risk management so as objectives and goals will be achieved.

11. Information and Communication: Information is defined as the comprehensive internal financial data, operational and compliance data and external data that are related to decision-making. Communication refers to effective channels of communication to ensure that all staff fully understand and adhere to policies and procedures affecting their duties and responsibilities and other relevant information.

12. Monitoring: Monitoring refers to establishing a follow-up process and disposition of results by the CAE to ensure that management actions have been effectively implemented, or that senior management has accepted the risk of not taking action.

13. Performance of Internal Audit Department: Performance of internal audit department refers to measurement of internal auditors capabilities towards the goals of the company and attainment of those goals. The measurement used in the study is external audit fees.

14. External Audit Fees: This refers to a certain amount of money paid to the external auditors for the auditing work performed during the period.

1.7 Organisation of the Study

This study is organized into five chapters. Chapter 1 provides the background of the study, problem statement, research questions, research objectives, research significance, definitions of terms and organisation of the remaining chapters.

Chapter 2 contains literature review and previous research that are related to this study. The review presented in this chapter includes the overview of internal auditing, the history and evolution of internal auditing, the roles of internal auditors, development of SPPIA, agency theory and the internal audit, previous literatures on internal auditing practices, elements of SPPIA, internal control system and performance of internal audit department.

Chapter 3 describes the research framework and methodology employed in the study. Hypothesis, research design, sample and data collection, research instrument, operational definition and measurement of the variables, method of data analysis are also discussed in this chapter.

Chapter 4 presents an analysis and interpretation of the results of the study. This chapter will discuss unsolicited as well as requested responses to the survey form and an

interpretation of the statistical findings.

Finally, Chapter 5 summarises and discusses the major findings, implications and limitations of the study including a statement as to the conclusions reached. In addition, recommendations for further research are also included in this chapter.

Chapter 2

LITERATURE REVIEW

2.0 Introduction

This chapter presents an overview of the literature that relates to the topic under investigation namely Internal Auditing Practices and Performance of Internal Audit Department. This chapter consists of overview of internal auditing, the history and evolution of internal auditing, the roles of internal auditors, the roles of audit committee, development of the Standards for the Professional Practice of Internal Auditing (SPPIA), agency theory and the internal audit, literature sources which review internal auditing practices, elements of SPPIA (2000), internal control system and performance of internal audit department.

2.1 Overview of Internal Auditing

Over the years, internal auditing has had different emphasis and roles. Previously, the emphasis was more towards one-size-fits-all approach whereby audits were scheduled on a cyclical, methodological basis, and auditors' role was reported against a checklist of existing company policies and procedures to ensure that the internal controls of the company were functioning well. Ever since, the role of internal auditor is only to reduce or to eliminate risk. This practice may have been appropriate in times of slower development and not-so-rapid technological evolution but they would not be applicable today since today's businesses rely on sophisticated electronic technology in every aspect of their operations and they also require timely information to make decisions regarding

global operations.

.

Internal auditing is an independent, objective assurance and consulting activity designed to add value and improve an organisation's operations (Sawyer & Dittenhofer, 1981). Being independent and objective, internal auditing helps an organization accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control, and governance processes.

Internal audit activities are performed in diverse legal and cultural environments; within organizations that vary in purpose, size, and structures; and by persons within or outside the organization (Sawyer, 1993). These differences may affect the practice of internal auditing in each environment. However, compliance with the Standards is essential if the responsibilities of internal auditors are to be met.

Internal auditing dates from ancient times. The role of auditors during that period was limited to providing validation services for governmental and family units in order to prevent theft, fraud, and other malfeasance from the treasuries of the ruler (Carmichael & Willingham, 1979).

For auditing purposes, two persons were employed to check the accounts: one was the internal auditor and the other was the external auditor (Felios, 1984). The usual technique utilized by the auditors was to listen to the oral reports given by the appointed officials

responsible for financial matters. That is why the term “auditor” is thought to have been derived from this “hearing of accounts”. This practice continued until it was replaced by paper as the means to evidence financial transactions.

Internal auditing is an important element to management since it provides audit services for managers at all levels including the board of directors and audit committee (Rezaee & Lander, 1993). Internal auditor’s responsibilities are assuring the integrity of financial and operational information and reports, organization is complying with laws, statutes, policies, procedures and financial instruments and is operating efficiently and economically, the goals and objectives of the company have been accomplished and resources have been provided with; and also safeguarding the assets of the organization.

This means internal auditors’ responsibilities are now broader and more demanding. Based on these responsibilities, it is not difficult to observe how the internal auditing practices can improve the company’s corporate governance structure. In fact the revised definition of internal auditing indicates that the scope of audit work includes evaluating and improving the effectiveness of a company’s governance process since the new internal auditing concept expects the internal audit to function efficiently, effectively and economically the organizational activities and controls besides assisting management in high-level decision-making (Internal Auditors, 2000).

Brodie (1989) however commented that generally management has been rather slow to

recognize the full value and potential of internal audit experience even though there has been a steady improvement in the professional standing of internal auditors. Therefore, there is a need for continuous effort to enhance the understanding of the role of internal auditing and the benefits it can bring to the organizations and to society as a whole.

2.2 The History and Evolution of Internal Auditing

Internal auditing was developed in the years between 1900 to 1950. However, it was not until the late thirties and early forties that it became widely utilized. Brinks (1941) published the first significant text on internal auditing. This publication served as a catalyst to bring together in that same year the twenty-four founders of the Institute of Internal Auditors (Cadmus, 1960). The Institute and the profession grew rapidly due, to a great extent, to the pressing needs of World War II.

It was also during this period that internal auditors began to be more concerned with more than a financial audit. Large organizations began to realise that the internal auditors can perform a greater service than just looking for accounting errors. Thus, internal auditors began to change to new concepts of auditing and focus upon improving operations rather than just scouting for accounting errors. This new concept of auditing received management acceptance because the recommendations made by internal auditors were more helpful than those typically provided by external auditors; and, significantly, because findings remained internal and were not made public.

Internal auditors adopted the term “operations” or “operational” auditing to describe their new improved service. This term first came to the attention of internal auditors in an article by Kent (1948). Basically, operational auditing uses an inductive approach in that it drew from accounting documents recommendations for change that is it moved from the specific or actual to the ideal. Internal auditors thus pioneered the concept of operational auditing. However, during this same period a similar concept, called management auditing, was developed in the literature of management.

It is believed that Rose (1932) first coined the term “management audit”. He wrote and published this book of the same name in London. Rose’s audit was basically designed to analyse the functional activities of a company and had been previously developed for policyholder companies. Benedict’s (1948) followed Rose’s work and his system offers to evaluate management by means of weighted factorial analysis.

Both writings by Rose (1932) and Benedict (1948) represent the earliest attempts to develop an interview type management audit. The management audit was organised around the functions of management and followed a deductive approach as opposed to the inductive approach of operational auditing. These two similar but separate concepts were the forerunners of today’s movement toward the extension of the scope of auditing.

Management auditing and operational auditing began to merge in the late 1950s and early 1960s. Internal auditors frequently referred to their audit as a management audit, and

many writers stated that the terms were synonymous. At present, both terms refer to an audit that goes beyond traditional financial attestation into the area of managerial economy, efficiency and effectiveness. Such audits may be deductive or inductive, internal or external.

2.3 The Roles of Internal Auditors

Internal auditors play a vital role in ensuring that an organization is efficiently run, morally sound, technologically advanced, cognizant of the environment and other areas of concern, and safe from unnecessary risk (Institute of Internal Auditors, 2000). Previous definitions on internal auditing suggested by different authors also enhanced the roles of internal auditors.

Sawyer and Dittenhofer (1981) defined internal auditing as “a systematic, objective appraisal of the diverse operations and controls within an organization to determine whether financial and operating information is accurate and reliable, risks to the enterprise are identified and minimized, external regulations and acceptable internal policies and procedures are followed, satisfactory standards are met, resources are used efficiently and economically, and organization’s objectives are effectively achieved” (p. 7).

In the revised Statement of responsibilities of Internal Auditing issued by the Institute of Internal Auditors (1990) as part of the Standards framework, the section on objectives

states:

“The objective of internal auditing is to assist all members of management in the effective discharge of their responsibilities by furnishing them with analyses, appraisals, recommendations and pertinent comments concerning the activities reviewed. The internal auditor is concerned with any phase of business activity where he can be of service to management. This involves going beyond accounting and financial records to obtain a full understanding of the operations under review”(p. 3).

With reference to these objectives, Sawyer (1996) noted four benefits managers have gained from internal auditing assistance. These benefits were providing managers with the bases for judgement and action, helping managers by reporting weaknesses in control and performance and in recommending improvements, providing counsel to managers and boards of directors on the solutions of business problems, and supplying information that is timely, reliable and useful to all levels of management (pp. 4 – 9).

Additionally, the Statement sets forth the types of services that should be performed and the kinds of activities carried on by the internal audit function in attaining the overall objective. Internal auditors should first review and appraise the soundness and adequacy of the accounting, financial, and other operating controls, and promote effective controls at reasonable cost. Secondly, the internal auditors should ascertain the extent of compliance with established policies, plans, procedures, laws and regulations, which could have a significant impact on the company's operations. Then the internal auditors

review the means of safeguarding assets and when appropriate, verify the existence of such assets and appraise the economy and efficiency with which resources are employed. Lastly, the internal auditors review operations or programs to ascertain whether results are consistent with established objectives and goals and whether the operations or programs are being carried out as planned.

Reviewing and evaluating the adequacy and effectiveness of an organisation's internal control system and the quality of performance in carrying out assigned responsibilities is representative of several primary core activities of internal audit work. The purpose of the review of the adequacy of the internal auditing is to ascertain whether the established system provides reasonable assurance that the organisation's objectives and goals will be met efficiently and economically.

Adequate control is considered to be present if administrative management has planned and organised in a manner, which provides reasonable assurance that the organisations's objectives and goals will be achieved efficiently and economically. Reasonable assurance is provided when cost-effective actions are taken to restrict deviations, such as improper or illegal acts, to a tolerable level.

The role of internal auditing in the review of effectiveness of the system of internal control is to ascertain whether the system is functioning as intended. Effective control is present when the administrative management directs the system in such as way as to

provide reasonable assurance that the organisation's objectives and goals will be achieved. The purpose of the review for quality of performance is to ascertain whether the organisation's objectives and goals have been achieved.

The primary objectives of an organisation's system of internal control are to provide administrative management with reasonable assurance that financial information is accurate and reliable; the organisation complies with policies, plans, procedures, laws, regulations and contracts; assets are safeguarded against loss and theft; resources are used economically and efficiently; and established objectives and goals for operations or programs can be met. Internal auditing focuses on an evaluation of this system or framework of internal control.

A second type of audit work that internal auditors are guided to perform is reviewing the accuracy and reliability of financial and operating information and the means used to identify, measure, classify and report such information. Information systems provide data for decision-making, control, and compliance with external requirement. Therefore, internal auditors should examine information systems and determine whether financial and operating records and reports contain accurate, reliable, timely, complete and useful information, and controls over record keeping and reporting are adequate and effective.

The performance of reviews of the systems established to ensure compliance with policies, plans, procedures, laws, regulations and contracts represents a third element of

audit activity described by the Standards. Administrative management is responsible for establishing the systems designed to ensure compliance with such requirements as laws, rules, regulations, policies and procedures. The internal auditors role is to determine whether the systems designed by management are adequate and effective and whether the activities audited are complying with the appropriate requirements.

Further, as described by the Standards, the internal auditor's role includes providing appraisals with recommendations regarding administration management established objectives and goals for operations and programs.

Figure 2.1 shows the internal auditor roles that is viewed as a monitoring agent who audits various levels of manager-agents (auditees) or the control mechanism (e.g., accounting and operational controls) over these agents on behalf of the principal(s). Acting as a monitoring agent, the internal auditor is expected to perform two interrelated functions, auditing and consulting. These are performed to maintain reliability of financial statements, prevent occurrence of irregularities and enhance effectiveness and efficiency of operations (Neuman, 1981). Thus, the demand for internal auditing is presumed to arise due to an accountability relationship between two (or more) parties (e.g. top management vs. board member) (DeAngelo, 1981; Evans, 1980).

Figure 2.1 also depicts the principals of the internal auditor. From 1940 to 1960, the internal auditor often viewed his principal as being singular in nature – the controller.