

INTERNAL AUDIT PRACTICES OF LISTED CONSTRUCTION COMPANIES IN MALAYSIA: SOME PRELIMINARY EVIDENCE

Main author: Damien LEE

Swinburne University of Technology
Sarawak Campus Jalan Simpang Tiga
93350 Kuching Sarawak, Malaysia
E-mail: dlee@swinburne.edu.my

Co-author: Dr Issham ISMAIL

School of Distance Education
Universiti Sains Malaysia
11800 USM Penang, Malaysia

Co-author: Dr. Daniela MITRAN

“Athenaeum” University Bucharest

Abstract

This study aims to find out the current internal audit practices of listed construction companies in Malaysia is in compliance with newly released International Professional Practice Framework (IPPF) standards. IPPF standards were recently updated in January 2009 and there are drastic changes from January 2002 version. This event has motivated the study to investigate whether current internal audit practice is in line with newly released standards. More than half of listed construction company who runs internal audit function in-house complied with IPPF standards.

Keywords – Internal audit, corporate governance, IPPF standards, Malaysia

Introduction

Malaysian listed companies are required have internal audit function by Bursa Malaysia (previously is now as Kuala Lumpur Stock Exchange) regulation. The Institute of Internal Auditors (IIA) promotes internal audit practice to be at par with internal auditing standards.

Theoretical and internal audit background

Corporate governance was originated from agency theory where shareholder (the owner) appoints board of director to run the business. This agency (principal-agent) relationship seeks to make agent (board of director) accountable to its principal (shareholder) for any resources used (Adams, 1994). Corporate governance system was there to deliver this ‘accountability’ task.

Corporate governance is the system by which companies are directed and controlled (Cadbury Report, 1992). The Corporate governance system was designed to delivery corporate accountability through its mechanisms of reporting, audit and internal control (Spira & Page, 2003).

Therefore, internal audit is an essential part of corporate governance framework. Bursa Malaysia, Main Market's listing requirement Chapter 15, Corporate Governance, Para 15.27(1) make compulsory for all listed company to have an establishment of internal audit function, (Bursa Malaysia₁, 2009).

IIA defines internal audit as an independent, objective assurance and consulting activity designed to add value and improve an organization's operations (IIA₁, 2010). IIA's IPPF attribute standards stressed that internal audit function and individual internal auditors must possess four main characteristic, so that internal audit services can perform effectively (Reding, et al., 2009). The four characteristic are as follows:

- purpose, authority, and responsibility
- independent and objectivity
- proficiency and due professional care
- quality assurance and improvement program

The recent development of IPPF and development of research questions

IPPF development

IIA's IPPF was recently updated in January 2009 and there are drastic changes in 2009 version compared with January 2002. For the purpose of this paper, the review is focused on Attribute Standards (the 1000 Series) and is summarized as follows:

| Attribute Standard Section | Major update/changes made |
|--|---|
| 1000 – Purpose, Authority and Responsibility | - the word 'should' has been replaced with 'must' |
| 1100 – Independence and Objectivity | - the word 'should' has been replaced with 'must' |
| 1200 – Proficiency and Due Professional Care | - the word 'should' has been replaced with 'must' |
| 1300 – Quality Assurance and Improvement Program | - the word 'should' has been replaced with 'must' |

From the above analysis, there is a complete change from optional to compulsory for adhere practice of internal audit standards. How well does internal audit practices in Malaysia cope with these big changes? There are three essential pillars supporting effective internal audit services, which are independent and objective; proficiency and due professional care (Reding, et al., 2009). The three pillars are requirement of IPPF's 1100 and 1200 series attribute standards. The internal audit charter is important as it is a formal document recognized the existence and purpose of internal audit function within an organization (IIARF, 2009). Without this recognition, the three pillars cannot function smoothly to support the effective internal audit performance. Independence is the freedom from conditions that threaten the ability of the internal audit activity or the chief audit executive to carry out internal audit responsibilities in an unbiased manner (IIARF,

2009). Objectivity is an unbiased mental attitude; proficiency refers to the knowledge, skills, and other competencies needed to fulfill internal audit responsibilities; and due professional care is the care and skill expected of a reasonably prudent and competent internal audit (Reding, et al., 2009).

Research questions

Fadzil et al., in 2005 study has focused independent & objectivity, professional proficiency, scope of work, performance of audit work and management of internal audit department in compliance with 2002 standards in Malaysia. Christopher et al., in 2009 investigates internal audit function independent from management and relationship between audit committee and internal audit function provide internal audit independence in Australia. Have internal audit practices in Malaysia updated with the recent released standards? The above studies are also looking into overall practices of internal audit and did not zoom into various types of internal audit practices like assurance and consulting service. The facts above provide the basis development of the following research questions:

- RQ1. To what extend the assurance services/audit is practice by Malaysian listed construction companies is compliance with 2009's 1000 series attribute standards?
- RQ2. To what extend the consulting services/audit is practice by Malaysian listed construction companies is compliance with 2009's 1000 series attribute standards?
- RQ3. To what extend does Malaysian listed construction companies internal audit practices complied with 2009's 1000 series Quality and Improvement Program standards?

Research method

Questionnaire

An e-mail based questionnaire was used to collect data (Christopher, et al., 2009). Self designed questionnaires are prepared based on the 2009's 1000 series, IPPF Attribute Standards. The questionnaires are sent out through emails directed to the respective companies' general email obtained from company's website to internal auditor.

Research scope

Since, email survey is still new to Malaysia's research landscape; therefore I have selected 'construction sector' companies listed on Bursa Malaysia's main and second boards as research sample population.

Data collection

Based on Bursa Malaysia listing, there are 59 construction companies in 2008. However, there are almost half of listed construction companies do not have website and the analysis is shown as below.

| Category | Main Board | | Second Board | | Total no. of listed companies with website |
|--------------|--------------|-----------------|--------------|-----------------|--|
| | With website | Without website | With website | Without website | |
| Construction | 30 | 13 | 5 | 11 | 35 |

Source: Othman, et al., 2009, Web document analysis for companies listed in Bursa Malaysia, Tables I & II, pages 276 & 277.

Based on the above, there are 35 listed construction companies maintaining a website. A total of 8 responses were received, representing a response rate of 22.86%. The response rate is similar to internal audit research targeting on public listed companies, (Sumritsakun & Ussahawanitchakit, 2009 – 21.26%).

Questionnaire items

The research questions address the following issues:

RQ1. To what extent the assurance services/audit is practice by Malaysian listed construction companies is in compliance with 2009's 1000 series attribute standards? This research question try to identify whether assurance services conducted by the company is with reference to internal audit charter or term of reference (Question 3 & 4); does assurance services conducted independently (Question 5) and is there any impairment factors towards the independence or objectivity (Question 6); conduct the assurance engagement with proficiency and due professional care manner (Question 7 & 8 with Question 14).

RQ2. To what extent the consulting services/audit is practice by Malaysian construction companies is in compliance with 2009's 1000 series attribute standards? This research question try to identify whether consulting services conducted by the company is with reference to internal audit charter or term of reference (Question 10 & 11); conduct the consulting engagement with proficiency and due professional care manner (Question 12 & 13 with Question 14).

RQ3. To what extent does Malaysian construction companies internal audit practices complied with 2009's 1000 series attribute Quality and Improvement Program standards? This research question try to identify whether overall company's internal audit function has quality assurance and improvement program in place through internal and external means (Question 16 & 17); reporting of the quality program (Question 18).

Result and discussion

In this section, the survey result will be critically analyzed and discussed after the presentation of table statistic of each question.

| No. | Questionnaire items | Frequency | |
|-----|--|-----------|------|
| | | No. | % |
| 1. | Does substantial of Internal Audit Function runs internally? | | |
| | A. Yes | 6 | 75 |
| | B. No | 2 | 25 |
| 2. | Does Internal Audit Function of your company provide assurance services? | | |
| | A. Yes | 6 | 100 |
| | B. No | 0 | 0 |
| 3. | Does your company have Internal Audit Charter or Term of Reference in defining the nature of assurance services provided? | | |
| | A. Yes | 5 | 83.3 |
| | B. No | 1 | 16.7 |
| 4. | Is Assurance's Internal Audit Charter or Term of Reference reviewed annually? | | |
| | A. Yes | 3 | 60 |
| | B. No | 2 | 40 |
| 5. | Do you agree that your company's internal audit function that is free from interference in determining the scope of internal auditing, perform work, and communicating results for assurance services? | | |
| | A. Yes | 5 | 83.3 |
| | B. No | 1 | 16.7 |
| 6. | In 2009, any of internal audit staff was assigned to the same assurance task as they did for 2008? | | |
| | A. Yes | 1 | 16.7 |
| | B. Sometime | 1 | 16.7 |
| | C. No | 4 | 66.6 |
| 7. | Did the internal audit staff ever seek advice from others/expert in the event that internal auditors have lack of knowledge, skills, or other competencies for particular assurance services. | | |
| | A. Yes, sometime when they need it. | 6 | 100 |
| | B. No, all the staffs have all the necessary knowledge, skills or other competencies. | 0 | 0 |
| 8. | Do you agree that your company's internal audit function has exercise necessary due professional care in providing assurance services? | | |
| | A. Yes | 5 | 83.3 |
| | B. Partially | 1 | 16.7 |
| 9. | Does Internal Audit Function of your company provide consulting services to department/unit within the company? | | |
| | A. Yes | 3 | 50 |
| | B. No | 3 | 50 |

| No. | Questionnaire items | Frequency | |
|-----|---|-----------|------|
| | | No. | % |
| 10. | Does your company have Internal Audit Charter or Term of Reference in defining the nature of consulting services provided? A. Yes B. No | 2 | 66.7 |
| | | 1 | 33.3 |
| 11. | Is Consulting's Internal Audit Charter or Term of Reference reviewed annually? A. Yes B. No | 2 | 66.7 |
| | | 1 | 33.3 |
| 12. | Any of internal audit staff has took up consulting engagement when they have lack of knowledge, skills, or other competencies in performing the particular job. A. Yes B. No | 1 | 33.3 |
| | | 2 | 66.7 |
| 13. | Do you agree that your company's internal audit function has exercise necessary due professional care in providing consulting services? A. Yes B. No | 3 | 100 |
| | | 0 | 0 |
| 14. | Does most of internal audit function's staff sent for continuing professional development course at least once a year? A. Yes B. No | 4 | 66.7 |
| | | 2 | 33.3 |
| 15. | Does internal audit function have quality assurance or improvement program in place? A. Yes B. No | 6 | 100 |
| | | 0 | 0 |
| 16. | Does internal assessment of performance of internal audit activity taken in place annually for quality assurance and improvement purposes? A. Yes B. No | 4 | 66.7 |
| | | 2 | 33.3 |
| 17. | Does internal audit function ever engage an external assessor to review the performance of internal audit activity for quality assurance and improvement purposes? A. Yes B. No | 1 | 16.7 |
| | | 5 | 83.3 |
| 18. | To whom the result quality assurance and improvement program reported to? A. Audit committee B. Not reported. Keep for departmental self improvement. C. No comment | 3 | 50 |
| | | 2 | 33.3 |
| | | 1 | 16.7 |

Internal audit function

Response on Question 1 shows there are only 75% of construction listed companies run internal audit internally, the remaining 25% of the company outsourced internal audit function.

Assurance services

83.3% of companies who conduct internal audit functions in-house have assurance service defined in their internal audit charter or term of reference. 60% of the companies who have assurance's charter or term of reference them reviewed annually. IPPF's standard requires all companies to have their assurance defined and review annually (IIA₂, 2009).

83.3% of the companies conducted their assurance services independently with 33.4% conducted it with potential threat towards independence or objectivity. According to 2009 IPPF standards, internal auditor must avoid taking up the responsibility that he has taken in previous year (IIA₂, 2009).

All companies carried out internal audit function in-house have necessary proficiency to undertake the job with 83.3% provide with necessary due professional care.

Consulting services

50% of companies who runs internal audit function in-house provide consulting services. 66.7% of companies who offered consulting services defined this function in their internal audit charter or term of reference; and all companies who defined consulting services the charter or term of reference review them annually.

33.3% of the companies perform consultancy services assigned job their staff to when they have lack of competency to perform a particular task. This might post potential problem where the company should not accept the consulting engagement if their staff to not have necessary competency to perform their job, according to IPPF standard pertaining to proficiency (IIA₂, 2009). All the companies providing consulting services must have necessary due professional care.

Continuing professional development

66.7% of companies who provide assurance or/and consulting services sent their staff to attend internal audit course(s). IPPF standards make compulsory for employer to send their internal audit staff for update (IIA₂, 2009).

Quality assurance and improvement program

All companies who run internal audit function in house have quality assurance or improvement program in place. 66.7% of the companies employ internal assessment as a mean for quality assurance and improvement where and only 16.7% of the companies employ external assessment for the same purpose. 16.6% of companies did not indicate whether they employed internal or external mean of assessment for this purpose. However, 2009 IPPF standards required all company to have internal and external assessment (IIA₂, 2009) for the purpose above.

50% of the companies reported quality assurance and improvement program to audit committee and 33.3% of them kept it in internal audit department for future self improvement. 2009 IPPF standards requires chief auditor to report to senior management and the board (IIA₂, 2009).

Conclusions

This study painted a clear picture about the practices of internal audit in Malaysia where there are 25% of construction listed companies did not have internal audit function and relied on outsource services. All the companies who have internal audit department runs assurance services but only 50% of them offered consulting services.

To date, 16.7% of listed construction companies need to define their nature of assurance service in their charter and 40% companies defined their assurance service in the charter should review it annually. There are 33.3% of company provide consulting service assigned job to their staff even though they do not have necessary competent skills. Internal audit practices in assurance and consulting services within listed construction companies in Malaysia have reached at least 66.7% compliance level with 2009's 1000 series attribute standards.

Limitation of the study

When interpreting the result of this study, a number of limitations need to consider. Firstly, this research is solely focus on listed construction companies and it does not represent the practices of whole listed companies in Malaysia. Secondly, the result is solely from internal audit perspective.

REFERENCES

1. Adams., M. B., 1994, Agency theory and the Internal Audit, *Managerial Auditing Journal*, Vol 9 No. 8, pages 8-12.
2. Bursa Malaysia [1], 2009, Main Market Listing Requirement, Chapter 15 Corporate Governance, 3/8/2009, http://www.klse.com.my/website/bm/regulation/rules/listing_requirements/main_market.html, viewed 15 January 2010.
3. Cadbury Report, 1992, 'Report of the Committee on the Financial Aspects of Corporate Governance', available at: <http://www.ecgi.org/codes/documents/cadbury.pdf>, assessed on 12 December 2007
4. Christopher., J., et al., 2009, A critical analysis of independence of the internal audit function : evidence from Australia, *Accounting, Auditing & Accountability Journal*, Vol 22 No.2, pages 200-220.
5. Fadzil., F. H., et al., 2005, Internal audit practices and internal control system, *Managerial Auditing Journal*, Volume 20 No. 8, pages 884-886.
6. IIA [1], Definition of Internal Audit, <http://www.theiia.org/guidance/standards-and-guidance/ippf/definition-of-internal-auditing/>, viewed 15 January 2010
7. IIA [2], 2009 IPPF Standards, <http://www.theiia.org/guidance/standards-and-guidance/ippf/standards/full-standards/>, viewed 15 January 2010
8. Othman., M.S., et al., 2009, Web document analysis for companies listed in Bursa Malaysia, *International Journal of Computer Science and Information Security*, Vol 6 No. 2, pages 275-280
9. Reding, K. F., et al., 2009, *Internal Auditing : Assurance & Consulting services*, 1st Ed, The Institute of Internal Auditor Research Foundation, Altamonte Springs, Florida
10. Spira, L. F., & Page, M., 2003, Risk Management, The reinvention of internal control and the changing role of internal audit, *Accounting, Auditing and Accountability Journal*, Volume 16 No. 4, pages 640 – 661
11. Sumritsakun, C. & Ussahawanitchakit, P., 2009, Internal audit innovation and firm stability of Thai listed company: How do implement in an organization?, *Journal of Academy of Business and Economics*, Vol 9 No. 4, pages 1-23
12. The Institute of Internal Auditors Research Foundation [IIARF], 2009, *International Professional Practices Framework*, 1st Ed, The Institute of Internal Auditors, Altamonte Springs, Florida