

Importance of Internal Audit Capability in Management Accounting and Organization
Performance - Case Study of Malaysian Public Sector Organizations

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Abstract

The purpose of this paper is to explain the importance of internal audit capability in enhancing the management accounting and performance of Malaysian public sector organizations. The structure of public sector organization in Malaysia comprises of several level and types of organizations which lead to the complexity of the structure. Therefore, it requires a comprehensive procedure and guidelines especially in financial management. This study specifically focused on the role of internal audit in two different types of public sector entities i.e., state level and state statutory body. An explanatory case study method was used to collect the data whereby semi structured interviews, informal conversations, questionnaire and document reviews were conducted. It is found that internal audit unit in PSA obtained higher capability level of Level 2 (infrastructure) with overall percentage capability of 57%. CSA scored level 5 (optimized) for four of the IACM dimensions which are Professional Practices, Performance Management and Accountability, Organizational Relationships and Culture, as well as Governance Structure. CSB only achieves level 5 (optimized) for dimension of performance management and accountability. For dimension of governance structure, CSB achieves level 3 (integrated). Other three dimensions of services and role of internal audit, professional practices and organizational relationships and culture achieves level 2 (infrastructure). However, CSB scores poorly for people management dimension which is only level 1 (initial) which resulting the overall capability of only level 1 (initial) with overall percentage of 52%. There is a critical need to review the dimensions of services and role of internal audit, people management, and professional practices for both organizations to enhance the effectiveness of the IA function. Implications and suggestions for further studies are also provided.

Keywords: internal audit, internal audit capability, public sector, Malaysia,

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Management accounting is a profession that involves partnering in management decision making, devising planning and performance management systems, and providing expertise in financial reporting and control to assist management in the formulation and implementation of an organization's strategy. The management accounting field has advanced considerably from a transaction and compliance to that of a strategic business partner i.e. to be stewards of corporate performance management, planning, and budgeting; champions of the corporate governance process, providing risk management, internal control, and financial reporting at a time of great change; and experts in cost management methods that help the organization become more competitive and successful (Institute of Management Accountants, 2008). Organization performance, on the other hand, has been recognized as a key influence on investment decisions and also one of the indicators for management performance. Organization performance is used as a measurement to reflect management effectiveness and efficiency in resource allocation, aiming ultimately at maintaining sustainable firm performance (Teoh, 2009).

The issues of globalization, transparency, integrity and improvement of government service delivery increase the need for governance and accountability of organizations, which leads to the importance of the existence of a quality internal audit function in the organisation (Goodwin, 2004). Following events such as the financial crisis and accounting scandals, the roles of internal auditing as well as internal control and its responsibilities in corporate governance and firm performance has expanded (Shenkir & Walker, 2006). Internal audit is an independent, objective assurance and consulting activity designed to add value and improve an organization's operations

and helps an organization accomplish its objectives by bringing systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control and governance processes (Institute of Internal Auditors Research Foundation, 2009).

Besides, the internal auditing departments are responsible for exercising control over an entity's system of internal control system as a service to management. In the absence of internal auditing practices, the management needs to apply other monitoring processes in order to assure itself and the board that the system of internal control is functioning as intended. Effective internal control system has an essential role to play in a firm's success. As such, all government ministries and agencies should improve the effectiveness of their internal control system, and internal audit function because they improve good governance. In general, the establishment of internal control systems ensures effective functioning of any entities (Badara & Saidin, 2013).

According to the Auditor General of Malaysia, internal audit function plays a proactive role as a monitoring mechanism and in examining ongoing projects. It may assist public sector entities in achieving their objectives effectively, efficiently, economically and ethically by providing unbiased and objective assessments (Ahmad, Othman, Othman, & Jusoff, 2009). Public organizations in Malaysia have faced widespread criticism regarding their perceived lack of financial discipline, good governance and accountability (Khalid, 2010). The structure of Malaysian public sector organization that comprises of several level and types of organizations results in the complexity of structure, thus, requires a comprehensive procedure and guidelines especially related with planning and control on the financial management matters. Continuing developments in the financial management, budgeting and accounting systems put pressure on the Auditor General to review its own techniques and methodologies in auditing so as to play a dynamic role in the accountability (E. I. E. Ali, 2015).

Since 2007, Auditor General Reports continuously emphasized there is a need for the internal auditors to expand and improve their auditing competencies. They are required to assess and monitor the public sector's execution and management of programs, activities, and projects to ensure that if they are being implemented efficiently, economically and if the objectives are met. However, the issues of inefficiencies, ineffectiveness and other weaknesses seems to be repeating every year, which result in the loss of billions of Ringgit Malaysia of public money. Transparency International Malaysia (TI-M) is a strong advocate of the Auditor General's audit report and has urged the government to take corrective actions to address the findings in the Auditor-General Report. This brings the question as to what has led to the weaknesses highlighted in the Malaysian public sector organization (Ahmad et al., 2009). Therefore, the objectives of the paper are: (i) To measure the capability level of internal audit function in the organization; (ii) To relate the capability level of internal audit function with the characteristic of organizations and its performance; and (iii) To provide recommendations and solutions for organizations.

Background of Research

Malaysian government system is unique as compared with other federal system around the world. Malaysia employs federalism form, democratic and monarchy system of government and practiced the concept of separation power. Federalism form of Malaysian government shows three different levels of government i.e. the Federal Governments, the State Governments and the Local Governments. The first two level of the governments enjoy the power in making laws and policies, while the third level only enjoy the autonomy power in terms of financial and management decision making. The Government of Malaysia refers to the Federal Government or National Government authority which has its base in the federal territories of Kuala Lumpur. Malaysia is a

federation of 13 states operating within a constitutional monarchy under the Westminster of parliamentary system and is categorized as a representative parliamentary democracy (E. I. E. Ali, 2015). Figure 1.0 shows the general structure of Malaysian public sector.

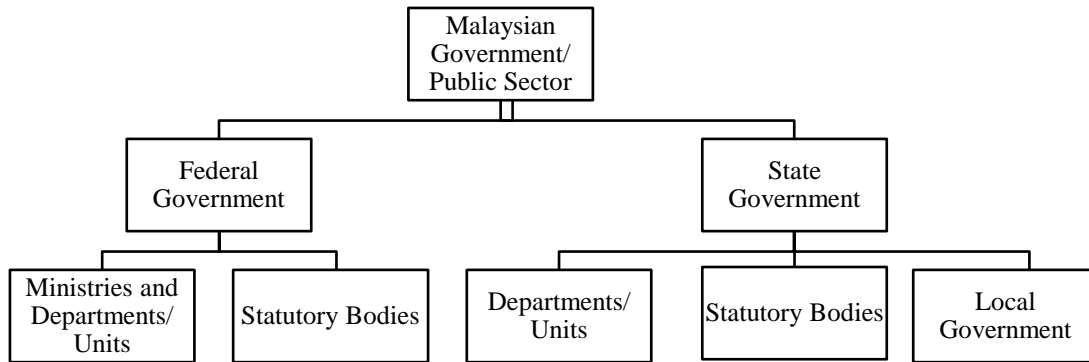


Figure 1.0. General Structure of Malaysian Public Sector Organization (E. I. E. Ali, 2015)

Malaysian government has set up several level of management mechanism. The main purpose is to provide an efficient and effective mechanism to ensure the public resources can be used and manage properly and objective being achieved. Basically management mechanism can be divided into three broad levels, pre-implementation i.e. policy maker, implementation level and post implementation. Policy level refers to the management mechanism at the parliament (legislature) where all the policy regarding the financial management is set-up through budget (annual appropriations). Management mechanism at implementation level refers to the mechanism at the ministries, departments and agencies. At this level, every public officer of any rank who has dealings with public moneys or stores by the definition under the section 3 of Financial Procedure Act, 1957 is an “accounting officer”. All accounting officers are required to comply with financial and accounting procedures prescribed by the Federal Treasury and are held accountable for their actions. Post level refers to management mechanism at Auditor General Office (NAD) and other

watchdog agencies like Malaysian Anti-Corruption Commission (MACC), Malaysian Institute of Integrity (MII) (E. I. E. Ali, 2015).

Financial management activities in Malaysian public sector comprises of such several activities such as budgeting, accounting and reporting, auditing, and performance management apart from core activities that is revenue generating and expenditure incurring. The matters regarding the financial management are stated in the constitution under the part VII: Financial Provisions. This provision comprises of 17 articles; these include the budgeting activities, financial accounting activities, reporting and auditing. Budgeting activities is related with the estimation of revenues be generated by the government for that particular year and the estimated expenditures will be spend for that year. Financial accounting activities deals with recognizing and recording all the expenditure allocations to all government agencies and the actual revenues and expenditure based on the code and object of the accounts for each of the government agencies. Financial reporting activities deals with the preparation of a financial statements comprises of balance sheet, income and expenditure statement, notes to be accounts and the statement of memorandum accounts. While the last activity is auditing, where the auditor need to audit all the financial report and record of the government agency together with the performance audit to discharge the financial accountability entrusted to each level of government organization's and officers (E. I. E. Ali, 2015).

Legal provisions in Malaysian public sector financial managements comprises of laws made by the legislative authority, regulations and accounting standards. The laws include the Federal Constitution, Acts, Enactments and as well as Ordinance. There are a number of laws related to the public financial management in Malaysia. They are Federal Constitution (FC) 1957; Financial Procedure Act (FPA), 1957; Audit Act (AA), 1956; Local Government Act (LGA), 1976

and Statutory Bodies Act (SBA), 1980. On the other hand, regulations are any rules that are approved by the ministries and administrative. Regulations include Treasury Instruction (TI), Federal Treasury Circular (FTC) and Treasury Circular Letter (TCL). Whereas, Accounting Standards are any effective accounting standards proposed and approved by regulated professional bodies. Examples of accounting standards are International Financial Reporting Standards (IFRS), Malaysian Financial Reporting Standards (MFRS), Government Accounting Standards (*Piawaiian Perakaunan Kerajaan* - PPK), Public Sector Accounting Standards (IPSAS) and Malaysian Public Sector Accounting Standards (MPSAS) (E. I. E. Ali, 2015). Hierarchy of legal provisions related to the financial requirements in the public sector is shown in Figure 2.

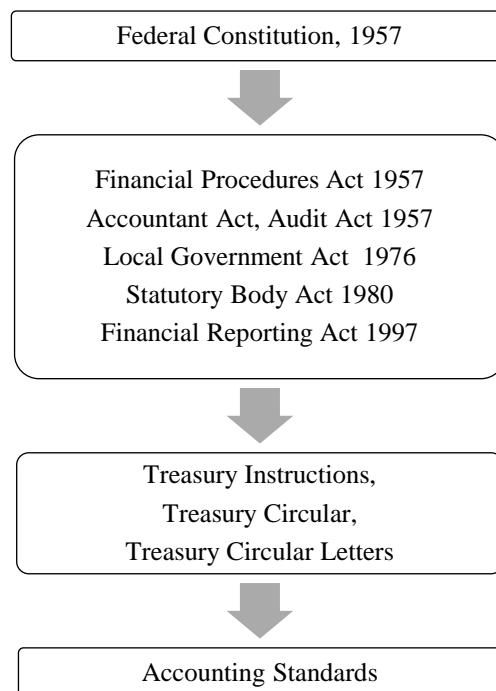


Figure 2. Legal provisions in financial management of Malaysian public sector organizations.

In Malaysia, the requirement to adopt internal audit function in public sector has been documented in the Treasury Circular No. 9, 2004. Historically, the development of internal

auditing in the Malaysian public sector started in 1970 when the Ministry of Defence set up its internal audit department. However, the scope is limited to financial audit. Progressively, the extension of the scope has been recognized in later years where the scope covered both, financial and management audits. The recommendation is documented in the Treasury Circular No. 2, 1979 which required all ministries and departments in the Federal Government to establish their internal audit unit or department. However, the Government issued Treasury Circular No. 9 2014 to replace the 1979 circular. This circular extended the formation of Internal Audit function at all Ministry, Department and State Government level and to agencies and departments in the State Governments. However, this requirement excludes the state agencies, local authorities and state economic development corporations. This alluded to the assumption that internal audit is not a necessity in these organizations (Ahmad et al., 2009).

During year 2011, review and consolidation for all circulars were mandated under one Treasury Circular (1PP – 1 *Pekeliling Perbendaharaan*). There are two main sections outlined in 1PP to describe the duties and establishment of Internal Audit function which are the PS 3.1/2013 and PS 3.2/2013. Treasury Circular PS 3.1/2013 outlines the roles and responsibilities of the Internal Audit unit, Ministry Secretary or Head of Federal Department or State Secretary and the Treasury of Malaysia. This circular also details the commands of internal audit duties. Treasury Circular PS 3.2/2013 explains the requirements and responsibilities of the Audit Committee at both federal ministry and state government level (Ministry of Finance, 2016). Despite of its long history and requirement in the organizations, the quality and effectiveness of the internal audit function in have always been questioned.

Literature Review

Several studies were carried out on the roles of Internal Auditors in the Federal and State

Government Ministries/ Departments of Malaysia inquiring the effectiveness of the unit. Reviewing the existing studies relating to Internal Auditing practices, there were very few researches conducted from the Malaysian perspective with regard to the Internal Auditing in public sector even though it has important role to play in the enhancement of government agency operations efficiency and effectiveness. Needless to say, the application of IA-CM in the context of Malaysia is even difficult to be found.

The research of Ali et al. in 2012 highlighted that very little is known of the state of Internal Audit in the Malaysian public sector as a whole (A. M. Ali et al., 2012). It is believed that the first one was conducted by the Malaysian Institute of Accountants (MIA) in June 1988 (MIA, 1989) as cited in Ali et al. (2012). Another comprehensive study was published in 2007 where in-depth interviews with internal auditors from 35 states and local government bodies located in Peninsular Malaysia were conducted in year 2003 (A. M. Ali, Gloeck, Ali, Ahmi, & Sahdan, 2007). This study revealed interesting findings that audit function in Malaysian state and local governments faces numerous challenges, ranging from staff (resources), skills and training shortages which contributed to the obstructions of auditors in their attempts to perform their duties.

However, major questions have remained unanswered when it concerns the practice of internal audit in the nation's federal government. Hence, a research was carried out by Ali et al. (2012) to study both the good and bad aspects of the internal auditing in the Malaysian federal government. The study disclosed that the discouraging aspects of internal audit function in the federal organizations are concerned with the inadequate number and relatively low competency of audit personnel. Both factors have then contributed to the emergence of other issues, for example limited audit scope and coverage. The study remarked that the National Audit Department (NAD) and Public Sector Internal Audit Advisory Unit (BNPK) in Treasury need to improve their roles

and functions in the public sectors' internal auditing. Yet again, competency of the internal auditors is being questioned in the case study done by Ali et al. (2012).

The challenge of not having a standard audit practices and assessments across the government entities leads to the deployment of the global Internal Audit Capability Model (IACM). The concept of capability models has been developed over the last decade and is well accepted by organisations (Hillson, 1997; Persse, 2001; Chapman 2009) as cited in Rensburg and Coetzee (2011). After comprehensive research, the IIA Research Foundation (2009) developed the internal audit capability model (IACM) for public sector internal auditing. The model was developed to assist internal auditors and other internal audit stakeholders to identify the fundamentals needed for an effective IAF within a government structure and within the broader public sector. IACM is a framework that identifies the fundamentals needed for effective internal auditing in the public sector. It describes an evolutionary path for a public sector organization to follow in developing effective internal auditing to meet the organization's governance needs and professional expectations. It shows the steps in progressing from a level of internal auditing typical of a less established organization to the strong, effective, internal audit capabilities generally associated with a more mature and complex organization (Institute of Internal Auditors Research Foundation, 2009).

There are limited researches pertaining to the application of IACM model. Janse and Coetzee mapped the South African public sector legislation and guidance that are regulating the IA practices, to the IACM mode overview of the key process areas (KPAs) that has been addressed. This paper was intended to plot potential weaknesses in the government legislations and guidance as it is indirectly related to its internal audit function. The methodology used to evaluate the capability level of respective elements of IACM is by summing up the capability level achieved

by each legislation and guidance. The total average of each element is then summed and average out again to obtain the overall capability level. The resulting of the mapping shows that the South African legislation and guidance achieved a total of 2.93 capability average which translates into coverage of above 50% of the overall KPAs (Rensburg & Coetzee, 2011).

In 2014, Elizabeth Mac Rae and Diane Van Gils from the IIA Research Foundation released a compilation report on a global internal audit survey conducted in year 2010 based on the IACM model. The survey was evaluated based on the IACM and covers majority of the KPAs. The survey was made possible by converting the matrix into a detailed questionnaire. The assessment is based on a building-block approach aligning with the IACM concept. Hence, the implementation and sustaining of IA practices builds the foundation prior moving to the next level. A total of 2824 respondents from the public sector were used as samples in this research study. The scope of the survey encompassed over 100 countries and categorized into seven regions. Malaysia and other 39 countries fall under the Asia-Pacific region. Excerpt from the report, It shows that there is an improvement needed for Element 4 “Performance management and accountability” which achieved a total of 54% KPAs, scoring the lowest among the other elements. It was also highlighted that approximately 20% of respondents indicated there was no formal performance measurement of the internal audit activity. This could be a barrier to evaluate the performance of the internal audit activities (MacRae & Gils, 2014). Referring to the Regional Averages by Capability Level of Figure 6, most of the Internal Audit from the Asia-Pacific region achieves a capability level of 2 (56%) and level 1 (35%). There is a minimal achievement of Level 3 & 4.

In 2015, Fern (2015) has conducted a preliminary study on the internal audit capability model of two public sector organizations in Penang State of Malaysia. The results shows that both

cases i.e. Public Sector A (local authority) and Public Sector B (State Statutory Body) achieved an overall capability rating of 2 (Infrastructure) while the average percentage scores of KPAs achievement at 67% and 69% respectively. In her research, it is found that despite various performance assessments established in the Malaysian public sector, yet they are primarily focused on the overall organisation performance measurement only with lack performance tracking system established within internal audit unit. It is also found that even though there is an available performance measurement to assess the performance of internal audit units under the Ministry of Finance Malaysia purview, but it does not include the other internal audit unit in government agencies. Thus, IACM is found to be one of the framework to evaluate the capability of the internal audit unit within public sector organizations which displaying the effectiveness of the internal audit unit.

On the other hand, the International Professional Practices Framework (IPPF) carries the purposes of delineating basic principles that represent the practice of internal auditing as it should be, providing a framework for performing and promoting a broad range of value-added internal audit activities, establishing the basis for the evaluation of internal audit performance and foster improved organisational processes and operation. It consists of Attribute Standards, Performance Standards, and Implementation Standards. The Attribute Standards address the characteristics of organisations and parties performing internal audit activities. The Performance Standards describe the nature of internal audit activities and provide quality criteria against which the performance of these services can organisations that vary in purpose, size, complexity, and structure; and by persons within or outside the organisation as such the IPPF is written to be generic enough to apply to any internal audit. Internal audit are encouraged to comply with the IPPF if the responsibilities of internal auditors are to be met. Internal auditors are encouraged to report that their activities are

“conducted in accordance with the IPPF.” However, internal auditors may use the statement only if assessments of the quality improvement programme demonstrate that the internal audit activity is in compliance with Standards. Although the internal audit activity should achieve full compliance with the Standards and internal auditors with the Code of Ethics, there may be instances in which full compliance is not achieved. When non-compliance impacts the overall scope or operation of the internal audit activity, disclosure should be made to senior management and the board (Institute of Internal Auditors Malaysia, 2008)

Methodology

This research is a case study, which looks at capability level of internal audit unit at two public sector entities i.e. state level (case study A) and state statutory body (case study B). Data were gathered from both primary and secondary sources that include the following which are: (i) Interviews with head of internal audit unit. Interviews were conducted and all interviews were tape-recorded and transcribed for analysis. (ii) Internally generated documents made available by the head of internal audit unit– information such as the function of internal audit, internal audit charter. The documents were reviewed and (iii) Questionnaire to measure internal audit capability level was distributed to the head of internal audit of both organizations. Prior to visiting the organizations, their official website was reviewed the organization better including organizational chart and the history of organizations. Moreover, to gain deeper insight of the practices of internal auditing in Malaysian public sector organizations, interviews with National Audit Department officers (NAD), Institute of Internal Auditors of Malaysia (IIAM) and researchers from public universities were conducted within December 2015 to March 2016.

Measurement of Internal Audit Capability

Internal Audit Capability is measured by the self-developed checklist suggested Fern (2015) as recommendation for future studies in her master research. This checklist contains six dimensions of IA-CM elements i.e. Service and Role of Internal Audit, People Management, Professional Practices, Performance Management and Accountability, Organizational Relationships and Culture and Governance Structure. Based from these six elements, each of dimensions will be evaluated for its capability levels i.e. Level 2 (Infrastructure), Level 3 (Integrated), Level 4 (Managed), and Level 5 (Optimizing) as shown in Figure 3.1.

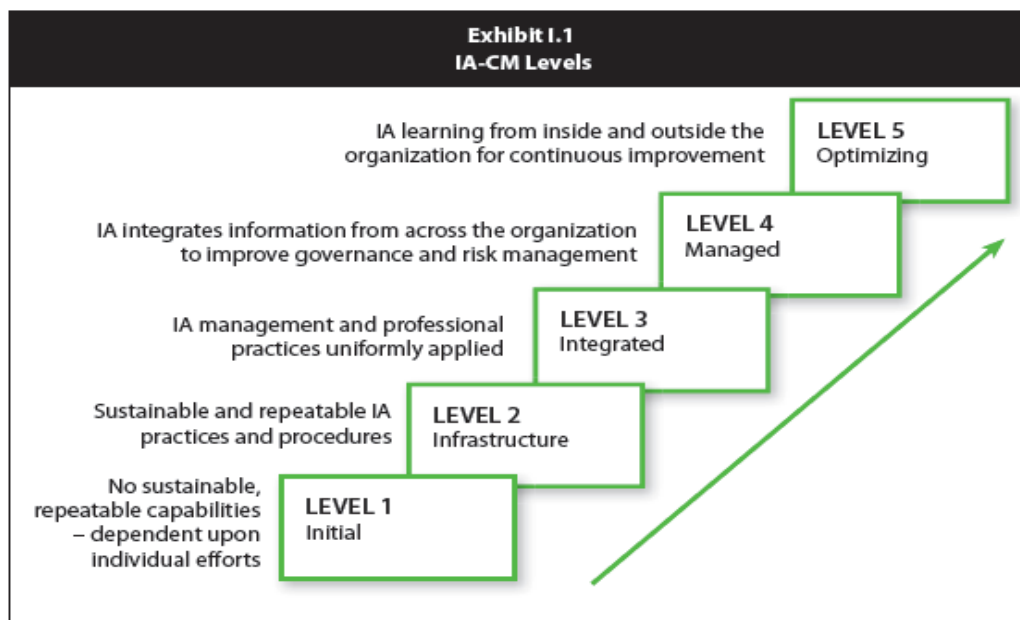


Figure 3.1. Internal Audit Capability Level.

The evaluations of questionnaires are analysed with two different methodologies. The first measurement is based on the building block approach guideline outlined by the IACM to emphasize the establishment of an effective internal auditing function which cannot be improved if it cannot be sustained (The IIA Research Foundation, 2009). The outcome of the evaluation will summarize the overall capability level which is reflected from each dimension. The second measurement calculates the percentage of KPAs (Key Process Area) achievement from each

dimension (Fern, 2015). There are six elements of internal audit capability model as shown Table 3.1.

The first one is Services and Role of Internal Audit. The ‘services’ of internal auditing refer to the type and extent of services that the IAF provides to a government organization. Internal auditors typically provide assurance services, consulting services or a combination of the two. The types of audit engagements could include, *inter alia*, compliance reviews, performance audits, financial audits or information technology audits. The ‘role’ of internal auditing refers to the responsibility of the internal auditor to assist the organization in achieving its objectives and improving its operations by providing audit assessments that are independent and impartial. The model describes the role and services of the IAF as falling between the following two extreme capability focus points; (a) On the highest capability level internal auditing is recognized as a key contributor to change, specifically with regard to the governance processes of the government organization; (b) On the lowest capability level (level 2) internal audit auditing merely reviews compliance with policies, contracts and legislation. Level 1 is not included, as the IACM Matrix refers to this level as “*ad-hoc*” and/or “unstructured” (IIA Research Foundation, 2009).

‘People management’ constitutes the establishment of a working atmosphere that endeavours to promote the most effective use of internal audit human resources. The model depicts the people management of the IAF as falling between the following two extreme capability focus points; (a) On the highest capability level the IAF practices workforce projection, which involves the development of a strategic workforce plan in accordance with the strategic objectives of the government organization.; (b) On the lowest capability level (level 2) the IAF employs skilled internal auditors and practices individual professional development. Level 1 is not included, as the

IACM Matrix refers to this level as “ad-hoc” and/or “unstructured” (IIA Research Foundation, 2009).

‘Professional practice’ refers to all the policies and procedures that enable the IAF to perform its duties effectively and professionally. These include the ability of the IAF to align its own strategies with the ability of the applicable government organization. The model depicts the professional practices of the IAF as falling between the following practices of the IAF as falling between the following two extreme capability focus points; (a) On the highest capability level the IAF practices strategic internal audit planning, which entails the adaption of the IAF’s scope of services to the government organization’s future needs. Furthermore, the highest capability level also requires that the IAF continuously endeavours to improve its professional practices in such a way as to develop its capacity; and (b) On the lowest capability level (level 2) the IAF’s plan is based on stakeholder and management priorities as well as having some sort of professional practices framework in place. Level 1 is not included, as the IACM Matrix refers to this level as “ad-hoc” and/or “unstructured” (IIA Research Foundation, 2009).

‘Performance Management and Accountability of internal auditing’ refers to the information required to successfully manage and control the IAF as well as the extent to which the performance of the IAF is reviewed and reported on. The model represents the performance management and accountability functions of the IAF as falling between the following two extreme capability focus points. On the highest capability level the IAF should have public reporting structures in place to account for the effectiveness of its operations. On the lowest capability level (level 2) the IAF has an operating budget and business plan in place. Level 1 is not included, as the IACM Matrix refers to this level as “ad-hoc” and/or “unstructured” (IIA Research Foundation, 2009):

‘Organizational relationships and culture’ refers to the relational, organizational and cultural structures within the IAF, as well as the position of internal auditing within the government organization it serves. The IACM presents the organizational relationships and culture of the IAF as falling between the following two extreme capability focus points (a) On the highest capability level the IAF should not only have an effective relationship structure in place within the function itself, but also maintain strong and effective relationships with all the main stakeholders outside of the function, including management and the audit committee; and (b) On the lowest capability level (level 2) the IAF only focuses on its international relationship structures and operations. Level 1 is not included, as the IACM Matrix refers to this level as “ad-hoc” and/or “unstructured” (IIA Research Foundation, 2009).

‘Governance structures’ refers to the reporting structures of the IAF within the government organization. This includes the extent to which the IAF’s administrative and functional reporting structures have been established in the organization. The model depicts governance structures of the IAF as falling between the following two extreme capability focus points: (a) On the highest capability level the IAF should be totally independent, without any interference from the political or the organization’s management. The power and authority of the IAF should also be clearly in place to enable the internal auditors to perform their duties effectively; and (b) On the lowest capability level (level 2) the IAF should at least have full access to the government organization’s data, assets and people and should have some sort of reporting structure established. Level 1 is not included, as the IACM Matrix refers to this level as ad-hoc” and/or “unstructured” (IIA Research Foundation, 2009).

Table 3.1

Internal Audit Capability Model Matrix

	Services and Role of IA	People Management	Professional Practices	Performance Management and Accountability	Organizational Relationship and Culture	Governance Structures
Level 5 Optimizing	- IA Recognized as Key Agent of Change	- Leadership Involvement with Professional Bodies - Workforce Projection	- Continuous Improvement in Professional Practices - Strategic IA Planning	- Public Reporting of IA Effectiveness	- Effective and Ongoing Relationships	- Independence, Power and Authority of the IA Activity
Level 4 Managed	- Overall Assurance on Governance, risk Management and Control	- IA Contributes to Management Development - IA Activity Supports Professional Bodies - Workforce Planning	- Audit Strategy Leverages Organization’s Management of Risk	- Integration of Qualitative and Quantitative Performance Measures	- CAE Advises and Influences Top-level Management	- Independent Oversight of the IA Activity - CAE Reports to Top-level Authority
Level 3 Integrated	- Advisory services - Performance / Value-for-Money Audits	- Team Building and Competency - Professionally Qualified Staff - Workforce Coordination	- Quality Management Framework - Risk-based Audit Plans	- Performance Measures - Cost Information - IA Management Reports	- Coordination with other Review Groups - Integral Component of Management Team	- Management Oversight of the IA Activity - Funding Mechanisms
Level 2 Infrastructure	- Compliance Auditing	- Individual Professional Development - Skilled People Identified and Recruited	- Professional Practices and Processes Framework - Audit Plan based on Management / Stakeholder Priorities	- IA Operating Budget - IA Business Plan	- Managing within the IA Activity	- Full Access to the Organization’s Information, Assets and People - Reporting Relationships Established
Level 1 Initial	No specific Key Process Areas; Ad hoc or unstructured; Isolated single audits or reviews of documents and transactions for accuracy and compliance; Outputs dependent upon the skills of the specific person holding the position; No professional practices established other than those provided by professional associations; Funding approval by management, as needed; Absence of infrastructure; Auditors are likely part of a larger organizational unit; Institutional capability is not developed.					

Analysis and Findings

Both case studies discussed in this research were taken place in East Coast Region of Malaysia.

Case Study A

Case study A (CSA) is an internal audit unit at state level (PSA). CSA has been established since 2001. The establishment of the internal audit unit is according to the mandate of Treasury Circular PS 3.1/2013 and PS 3.2/2013. CSA is responsible to other state governments departments and agencies that do not have their own internal auditors as stated in PS3/1/2013. At the moment, there are 38 of departments under purview of CSA. The vision of the unit is to provide an efficient audit services to enhance the financial management accountability of agencies under the administration of the State Government while its missions are to conduct audits in a fair and professional manner towards enhancing the financial management accountability of agencies under the administration of the State Government. The objective of the unit is to assist agencies under the State Government Administration in achieving stipulated goals and improve the level of accountability in financial management.

According to the Designation Approval Letter N153/2007 dated 31 October 2007, it was stipulated that five staffing positions in CSA has been approved. In 2015, 10 additional posts through Designation Approval Letter N105/2015 dated 29 December 2015 have been approved. These 15 audit staffs has the highest education level is degree (two staffs) and others are secondary school. None of the audit staffs has the professional accounting qualification except of the head. On average, the years of experience of the internal audit staffs are three to less than six years. The head of internal audit unit has to report functionally and operationally to the State Secretary Officer. Figure 4.2 shows the organizational chart of CSA.

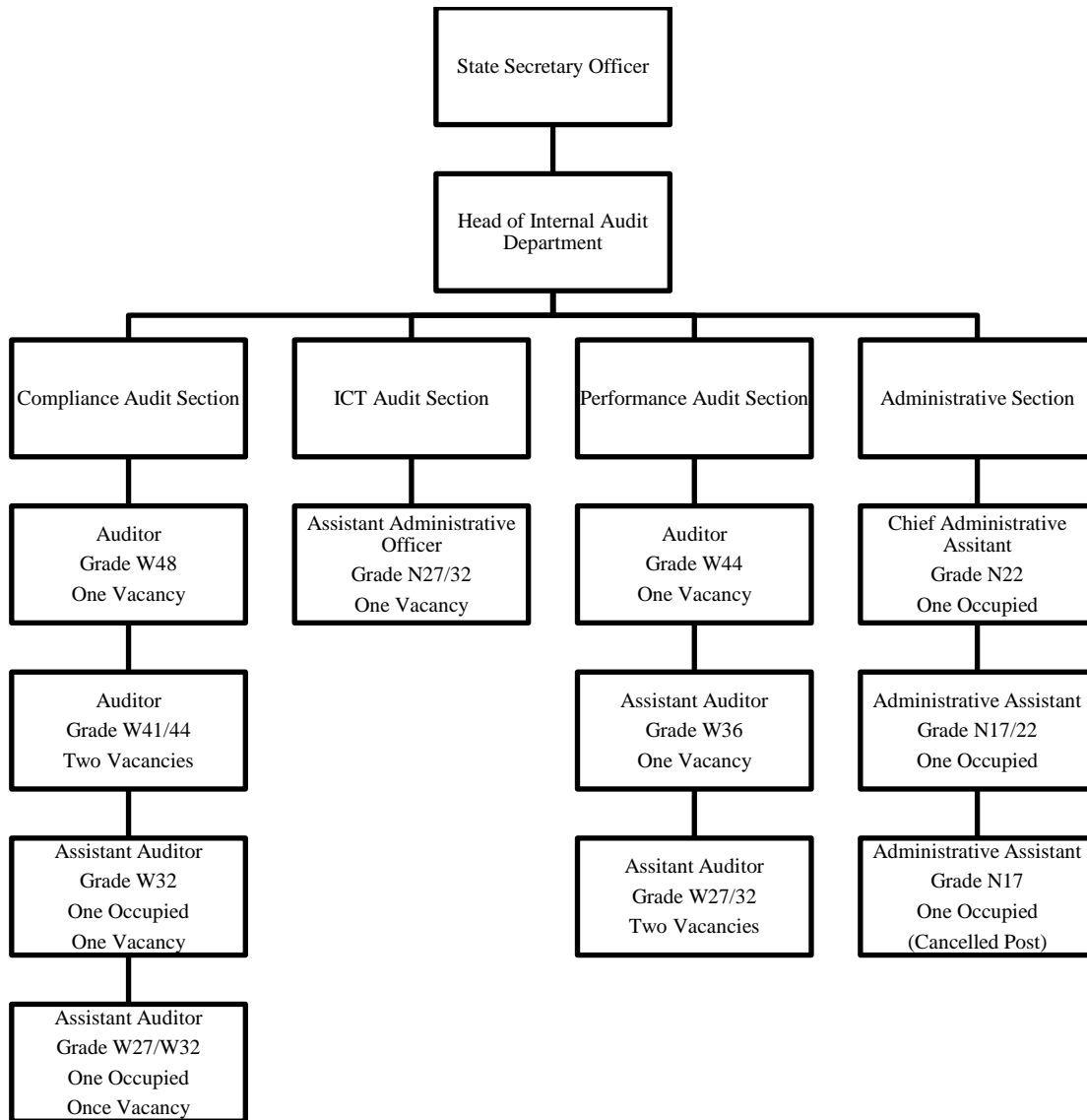


Figure 4.2. Organizational chart of internal audit unit of CSA. Adapted from Internal Audit Annual Report 2015 of Public Sector A.

Case Study B

Case study B (CSB) is an internal audit division from one of the state statutory body organizations (PSB). PSB serves as the foundation to further the advancement of education, sports, culture and expand opportunities for education among citizens in the State. PSB aims to be the organization that is a catalyst for the development of world-class human capital which is important

for the successful of Vision 2020. There are four subsidiaries under PSB which are basically related to plantation, mining and education with 82 staffs altogether.

CSB i.e. the internal audit division of PSB was initially started in 2008 where the warrant for the post of head of internal audit and assistant auditor were issued. Until 2010, there were no personnel officially appointed to fulfil the positions even though the National Audit Department had filed this issue in their audit for Accountability Index Rating. In 2010, the head of internal audit was elected and the internal audit division started to build up their roles and responsibilities with the help of head of internal audit from PSA mentioned in previous case study. Until recently, the proper nomination for the Audit Committee is yet to be endorsed by the Board of Committee due to the replacement of new Chief Executive Officer. Nevertheless, the current CEO gives full autonomy for the head of internal auditor to carry out auditing task due to the limited number of staffs. Operationally, head of internal audit division of CSB is reporting directly to the Chief Executive Officer. Administratively, the head of internal audit division of CSB is still at the level of assistant manager. Thus, she required to report to the head of department.

In 2014, the State Secretary Officer has given the instruction to establish the integrity unit in conjunction with the mandate given by the Prime Minister's Directive No. 1, which is the establishment of the Integrity and Governance Committee (JITU) in all ministries, state secretaries, departments and agencies in ministry. In a clause instructed by the State Secretary Officer, for the state departments and statutory bodies without the human resource for appointment of new head of integrity unit, the head of internal audit unit must play the respective role. Since then, the head of internal audit division of PSB also serves as the chief integrity officer. Besides that, she is also given another portfolio that is to look after the investment division of PSA. Table 4.1 summarizes the overall findings from both case studies.

Prime Minister Directive No. 1 of 2009

Table 4.1

Summary of Findings for Case Studies A and B

Elements	Case Study A	Case Study B
Type of Organisation	State Government	Statutory Body
Head of Internal Audit	Male	Female
Education Level	Bachelor Degree	Master Degree
Professional Certificate	None	Association of Chartered Certified Accountants (ACCA) UK
Membership of Institute of Internal Auditor (IIA)	Yes (since 2010)	No
Operational Reporting level	State Secretary Officer	Chief Executive Officer
Administrative Reporting Level	State Secretary Officer	Head of Department
Internal Audit Establishment	Department	Division
Portfolio	2001	2010
Internal Audit Staff	Solely internal audit	Internal audit, integrity unit and investment unit
Average Years of Experience	5	2
Existence of Audit Committee	3 to less than 6 years	6 to less than 9 years
	Yes	No

Analysis and Discussion of Internal Audit Capability

From the analysis of internal audit capability matrix using the questionnaire answered by both head of internal auditor of CSA and CSB, it is found that internal audit unit in PSA obtained higher capability level of Level 2 (infrastructure) with overall percentage capability of 57%. CSA shows that it achieves level 5 (optimized) for all four dimensions of professional practices, performance management and accountability, organizational relationships and culture as well as governance structure. However, it only achieves level 2 (infrastructure) for both dimensions of services and role of internal audit and people management .

On the other hand, CSB only achieves level 5 (optimized) for dimension of performance management and accountability. For dimension of governance structure, CSB achieves level 3 (integrated). Other three dimensions of services and role of internal audit, professional practices

and organizational relationships and culture achieves level 2 (infrastructure). However, CSB scores poorly for people management dimension which is only level 1 (initial) which resulting the overall capability of only level 1 (initial) with overall percentage of 52%. Table 4.2 and 4.3 illustrate the mapping of result for overall capability level and percentage of CSA and CSB as well as the result obtained for each dimension respectively.

From the following comparison in Figure 4.3, it shows that both cases have achieved low level of capability for the first three dimensions of services and role of internal audit, people management and professional practices. However, CSB achieved higher percentage of services and role of internal audit compared to CSA. Even though both score capability level 5 of performance management and accountability dimension, they do not achieved 100% of key process areas (KPAs).

Table 4.2
 Analysis of Internal Audit Capability of Internal Audit Unit in PSA

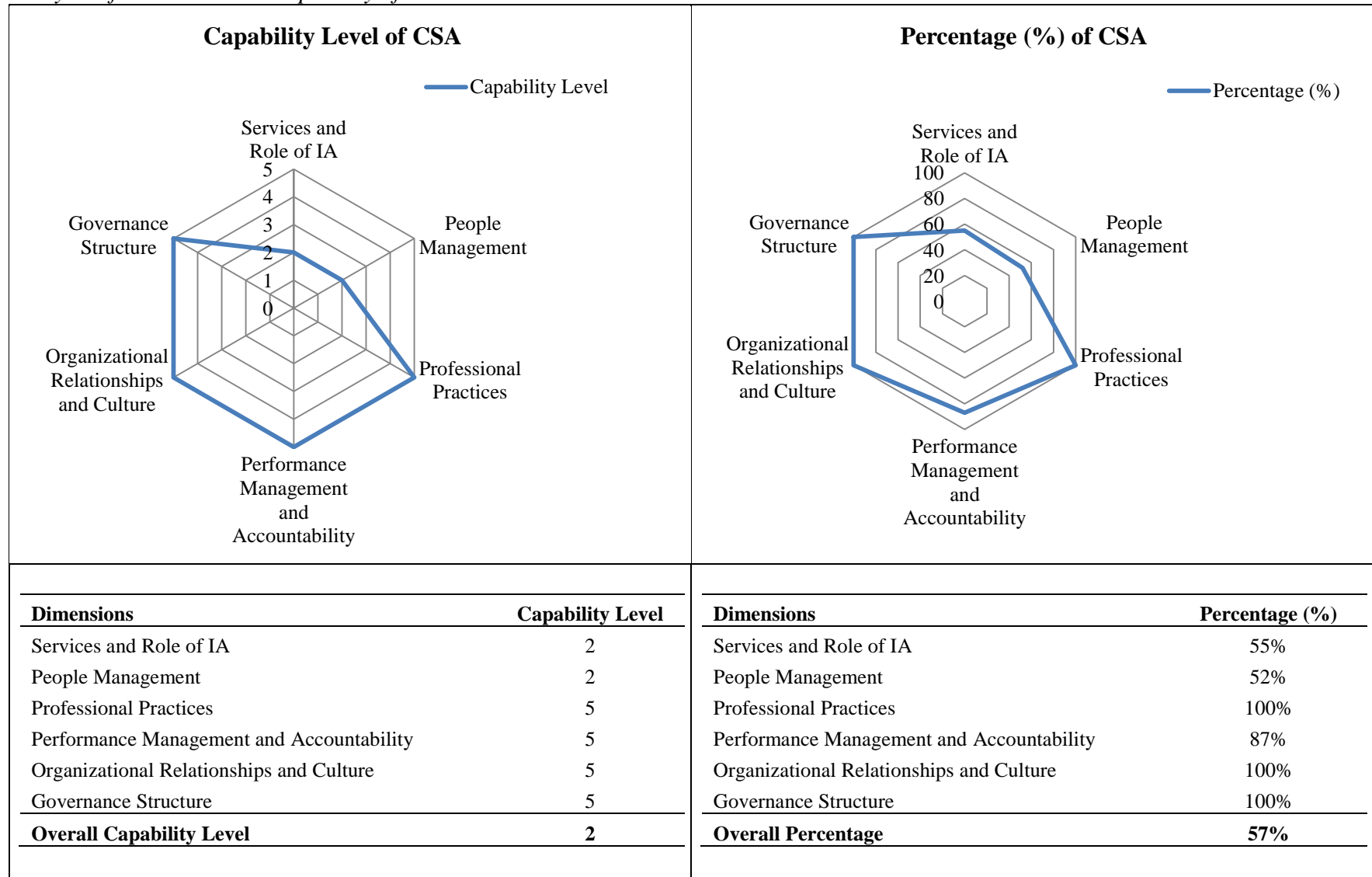
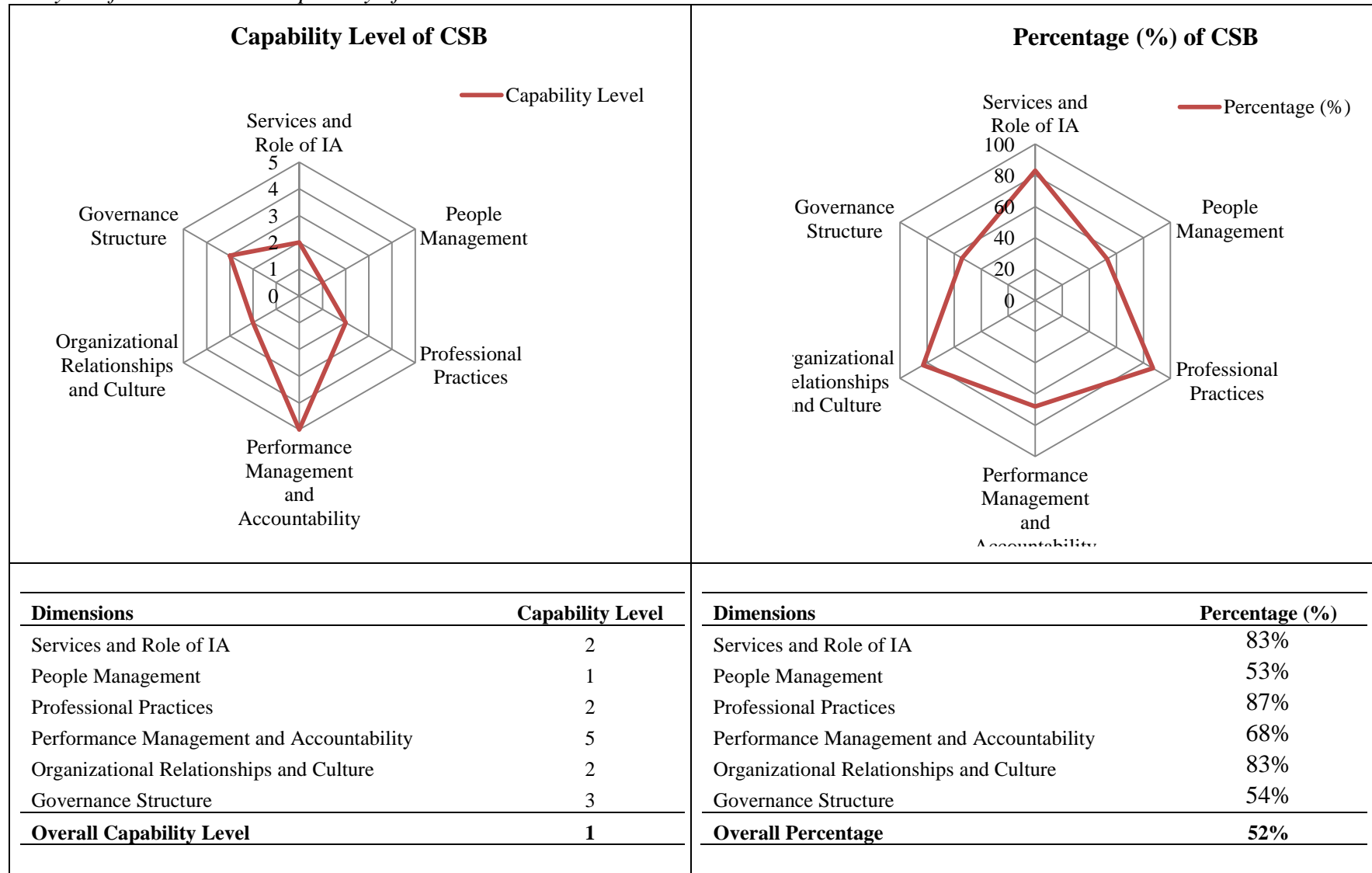
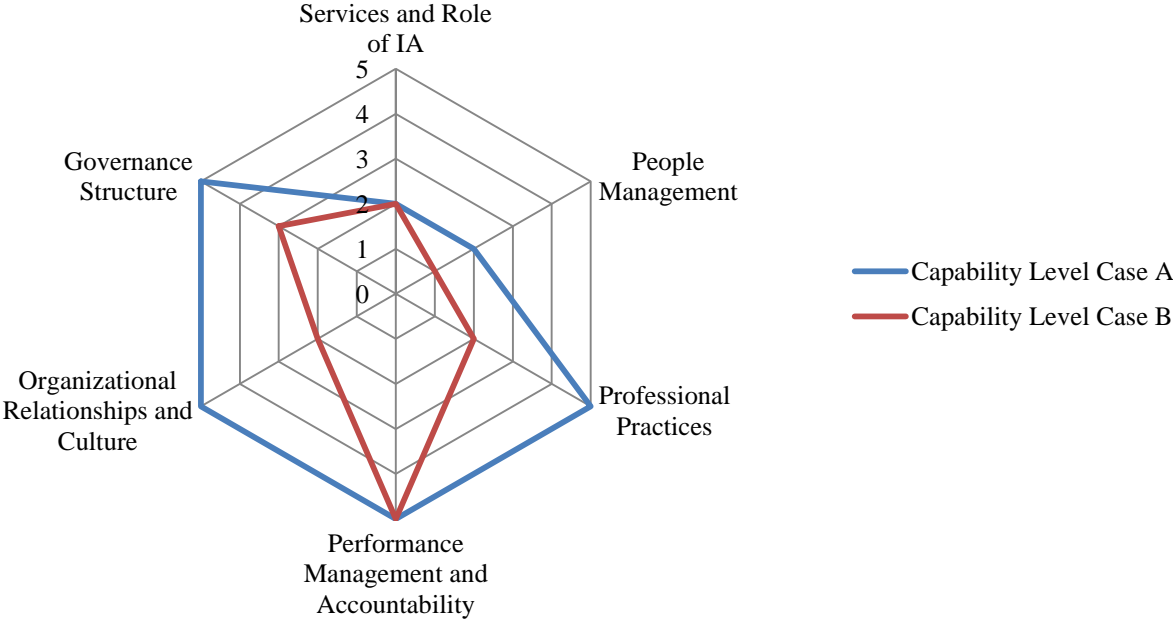


Table 4.3
 Analysis of Internal Audit Capability of Internal Audit Division in PSB

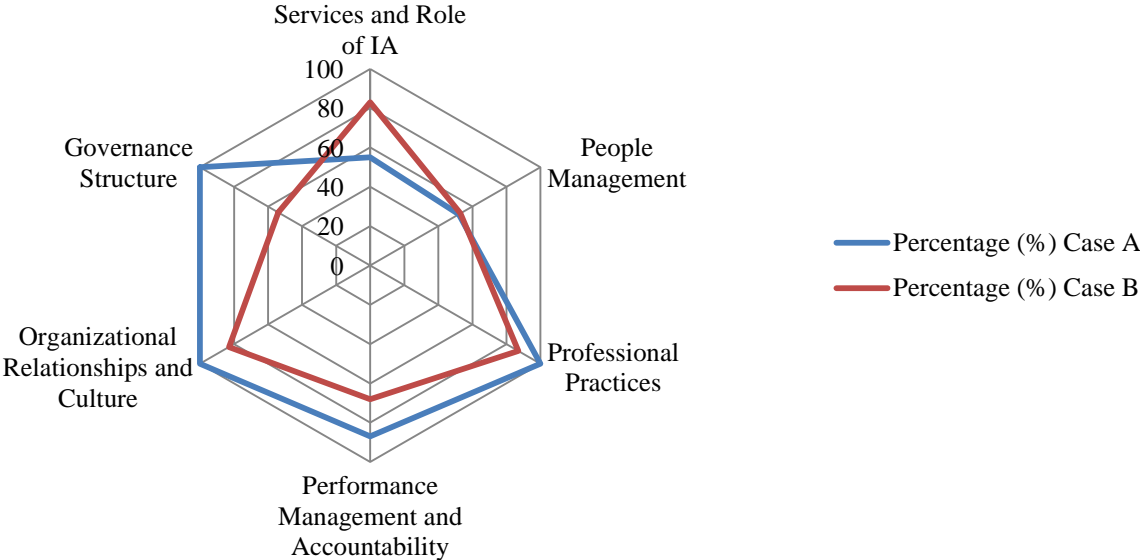


Capability Level of CSA and CSB



(a)

Percentage Achievement of Key Process Areas



(b)

Figure 4.3. Comparison of Capability Level (a) and Percentage of Key Process Areas (b) achieved by CSA and CSB.

The result obtained might be due to the nature of both organizations. CSA is a state level organization which has been established since 2001 compared to CSB, a statutory body organization which has only been established in 2010. The requirement of establishment of internal audit unit in state level is stricter according to Treasury Circular PS 3.1 and PS 3.2 2013. On top of that, CSB has not yet officially endorsed the Audit Committee which would result in the difference of level of independence. According to the Attribute Standards of 1100 IPPF (Independence and Objectivity), the internal audit activity should be independent, and internal auditors should be objective in performing their work. The chief audit executive (CAE) should report functionally to the board and administratively to the chief executive officer of the organization (Institute of Internal Auditors Malaysia, 2008).

Besides that, IPPF Standard 1130 has also stated that internal auditor should refrain from accepting responsibility for non-audit, operational functions or duties; as happened in CSB where the head of internal audit division has also carried out other functions which is as head of integrity unit and part of investment unit for PSB. Acceptance of such responsibilities can impair independence and objectivity (Institute of Internal Auditors Malaysia, 2008). Even though in IPPF Standard 1210 has stated that the internal auditors should have sufficient knowledge to identify the indicators of fraud and they are responsible for assisting the companies to prevent fraud, but it is not expected to have the expertise of a person whose primary responsibility is detecting and investigating fraud. Internal auditors should examine and evaluate the adequacy and effectiveness of their internal control's system.

This is because internal control is the principal mechanism for preventing fraud (Institute of Internal Auditors Malaysia, 2008). Management is responsible for resolving fraud incidents, not internal auditors. Internal auditors should assess the facts of investigations and advise management relating to remediation of control weaknesses that lead to the fraud. They can also advise management in the design of a communication strategy and tactical plan

(Institute of Internal Auditors Malaysia, 2008), especially with management accountant of the organizations.

Other factor that may cause such result is related to the professional qualification and membership. Since the IACM is developed by the Institute of Internal Auditors, the requirement of being the IIA membership is one of the elements in Key Process Areas (KPA) of people management dimension. Neither head nor staffs of internal audit CSB have such membership which impacts the capability level of this dimension. However, head of internal audit CSB was able to carry out her task well with the qualification of ACCA and assistance from the head of internal audit CSA at the earlier stage of setting up the internal audit department.

According to Standard 2030 IPPF related to resource management – the CAE should ensure that the internal audit resources are appropriate, sufficient, and effectively deployed to achieve the audit plan. Staffing plans and financial budgets, including the number of auditors and the knowledge, skills, and other competencies required to perform the audit work, should be determined from engagement work schedules, administrative activities, education and training requirements, and audit research and development efforts (Institute of Internal Auditors Malaysia, 2008). However, both CSA and CSB have lack of human resource which may impede their performance of audit services. This is one of the reason for ineffective internal audit unit of Malaysian public sector organizations (Ahmad, Othman, & Othman, 2010; Ahmad et al., 2009; A. M. Ali et al., 2009, 2012, 2007; A. M. Ali, Saad, Khalid, Sulaiman, & Gloeck, 2011).

According to the interview conducted, the issue of staffing might happen due to the policy where it is clearly stated that all internal auditor warrant or appointment in all government entities should only be authorized by National Audit Department. Thus, the utilization of manpower is restricted based on the availability of staff from NAD.

Recommendations

Based on the case studies, the most intriguing facts that clearly impact the function of internal audit might be the human resource and the portfolio or job scope of internal auditors. Thus, it is highly recommended that the internal audit unit should only focus on their auditing services, unless, they have enough staff to do otherwise. On the other hand, CSA should focus on how to advance the capability level of the following dimensions i.e. services and roles of internal audit and professional practices. They may provide individual internal audit reports and conduct the governance, risk management, and control processes. The audit staff of CSA should obtain professional certifications in the internal audit profession.

For CSB, they should focus on enhancing all dimensions except for performance management and accountability. As the IACM uses the building-block methodology as shown in Table 3.1, the IA unit can easily analyze and choose the weak KPAs to focus in order to proceed to the next capability level. They may conduct the advisory services; become members of IIA; as well as develop team building within and across the organization. The most crucial step that CSB should take is to obtain the endorsement for Audit Committee which has yet to be done.

Limitations and Conclusions

In-depth studies with more generalize method and bigger sample size should be conducted. This is because this study employed case study method focusing on two organizations only, which result could not be generalized to all Malaysian public sector organizations. In summary, the IACM model is a framework to identify the fundamental requirements for an effective IA function in the public sector. The model will be able to help assist the Malaysian public sector IA units in identifying the KPAs that are needed to establish

in order to build a strong foundation of the capability level prior moving to the next. The outcomes of the IACM can then be utilized as a communication tool among the organisation, its stakeholders, at all government levels, and internationally to advocate the essential IA roles (Institute of Internal Auditors Research Foundation, 2009). If the internal audit unit able to perform effectively, the management accounting is rest assured with the control mechanism within company. Indirectly, the organizations can perform well effectively, efficiently, economically and ethically (4Es).

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