

Conference Paper

An Analysis of Internal Audit Investment Among Top Malaysian Listed Companies

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Abstract

The importance of internal audit function in improving the company's internal control risk management and corporate governance has been emphasized in the Malaysian Code of Corporate Governance (MCCG) and Bursa Malaysia Listing Requirements. Based on the Listing Requirements, Malaysian listed companies are required to establish the internal audit function, which is independent and this function must be supervised by the audit committee. Although the importance of internal audit function has been highlighted in various code of corporate governance, little is known about the investment made by the company in internal audit activity. This study capitalizes the publicly available data on internal audit cost and the type of internal function provider in Malaysia setting. The primary purpose of this study is to describe internal audit practices, especially on the internal audit budget in Malaysia for the year 2017 for top 300 companies. Based on the descriptive analysis, it is found that the internal audit fee is relatively lower than the cost of external audit and most of the companies' internal audit function was carried out by in house teams. Also, the benefit from economies of scale is less pronounced in internal audit as compared to external audit services. Some further analyses were also conducted, and the article is ended recommendations for future research to be undertaken in investigating the internal importance audit in Malaysia.

Keywords: internal audit function, budget, in-house, outsourcing, corporate governance.

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1. Introduction

The auditor plays a vital role in minimizing and detecting various types of fraud and other accounting malpractices. There are two types of audit, namely, external audit, and internal audit. An external auditor statutory audit is the examination of a company's financial statement to ensure that the statement gives true and fair view. In Malaysia, under Section 169 (4), the Companies Act 2016 asks the company's financial statements to be audited before presented in annual general meeting. This is will enhance the credibility of financial statements, thus, help the users to make sound business or investment decisions.

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As compared to the external audit, internal audit practices are not compulsory for all types of Malaysian companies. The need for internal audit practices is not specified in the Companies Act 2016.

However, the establishment of internal audit function is conventional in Malaysia corporate landscape, especially for big size companies. Under the Malaysian Code on Corporate Governance or MCCG (2007), the role of the internal audit has been emphasized and highlighted. MCCG has called on big companies to create an internal audit function. Furthermore, the issue of internal audits is being addressed by Bursa Malaysia Listing Requirements. Based on these two significant guidelines, the internal audit also has a specific role in improving the quality of corporate governance.

The Institute of Internal Auditor defines internal audit as:

“Internal auditing is an independent, objective assurance and consulting activity designed to add value and improve an organization’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” (Institute of Internal Auditors, 2019).

Based on the above definition, apart from the audit committee function, internal audit is one of internal governance mechanism that serves to improve the company’s efficiency and effectiveness. Further, the audit committee and internal audit function are closely related, and the committee is responsible for monitoring internal audit activity. Among the functions of the audit committee on internal audits, based on MCCG (2017) in Guidance Practice 10.1, are to decide on the: (i) selection and termination of internal auditor, (ii) area need to be covered (iii) assessment of performance (iv) the cost allocation.

As one of the functions of the audit committee is to decide the budget for internal audit function, it is implied that the successfulness of internal audit operation will be partly determined by the audit committee. In general, higher cost allocation on internal audit activity allowed the internal audit team to properly discharge their duties. The investment in internal audit function also will determine the extensity of internal audit activity. The arisen questions are how much the allocation is provided by the audit committee for internal audit activity and did Malaysian companies willing to allocate high investment for this internal monitoring cost?

Previous studies have revealed the amount of budget for internal audit activity (Barua, Rama & Sharma, 2010; Wan Husin, Bamahros & Shukeri, 2018). However, the disclosure

and analysis of internal audit fee in those studies are limited, and it is hard to determine the importance of internal audit as an internal monitoring tool in Malaysia. The analysis is vital to enhance the understanding of the internal audit market structure and how the company perceives this internal governance as compared to external monitoring mechanism (e.g., external audit). Several studies on Malaysia external audit market structure have been carried out before (Che Ahmad, Houghton & Mohamad Yusof, 2006; Mohamad-Nor & Abidin, 2015); unfortunately none of the studies explain the structure of local internal audit fee. This finding also helps shareholders to assess how well companies are willing to invest in this activity, and this can illustrate the extent of the company's seriousness to protect the rights of the shareholders.

Therefore, the main objective of this study is to (i) evaluate the amount of the allocation of internal audit activities; (ii) compare the internal audit investment against the size of the company, and (iii) analyze the internal audit cost based on the type of internal audit function provider.

This study will use the 300 largest companies in Malaysia in 2017. In order to answer the research objectives, the collected data will be analyzed using descriptive analysis.

2. Literature Review

Internal auditing is one of the critical elements in corporate governance ecosystem. Internal audit plays a role in ensuring that internal control, risk management, and corporate governance aspects are effective and efficient. The internal audit function provides consultation services and assists the company in offering independence assurance to the organization (Pickett & Pickett, 2005).

There are several theories that can explain the importance of internal audit to the company. Among the most commonly used theories is Agency theory. The establishment of an internal audit function by a company is to ensure that financial, internal control, and risk management activities are always in place. In doing so, internal audits function able to ensure that the business process executed is appropriate and complied with relevant rules and regulations. Also, internal audit functions act as a monitoring mechanism for internal business functions and would reduce business malpractice within the company. Thus, the internal audit can assist in enhancing the governance process, and the business entity is properly managed as well. By doing so, the interests of shareholders as owners of the company will be preserved.

The internal audit function/unit is accountable to the audit committee. Accordingly, any internal audit activity, including matters relating to the provision for internal audit

investment, will be monitored and determined by the audit committee. The establishment of an internal audit is one of the forms of agency cost that has to be incurred to ensure that the relationship between the agent (company management) and the principal (company holder) is aligned and the agent (management of the company) always prioritizes the principal's interest.

In Malaysia, there are several rules and regulations that have been enacted in relation to the internal audit function. The Malaysian Code on Corporate Governance (2017) paragraph 10.2 states that:

“The board should disclose:

- *whether internal audit personnel are free from any relationships or conflicts of interest, which could impair their objectivity and independence;*
- *the number of resources in the internal audit department;*
- *name and qualification of the person responsible for internal audit; and*
- *whether the internal audit function is carried out by a recognised framework.”*

Further, in MCCG (2017) paragraph 10.1, it is stated that:

“In developing the scope of the internal audit function, the Audit Committee should satisfy itself that:

- *the person responsible for the internal audit has relevant experience, sufficient standing, and authority to enable him to discharge his functions effectively;*
- *internal audit has sufficient resources and can access information to enable it to carry out its role effectively; and*
- *the personnel assigned to undertake internal audit have the necessary competence, experience, and resources to carry out the function effectively.”*

Apart from MCCG (2017), the importance of internal audit function also highlighted in Bursa Malaysia Listing Requirements. Paragraph 15.27 of Listing Requirements mentioned that:

1. *“A listed issuer must establish an internal audit function which is independent of the activities it audits*
2. *A listed issuer must ensure its internal audit function reports directly to the audit committee.”*

Based on the above provisions, it is clear that authorities in Malaysia regard the existence of internal audit function as an essential matter, and public listed companies must always abide by it. However, when compared to the MCCG (2017) and Bursa Malaysia Listing Requirements (BMLR), it is found there is little guidance given by BMLR to the company to run its internal audit activity. This will give the flexibility to a listed company to carry out their internal audit activities. On the other hand, there will be inconsistencies in the internal audit practices, and the various forms of practice in the internal audit activity may be observable.

There are few studies carried out in investigating internal audit activity, especially on the investment in internal audit. For example, Barua et al. (2010) examine the relationship between the characteristics of the audit committee and the internal audit cost in the USA. Their study finds that there are complementary or substitute effects between internal audit function with the characteristics of the audit committee.

Working in the same line, Al-dhamari, Almagdoub, and Al-Gamrh (2018) investigate the relationship between the characteristics of the audit committee and the internal audit cost in Malaysia. Based on the 96 companies from the year 2012 to 2014, their results suggest that audit committee characteristics have a significant influence on internal audit costs. They also show that the average internal audit cost is RM3.986 million, the minimum is RM15,000, and the maximum is RM65 million. Approximately 17% of the sample survey has outsourced the internal audit function.

Meanwhile, using a sample of 651 Malaysian listed companies in the year 2013, Wan Hussin, Bamahros and Shukeri (2018) show that the average internal audit cost is RM436,560 with the minimum fee is RM2,000, and the maximum is RM39.7 million. Also, about 39% of companies have carried out an internal audit function internally. The reported mean is lower than disclosed by AL-Qadasi, Abidin, and Al-Jaifi (2019). Based on the observation for 2,176 companies from 2009 to 2012, AL-Qadasi et al. (2019) reveal that the mean for internal audit fee is RM329,587.

Based on the studies mentioned above, the internal audit plays a dominant role in enhancing corporate governance practices. Nevertheless, the quality of internal audit practices should be further studied, and it is partly determined by the type of internal audit function provider and the cost of internal audit (AL-Qadasi et al., 2019). This two information found to be missing in current internal audit literature and warrant further examination.

3. Methodology

The study employed a sample of the top 300 companies (excluding related financial companies) based on market capitalization listed on Bursa Malaysia. Data is obtained from the company's annual report and Datastream database. The year 2017 was selected since it is the latest data available. The collected data consist of internal audit costs, types of internal audit function providers, external audit costs, and company size (total assets). Data were then analyzed using descriptive analysis. Three primary analyses were performed namely: (i) determining the average internal audit cost rates against company's size; (ii) analyzing internal audit cost based on the type of internal audit provider; and (iii) analyzing internal audit cost based on the type of external auditors.

4. Results and Discussion

4.1. Descriptive statistics

Table 1 presents total internal audit (IA) cost, external audit (EA) costs, and the differences between these two costs.

TABLE 1: Total Internal and External Audit Fee.

	IA fee (a)	EA fee (b)	Difference (a-b)
Total Fees	323,450,693.80	409,083,000.80	-85,632,307.00
Mean	1,078,168.98	1,363,000.13	-284,831.15
Minimum	7,500	28,000	-20,500.00
Maximum	44,200,000	33,300,000	10,900,000.00

The above table shows descriptive statistics on the cost of internal and external audit. Based on 300 samples, the total internal audit cost in 2017 is about RM323.450 million. This figure is lower than the external audit cost incurred by the company amounted to RM409 million. On average, the company spends RM1.07 million on the internal audit activity and RM1.36 million for the audit of the financial statements. Concerning the mean of IA fees, the reported figure is lower than earlier study as disclosed by Al-dhamari et al. (2018) (i.e., RM3.986 million). The minimum amount for internal (external) audit costs is RM7,500 (RM28000). However, for maximum rates, the expenditure on internal audit is higher than the external audit activity of RM10.9 million.

4.2. Rate of audit fees per unit of size

Further analysis is conducted to determine the effect of the company size on the internal audit cost rate. This analysis explains the influence of the company’s size on the internal audit investment. Based on the previous studies (Abidin, Goodacre & Beattie, 2010, Mohamad-Nor & Abidin, 2015), the size of the company is commonly referred to the total assets. Besides, total assets indicate the complexity of the company’s operations. In the present study, the total number of sample size (i.e., 300) are divided into ten groups, based on the total assets of a company. Size 1 represents the smallest size, and size 10 is the largest size of the company. The internal audit cost per RM1,000 of total assets is calculated for each company, and the results are shown in the following tables and graphs.

TABLE 2: Mean Internal Audit Fee per RM'000 Total Assets.

Year/Size	Small									Large
	1	2	3	4	5	6	7	8	9	10
2017	0.31	0.23	0.27	0.31	0.22	0.38	0.26	0.20	0.16	0.20



Figure 1: Mean IA Fee per RM'000 Total Assets.

Table 2 shows the mean of internal audit fee per RM'000 total assets. The graph in Figure 1 demonstrates that the mean rate of internal audit is inconsistent against the size of the company. The rate shows a decreasing pattern from size 1 to 2 but starts to increase from size 2 to 4. The fee rate is lower for middle size companies (size

5). However, the rate has increased dramatically to almost RM0.40 for companies size between 5 to 6. Interestingly, the rate shows a declining pattern from size 6 to 9. After that, the average internal audit fee rate per RM'000 total assets was found to be higher (RM0.20) for big size companies (size 10).

The following table demonstrates the rate of external audit fees against the company's size.

TABLE 3: Mean EA Fee per RM'000 Total Assets.

Year/Size	Small									Large
	1	2	3	4	5	6	7	8	9	10
2017	0.82	0.51	0.58	0.36	0.38	0.50	0.33	0.29	0.26	0.21

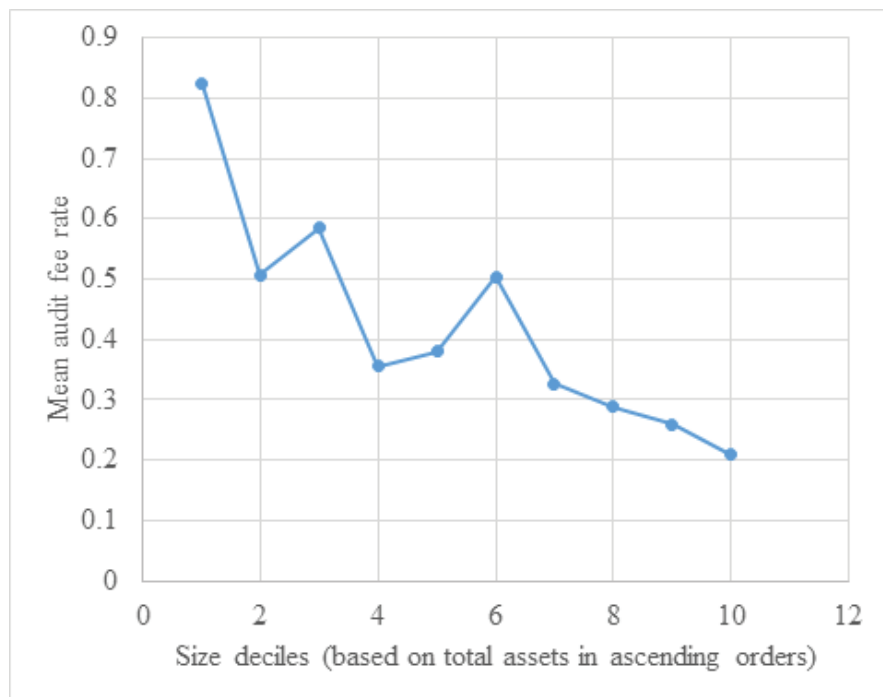


Figure 2: Mean External Audit Fee per RM'000 Total Assets.

Figure 2 shows the mean of external audit fee per RM'000 total assets. Based on Figure 2, the mean rate is inconsistent between size 1 to 6. However starting from size six onwards, the rate has started to decline. The rate has decreased from RM0.50 (size 6) to RM0.20 (size 10). The reduction is in line with the findings of Mohamad-Nor and Abidin (2010), where the larger the company size, the lower their external audit fee rates. This suggests that after size six, the effect economies of scale is more pronounced. Indirectly, this explains that the benefits of economies are generally only enjoyed by a very large company.

The above tables (Table 2 and 3) indicates that the rates for internal audit fees are lower (between RM0.10 and RM0.40) than the rates for external audit (0.20 to RM0.80) against the total assets of the company. Based on Figures 2 and 3, the pattern of graphs for both types of audit services are different. As for internal audit cost, the pattern of the graph is unstable where there is fluctuation rate of the mean from one size to another size of companies. Meanwhile, for external audit cost, the pattern is slightly stable, and there is a reduction in the cost of the big size of companies. The fee reduction suggested that an economy of scale is achieved.

4.3. Audit function as a service provider

The following section analyzes the internal audit cost based on the type of audit service provider (internal and external audit services). Table 4 reports internal audit investment based on the type of internal audit function provider.

TABLE 4: Internal Audit Investment based on the Type of Internal Audit Function Provider.

Type of IA provider	Number of companies (%)	Total IA fees (RM)	Mean IA fees (RM)	Mean size of companies (RM)	% auditee of Big 4* firms
In-house	187 (62%)	310,181,090.40	1,658,722	7,540,838,000	78%
Outsource/co-source	113 (38%)	26,138,756.91	117,430	1,075,930,000	42%

* type of external auditor; consist of Deloitte or Ernst & Young or KPMG or PricewaterhouseCoopers.

Based on Table 4, more than 60% of the sample carried out the activity internally as compared to almost 38% of companies that outsources internal audit function to the third party. The high number of companies carried out internal audit function internally in line with the finding revealed by Al-dhamari et al. (2018) that many of the big companies have their own in-house internal audit teams. The costs incurred for internally conducted internal audit activities are RM310 million, and on average the company allocates RM1.66 million for internal audit activity. It is higher than companies which outsource their internal audit activity (RM0.12 million). In terms of the company’s size, the company that conducting its internal audit function is larger than the company that has appointed external firms. Meanwhile, most of the companies with their own in-house internal audit department hired Big Four firms as their external auditor (78%).

Table 5 displays internal audit costs analysis based on the type of auditee (i.e., auditee of Big Four Firms vs. non-Big Four firms

The result displayed in Table 5 divided companies into two categories; auditee of Big Four firms and non Big Four firms. A total of 201 companies audited by Big Four

TABLE 5: Internal Audit Investment based on the Type of External Audit Firms.

Type of EA provider	Number of auditees (%)	Total IA fees (RM)	Mean IA fees (RM)	Mean EA fees (RM)	Mean size of the auditee (RM)	% companies outsource/co-source IA function
Non Big 4	99 (33%)	30,400,608	307,077	511,000	2,385,106,000	66%
Big 4	201 (67%)	293,050,086	1,457,961	1,783,000	6,445,727,000	24%

firms and the total internal audit fee amounted to RM300 million. The fee is about ten times higher than the amount of internal audit fee involving a sample of non-Big Four firms. The company, which has appointed the Big Four, also allocated higher budgets for internal audit activity (RM1.4 million) compared to companies that have appointed non-Big Four firms. In terms of company size, companies audited by Big Four firms are almost three times bigger than non-Big Four firms, and it is in tandem with finding by Mohamad-Nor & Abidin (2015). Also, only 23% of Big Four auditee appointed external firms to carry out internal audit activities. This is lower than the non-Big Four auditees; which 65% of the company has outsourced the internal audit function.

The findings of this study and reviews from prior literature indicate that internal audit has become a mandatory and routine activity for every Malaysian listed company. The existence of an internal audit function will further strengthen the company's internal monitoring activities. Despite its existence, the effectiveness of the internal audit function and its contribution to the company's operations still requires further research. The present study shows that the allocation of costs for this activity is relatively low compared to external audit costs. Low provisions will affect the nature, scope, and quality of the audit conducted by the internal auditors. This can lead to the purpose of the establishment of an internal audit function challenging to be achieved, i.e. to ensure the effectiveness of risk management and good governance practices. It is argued that the internal audit activity is still carrying out the traditional internal audit function which is to assist external auditor activities, emphasizing on a fault-finding mission, focus on audit processes and ensure rules and regulations comply. Such activities will limit the contribution of internal audit function as a strategic partner and a provider of quality assurance providers to various critical risks within the company. Lack of attention to risk monitoring and management activities could lead to business risks not being well-managed, effective risk management strategies can not be applied and increased risk governance factor. As a result, the company's governance structure and the process will be weak and might affect the company's performance and sustainability.

5. Conclusion and Implications

This study investigates internal audit function activity in Malaysian, especially on the internal audit investment. The sample of the study comprised of the top 300 companies listed on the Bursa Malaysia in 2017. The findings show that the company's total investment in internal audit costs is RM323 million. Meanwhile, the average internal audit cost is RM1.08 million.

The study revealed that the average cost of internal audit cost per RM1,000 of company's assets is between RM0.10 to RM0.40. The audit fee rate is inconsistent with the size of the company. There is an increase and decrease for each internal audit rate for a particular size of the company. This may be due to the fact that the stock exchange regulations merely require the setting up of internal audit function among companies and no specific direction is given on the how the cost of internal audit needs to be allocated. Besides, the company has the discretion to decide who is their internal audit function provider. Thus, it is not surprising that more than half of the sample carried out their internal audit function internally.

Also, the study reveals that the internal audit function carried out by an in-house audit team is higher than outsourced to firms. Again, this might reflect the Bursa Malaysia Listing Requirement, which is silent on whom should or which party should perform this function; either in-house or outsource to the third party. The current audit practice indicates that many of the companies prefer to carry out this function internally. This can be explained by the sufficient internal audit resources available owned by big companies, and this activity is performed by skilled and experienced staff. The staff are familiar and well versed in dealing with specific business issues. Appointment of external consulting firms could delay the internal audit process since the firms need longer time to understand the background and business issues faced by a company (i.e., steep learning curve).

The findings of this study may draw some theoretical and practical implications. As internal audits are conducted by in-house internal audit teams, it will raise the question on quality of internal audit especially the aspect of the service provider's objectivity. It is perceived that the level of independence of external firm is higher than the in-house internal audit providers. This is because the in-house internal audit function is part of the company, and this potentially result in auditor's judgment will be biased. The issue of internal audit independence among outsourced firms is less pertinent since they are not salaried employed, and this would reduce the economy of a dependency problem. The issue of internal audit function objectivity is less relevant if the service provider has

a large customer base. As internal audit practices become more critical in the Malaysian corporate governance setting, relevant authorities have to formulate a comprehensive internal audit standard and procedures. This is evidenced by the average mean rate on different assets for each company size. Based on the comprehensive internal audit guideline, the internal auditors will have a better understanding of the procedures involved and the quality of the work performed both by in-house or outsource firm is comparable. Finally, the use of the term internal audit quality is a debatable issue. The indicator used to measure internal audit quality is still unresolved, and it is too early to emphasize that internally performed internal audit activity is better than outsourced firms.

The current study, however, suffers some limitations. Since the study examined listed companies on one financial year, it is suggested for future research to use the more extended study period. Thus, the pattern of internal audit cost can be clearly seen. This study also relies heavily on secondary data sources to determine the nature of internal audit practices. It is recommended that future study incorporate data from the company's annual report and interviews to gain a better understanding of the procedures involved in determining the cost of internal audit. Also, it is interesting for future research to examine the effect of this internal governance cost towards the quality of corporate practice and financial reporting. Future studies may also be carried out to determine the appropriate method for measuring internal audit quality by employing relevant theories of corporate governance.

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