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## Enterprise Risk Management (ERM) System: Implementation Problem and Role of Audit Effectiveness in Malaysian Firms

\*\*\*Waseem-Ul-Hameed<sup>1</sup>, Faiza Hashmi<sup>2</sup>, Mohsin Ali<sup>3</sup> and Muhammad Arif<sup>4</sup>

<sup>1</sup>School of Economics, Finance & Banking (SEFB), College of Business (COB)  
Universiti Utara Malaysia (UUM)

Changlun, Sintok 06010 Kedah, Universiti Utara Malaysia (UUM), Trade wind Block D, Room#335  
Ph # +923346169730, +60168570523 Email: [Expert\\_waseem@yahoo.com](mailto:Expert_waseem@yahoo.com)

<sup>2</sup>The Islamia University of Bahawalpur, Pakistan

House#423/19 Qureshi colony inside Ahmed Puri gate chowk Fawara Bahawalpur, Pakistan  
Ph # +923006844353 Email: [faizahashmi16@yahoo.com](mailto:faizahashmi16@yahoo.com)

<sup>3</sup>National College of Business Administration & Economics (NCBA&E), Bahawalpur, Pakistan  
CA-385 model town Rehman street Bahawalpur, Pakistan

Ph # +923324740976 Email: [mohsinpak@yahoo.com](mailto:mohsinpak@yahoo.com)

<sup>4</sup>National College of Business Administration & Economics (NCBA&E), Bahawalpur, Pakistan  
House # 7b, street # 01, Dilawar colony airport road Bahawalpur, Pakistan

Ph # +923136626216 Email: [khalifa.arif90@gmail.com](mailto:khalifa.arif90@gmail.com)

**ABSTRACT:** Level of risk management implementation is a core element in the success of enterprise risk management (ERM) system. However, most of the Malaysian firms are less likely to implement risk management practices. Therefore, their enterprise risk management (ERM) system is not performing well to mitigate potential risks. To resolve this problem, the current study focused on internal and external audit effectiveness. Thus, the prime objective of this study is to highlight the importance of risk management implementation with the help of internal and external effectiveness to enhance enterprise risk management (ERM). To achieve this objective three hypothesis are developed concerning the relationship of the audit with the level of risk management implementation, and the relationship between the level of risk management implementation and enterprise risk management (ERM) system. It is found that internal and external audit has a significant positive relationship with the level of risk management implementation. Moreover, it is found that level of risk management implementation has a significant positive relationship with enterprise risk management (ERM) system. Finally, this study can help Malaysian firms to develop a better enterprise risk management (ERM) system by mitigating the problem of risk management implementation.

**Keywords:** Enterprise Risk Management (ERM), Risk Management Implementation, Internal Audit, External Audit

### 1. INTRODUCTION

Enterprise Risk Management (ERM) now becomes a central concern in all industries (Soltanizadeh et al., 2014). It is an organization-wide process which detects various potential adverse events which can harm the firm and provides different strategies to manage these adverse events (see, for example, Beasley *et al.*, 2009). Therefore, enterprise risk management (ERM) is one of the vital process to mitigate the potential risk. Because of the high

importance of enterprise risk management (ERM), most of the prior studies (e.g., Cohen, Krishnamoorthy & Wright, 2017; Dabari & Saidin, 2014; Manab & Kassim, 2012; Nocco & Stulz, 2006) focused on this area, however, literature is missing to highlight the problem related to level of risk management implementation in Malaysian firms.

Implementation of risk management practices is most important in any firm. Because implementation of Enterprise Risk Management (ERM) enables management to identify different risks, manage as well as respond to risks effectively and efficiently (Beasley, Branson, & Hancock, 2008a). However, most of the firms in Malaysia facing the implementation problem. Enterprise risk management (ERM) system exists in Malaysian firms, but these firms are unable to implement risk management practices adequately. Because of implementation problems, most of the Malaysian firms are not performing in a right way. As Enterprise Risk Management (ERM) creates value through its significant impact on firms at both macro or company-wide level and micro or business-unit level (Nocco & Stulz, 2006).

The Malaysian economy is third fastest growing the economy by gross domestic product (GDP) among the countries of South East Asian, and worldwide it is ranked as 28th with 5.6% GDP growth rate (Soltanizadeh et al., 2014). The author further explained that in the financial crisis of 1997, Malaysian firms affected severely due to the poor risk management practices. In 1999, Bank Negara Malaysia revealed that these financial crises had caused approximately more than RM45 billion reductions in their total assets. This situation shows that implementation of risk management practices is improper in Malaysian firms. No doubt the



global financial crisis (GFC) of 2008 highlights the significance of enterprise risk management practices (Arena et al., 2010; McGinn, 2009; O'Donnell, 2009; Price, 2008; Quon, Zeghal, & Maingot, 2012) which caused to pay attention towards enterprise risk management (ERM) by most of the firms, however, it is limited among most of the Malaysian firms (Yusuwan, Adnan, Omar, & Jusoff, 2009). Moreover, failure in risk management practices is one of the crucial element which caused a global financial crisis in 2008 (Economist Intelligence Unit Limited and SAS, 2008). It means that Malaysian firms are less likely to adopt and implement enterprise risk management practices.

The literature pertaining to enterprise risk management (ERM), calls for further research on the level of enterprise risk management (ERM) implementation among firms (Daud, Yazid, & Hussin, 2010; Razali et al., 2011). Specifically, research on this issue is required in developing countries which is very scarce (Beasley, Branson, & Hancock, 2008a), particularly in Malaysia. Therefore, further research is needed on the aspect of enterprise risk management (ERM) in Malaysian firms.

However, Malaysian firms can better mitigate by implementing risk management practices adequately. As it is not possible to eliminate the risk entirely, firms may implement enterprise risk management (ERM) as a strategic planning instrument to respond the risk by proper identifying and managing the risk (Beasley et al., 2008a; Francis & Paladino, 2008), to better comprehend their crucial business risks (Moeller, 2007) while developing a sound risk management culture across the whole organization (Hanssen, 2005).

Nonetheless, internal and external audit effectiveness is equally important in the level of risk management implementation. Because of internal and external audit effectiveness influence, the level of risk management implementation and both have a significant relationship with the level of risk management implementation (Dabari & Saidin, 2014). Hence, internal and external audit effectiveness leads risk management implementation and risk management implementation leads enterprise risk management (ERM).

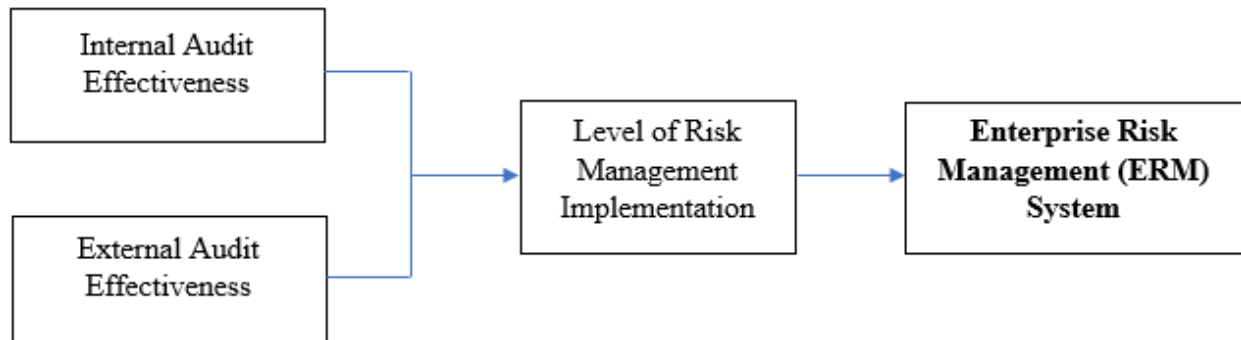


Figure 1.1: Theoretical Framework

The prime objective of the current research study is to highlight the importance of risk management implementations in Malaysian firms. To achieve the main objective, the current study has two sub-objectives:

1. To investigate the role of internal and external audit effectiveness on the level of risk management implementation.
2. To investigate the mediating role of risk management implementation level between audit effectiveness and enterprise risk management (ERM) system.

Therefore, the current study contributing to the body of knowledge by developing a framework to enhance enterprise risk management (ERM) system. This study filled literature gap by highlighting the critical problem regarding level of

risk management implementation and provide the solution to solve this crucial problem. Hence, this study introduced a mediating variable between audit effectiveness and enterprise risk management (ERM) system. Additionally, this study is more significant for Malaysian firms to mitigate the issue of risk management implementation through effective audit practices which will enhance enterprise risk management (ERM) system.

**2. LITERATURE REVIEW**

Traditional risk management practices comprise disaggregated approaches to face several risks in

firms (Liebenberg & Hoyt, 2003). In contrast with these practices, enterprise risk management (ERM) is relatively a new paradigm that enhances the capability of forecasting the portfolio of various





related risk that a firm encounter (Beasley et al., 2005). Now the enterprise risk management (ERM) is not a new phenomenon for firms. According to the Committee of Sponsoring Organizations (COSO), enterprise risk management (ERM) is defined as “a process affected by an entity’s board of directors, management and other personnel, applied in strategy setting and across the enterprise, designed to identify potential events that may affect the entity, and manage risk to be within its risk appetite, to provide reasonable assurance regarding the achievement of entity objectives” (COSO, 2004). Different studies revealed that enterprise risk management (ERM) adoption increased in different industries (Liebenberg & Hoyt, 2003; Pagach & Warr, 2011; Subramaniam, Collier, Phang, & Burke, 2011).

Enterprise risk management (ERM) is also concerned with various another element such as internal and external audit effectiveness (see, for example, Dabari & Saidin, 2014). These elements have significant effect on enterprise risk management (ERM) system through effective implementation of risk management. Because the proper implementation of risk management practices is vital for enterprise risk management (ERM) system (Kleffner, Lee & McGannon, 2003).

### **2.1 Internal Audit Effectiveness and Level of Risk Management Implementation**

According to De Zwaan, Stewart & Subramaniam (2011), internal auditors have a relationship with enterprise risk management (ERM), and internal auditors are involved in most of the enterprise risk management (ERM) assurance activities. Internal auditor’s involvement in enterprise risk management (ERM) assurance activities indicates that they have a role in the implementation of enterprise risk management (ERM). Audit committee generally examines the risk management practices and ensure the implementation of these practices.

Internal auditors performing a vital role in providing consulting facilities with regards to the risk management in their firms (Sarens & De Beelde, 2006) which enhances the level of risk management implementation. Moreover, according to Institute of Internal Auditors (IIA), internal auditors should support audit committee as well as management in their risk management obligations and play a role by recommending improvements after examining, evaluating, and reporting to improve the overall risk management process (IIA, 2004b). This statement shows that internal auditors have a significant positive relationship with the level of risk management implementation.

Internal audit has significant contribution in the implementation of risk management practices. Fraser and Henry (2007) conducted a research study in United Kingdom (UK) and found that internal audit can be involved heavily in risk management. Furthermore, De Zwaan, Stewart & Subramaniam (2011) argues that internal audit effectiveness has critical importance for risk management in firms. Thus, internal auditor’s effectiveness strengthens the risk management implementation activities.

Additionally, Dabari & Saidin (2014) conducted a research study on Malaysian listed companies. According to this study, internal audit effectiveness has a significant positive relationship with enterprise risk management (ERM) implementation. However, Malaysian firms are lacking in the implementation of risk management practices (Razali et al., 2011). Due to improper implementation of risk management practices, Malaysian firms are not performing adequately in their operations.

Hence, prior studies revealed that internal audit is one of the excellent facilitators to improve the level of risk management implementation. Internal auditor’s contribution in enterprise risk management (ERM) enhances the proper implementation of risk management practices. Thus, internal audit effectiveness has a positive relationship with the level of internal audit implementation. Therefore, it is hypothesized that;

**H1:** Internal audit effectiveness has significant positive relationship with level of risk management implementation

### **2.2 External Audit Effectiveness and Level of Risk Management Implementation**

Paape and Spekle (2011) advocate that a good quality audit companies are more likely to encourage their clients to enhance the level of enterprise risk management (ERM). The action implies that those firms that employ auditors with high quality are more concerned and committed to risk management implementation and thereby improve good governance (Dabari & Saidin, 2014). Therefore, there is a relationship between external audit effectiveness and level of risk management implementation.

In order to mitigate the possibility of fraudulent reporting as well as opportunistic behaviour, generally, companies demand higher risk management practices or demand higher external audit quality services (Desender, 2007). It denotes that external audit effectiveness has an influence on the level of risk management implementation. Additionally, the non-executive board always concerned about risk management implementation



and demand higher external audit services which monitor the risk management implementation. As it is reported in different studies (see, for example, Carcello et al., 2002; Hay & Knechel, 2004; O'Sullivan, 2000), there is a positive relationship between independence (non-executive) board and the demand for external audit quality to mitigate the risk and proper implementation of risk management practices.

Furthermore, according to Dabari & Saidin (2014), external audit effectiveness has a significant positive relationship with the level of risk management implementation. Beasley et al., (2005) also argue that external audit effectiveness is playing an essential role in risk management. Thus, there is a relationship with external audit and level of risk management implementation which automatically effect on overall enterprise risk management (ERM) system.

By summing up the discussion, an external audit has a crucial role in the level of risk management implementation. It is evident from literature; external audit quality has a significant effect on the level of risk management implementation and risk management implementation has significant impact on enterprise risk management (ERM) system. Hence, it is hypothesized that;

**H3:** External audit effectiveness has significant positive relationship with level of risk management implementation

### 2.3 Level of Risk Management Implementation and Enterprise Risk Management (ERM)

As above discussion denotes that level of risk management implementation has significant impact on every firm's enterprise risk management (ERM) system. It means that level of risk management implementation leads enterprise risk management (ERM) system.

Additionally, a survey conducted by Beasley et al., (2010) at North Carolina State University revealed that the enterprise risk management (ERM) implementation in most of the organizations is not developed and still relatively immature. That is the reason enterprise risk management (ERM) system is not meeting a reasonable level among most of the companies, particularly in Malaysia.

External consultants are usually acknowledged for their unique specialist knowledge as well as expertise (Gummesson, 1991). They are seen to have a range of working experience in

identification of various problems, generation of solutions and in designing new procedures in a given area (Dawes et al., 2007; Sharma, 1997). These external consultants also include external auditors which hire by the company to the proper implementation of risk management practices.

Nonetheless, according to the Dabari & Saidin (2014), level of risk management implementation has a significant positive relationship with enterprise risk management (ERM) system. Higher the level of risk management implementation, higher will be the enterprise risk management (ERM) practices. Hence, from the prior studies, it is hypothesized that;

**H3:** Level of risk management implementation has significant positive relationship with enterprise risk management (ERM) system

### 3. CONCLUSION

It is evident from prior studies that the internal audit effectiveness is crucial to implement risk management. Internal audit effectiveness increases the level of risk management implementation. Therefore, both have a significant positive relationship with each other. Similarly, external audit effectiveness has a positive effect on risk management implementation. High quality external audit increase the level of risk management implementation. However, low quality internal and external audit decreases the level of risk management implementation. Thus, both internal and external audit effectiveness has a significant positive relationship with the level of risk management implementation. Furthermore, level of risk management implementation has also a strong relationship with enterprise risk management (ERM) system. A quality risk management implementation has a positive influence on enterprise risk management (ERM) system. However, low level of risk management implementation weakens the enterprise risk management (ERM) system.

Malaysian firms should enhance their audit quality for better implementation of risk management practices which will lead to a high-quality enterprise risk management (ERM) system development. Further research is needed to validate the results of this study. The framework of this study can be improved by using other essential variables such as top management support and board characteristics to mitigate the risk management implementation problem.

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