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EFFECTIVENESS OF INTERNAL CONTROL: THE INFLUENCE OF BOARD AND AUDIT COMMITTEE EFFECTIVENESS

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Effectiveness of Internal Control: The Influence of Board and Audit Committee Effectiveness

AUTHOR'S DECLARATION

I declare that the work in this dissertation was carried out in accordance with the regulations of Universiti Teknologi Mara. It is original and is the results of my own work, unless otherwise indicated or acknowledged as referenced work. This topic has not been submitted to any other institution or non-academic institution for any degree or qualification.

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ABSTRACT

Strengthening corporate governance is not the only thing that should be focused on to reduce the risk of corporate collapses. Increasing the effectiveness of internal control also should be given the same consideration. However, factors that may influence the effectiveness of internal control were never been discussed in details, and therefore, the main objective of this study is to examine influence of board and audit committee effectiveness on effectiveness of internal control. Annual reports of top 133 public listed companies are examined by using content analysis for the year of 2011. Various statistical analyses were conducted to examine the effect of board and audit committee effectiveness on the effectiveness of internal control. The results reveal that board of directors' independence and meeting frequency has significant positive influence on the effectiveness of internal control. This implies that companies' internal control is effective when the board of directors is independence and when the board's meeting is conducted more frequently. The results also provide that audit committee's independence has significant negative influence on the effectiveness of internal control, which implies that companies' internal control is less effective when the audit committee is independence. Other determinants of board' and audit committee's effectiveness such as CEO duality, audit committee's size and audit committee's meeting frequency do not give any influences on the internal control effectiveness of Malaysian companies.

Keywords: Board of directors' effectiveness, Audit committees' effectiveness, Internal control effectiveness

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In the name of Allah the Almighty, the Merciful and the Beneficient.

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CHAPTER ONE

INTRODUCTION

1.1 INTRODUCTION

In 2001, Wall Street was rocked by Enron's third-quarter loss of more than US$600 million which resulted from the write-offs of Enron's investments. Moreover, *The Wall Street Journal* reported that US$35 million of the losses was derived from business dealings with partnerships managed by the company's CFO, Andrew S. Fastow. The third quarter report was devastating and barely six weeks after the crisis first broke, Enron filed for bankruptcy. Enron's collapse triggered investigations by various parties and the early targets included Enron's senior officers, the accountants at Arthur Andersen, the Enron Board and its various special oversight committees.

Not only had Enron apparently filed false and misleading disclosure documents, but also insiders allegedly sold stocks and exercised options while publicly restating their faith in the company. These conditions showed that the efficacy of its corporate governance in monitoring managerial performance is doubtful. This is supported by Gordon's (2002) study where one of the problems highlighted that led to Enron's collapse, is the Board-centered corporate governance. Gordon (2002, p.11) states that "if the report of the Enron Special Investigation Committee is accurate, the board was ineffectual in the most fundamental way and the audit committee was particularly sleepy if not inactive".

After the Enron case, a few more corporate scandals had also arisen and suggested a breakdown in internal controls and the lack of adequate corporate governance mechanisms. Countries all around the world then started setting the best practice as a guideline; Cadbury Report was produced in United Kingdom, Sarbanes Oxley in United States, The Dey Report in Canada, the Vienot Report in France, the Olivencia Report in Spain, the King's Report in South Africa, Principles and Guidelines on Corporate

Governance in New Zealand and the Cromme Code in Germany. The goal of most of these regulations was to improve firms' corporate governance environments (Bhagat & Bolton, 2009).

The Sarbanes-Oxley Act (SOX) that was passed by the U.S. Congress in October 2002 can be seen as an effort to reestablish public confidence in financial reporting, and has been commonly considered as the most essential corporate reform since the 1930s. The new Act includes provisions pointing corporate internal controls, firms' corporate governance structures, and non-audit services provided by external auditors, etcetera. One of the most debated provisions of SOX is the internal-controls reporting requirements under SOX 404 where the issues discussed centered on the costs and benefits of this provision (Goh, 2007). As provided by KPMG, among the benefits of SOX 404 compliance included raising profile and company-wide awareness of governance and control.

The introduction of SOX 404 shows that recent corporate collapses were due to the problems in corporate governance and the weaknesses and ineffectiveness of internal control. The assumption that internal control deficiencies had led to fraudulent financial reporting is supported by anecdotal evidence. In 1999, a study was conducted by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) where they insisted that the occurrences of fraud documented over a ten year time frame from 1987-1997 were contributed by a poor internal control environment, and this results is in line with the fraud surveys conducted by KPMG.

1.1 PROBLEM STATEMENT

In Malaysia, corporate misconduct at Technology Resources Industries Berhad (TRI) is one of the examples of corporate governance failure. During the Asian Financial Crisis in 1997, TRI faced millions of foreign exchange losses and high costs of borrowing because TRI had high foreign debts that they used to raise the funds needed in acquiring Celcom. In their efforts to settle the borrowing, TRI made an internal restructuring and a debt financing which resulted in the failure of their corporate governance. According to Lee, A Md Ali and Gloeck (2009), TRI was discovered to have issued fictitious invoices totaling nearly RM260 million in 1998 and 1999 (Krishnan, 2011). Those fictitious invoices were to mislead the financial statements so they reflected that the company had derived high revenues.

Transmile was another organization that had shaken up Malaysia's corporate governance, and was labeled as mini Enrons. The company was alleged to have overstated its revenue by a total of RM522 million in the financial years of 2004, 2005 and 2006. In addition, RM341 million in its properties, plants and equipment account appeared to have been fabricated as the amount was little supported by documents (Zaimee, 2007). In another occasion, Lim Guan Eng (member of Malaysian parliament) in his press release in June 2007 mentioned that: *"Accounting scandals in Transmile group where revenue and profits are falsified through creative accounting indicates three structural failures in regulatory oversight and full disclosure of our capital markets, unreliability of financial statements and poor corporate governance in Malaysia"* (Mat Norwani, Mohamad and Chek, 2011, p. 208).

Just as the Transmile issue was unfolding, on 28 May 2007 the Securities Commission (SC) charged two directors from NasionCom Holdings Bhd of submitting false information in their company's 2005 financial statements and its listing prospectus (Zaimee, 2007). More and more cases arose and the media reflected the general public's keen interest and insistence for the independence of the board of directors as well as the audit committee (Zaimee, 2007). However, having an independent Board and audit committee will not help much in monitoring a company's activities. They need to be active to ensure that the company has a strong and effective internal control.

In response to these issues, Malaysia Institute of Accountants (MIA) President, Abdul Rahim said: *"Since the committee comprises members of the board of directors of a company, it can never be said to be really independent. But the individual independent directors need to uphold their 'independent' roles effectively"* (Zaimee, 2007, p.25). On improving the function and accountability of the audit committees, Abdul Rahim stated that it can be done through better understanding and implementations of corporate governance and effective internal controls. He further elaborated that: *"We strongly feel that corporate accountability and effective internal controls are fundamental in achieving* *good corporate governance, and can only be safeguarded through appropriate disclosure and transparency when reporting to the capital markets"* (Zaimee, 2007, p.26).

The Chairman of the Securities Commission, Datuk Zarinah Anwar also voiced her concerns where in her speech entitled "Future Direction of the Legal and Regulatory Framework for Malaysia's Capital Markets", she said that: *"A lot more can be done by company directors, audit committees and auditors among others to instill the right level of self-discipline that will reduce the occurrence of the types of corporate transgressions that we have been seeing".* In the speech, Datuk Zarinah also discussed some salient areas concerning the two key players of the market; the company directors and audit committee. With regards to company directors, she pointed out that: *"They are under a fiduciary duty to act in the best interest of the company, to protect the company's assets, and safeguard the interest of all shareholders".* Where some of the responsibilities of the directors are delegated to board committees like the audit committee, she further added: *"It is incumbent on members of the audit committee to ensure that they effectively discharge their responsibility"* (Zaimee, 2007, p. 28).

Therefore, the issue raised in this study is; does the effectiveness of the board of directors and audit committee affect the internal control effectiveness? There are numerous studies that focused on the company's internal control. However, these studies did not focus on the effectiveness of the internal control; most of them were more concerned on the disclosure of the material weaknesses of the internal controls. For instance, a study by Zhang, Zhou and Zhou (2007) investigated the relationship between audit committee quality, auditor independence and the disclosure of internal control weaknesses. On the other hand, Goh (2007) examined whether the effectiveness of the audit committee and the board of directors is associated with firms' timeliness in the remediation of material weaknesses in their internal control.

In addition, previous study used COSO framework in evaluating the effectiveness of internal control. For example, Jokipii (2010) and Karagiorgos, Drogalas and Dimou (2010) assessed the internal control system using five components as described by the COSO Report. The five components are control environment, risk assessment, control activities, information and communication, and monitoring. This current study used a different method to evaluate the effectiveness of internal controls, which is by examining the numbers of internal control activities conducted by the firm which by referring to the statement of internal control included in the corporate annual report. In addition to a difference in the method used, this study can also be said to be a pioneering attempt to examine the direct relationship between the effectiveness of the board of directors and audit committee and the internal control's effectiveness.

1.3 OBJECTIVES OF STUDY

The objective of this study is to investigate the relationship between the board of directors' and audit committee's effectiveness on the internal control effectiveness of Malaysian public listed companies. The specific objectives of this study are:

1. To determine whether there is a significant relationship between the board of directors' effectiveness and internal control effectiveness of Malaysian companies;
2. To determine whether there is a significant relationship between audit committee's effectiveness and internal control effectiveness of Malaysian companies.

1.4 RESEARCH QUESTION

From the above discussion, the following research questions are addressed in the current study:

1. Do the board of directors' effectiveness influence internal control effectiveness?
2. Does the audit committee's effectiveness influence internal control effectiveness?

1.5 SIGNIFICANCE OF STUDY

From an academic perspective, this study will provide empirical evidence regarding the factors that contribute to the internal control effectiveness; that is the effectiveness of the board of directors and effectiveness of the audit committee. It will also be interesting to examine whether an effective board of directors and audit committee will lead to an effective internal control of an organization, specifically with regards to Malaysian companies. In addition, the results of this study should provide some evidence of the level of internal control effectiveness among Malaysian companies.

1.6 ORGANIZATION OF THE STUDY

Overall, this paper consists of five main chapters. It begins with an introduction in chapter one that highlights an overview of how internal control became an important issue in the corporate collapses and how the board of directors and the audit committee were being called upon regarding such issues. This chapter also discusses the problem statement, objectives of the study, as well as the research questions and the significance in pursuing this area of study. Chapter two explains the relevance of this study with the inclusion of previous literature conducted on the board of directors and audit committee. This chapter also discusses the previous literature on internal control effectiveness, as well as the underpinning theory and research framework. This is followed by chapter three with a description of the research methodology used in the study. It will also provide a discussion of the hypothesis development and followed by an explanation of the data and sample selection. Following this, the results of the study are reported in chapter four. This chapter highlights the analysis and findings of the study. Finally, conclusions, implications, limitations and directions for future research are discussed in chapter five.

CHAPTER TWO
LITERATURE REVIEW

2.1 INTRODUCTION

This chapter describes in detail the review of literatures on the effectiveness of the board of director and the audit committee, as well as the effectiveness of internal control from prior studies which are related to the research problem. Hence, this chapter is separated into five sections. Section 2.2 discusses on companies' board of directors' effectiveness while Section 2.3 highlights on audit committee's effectiveness. Internal control effectiveness is discussed in Section 2.4 while conceptual framework is described in Section 2.5. Finally, Section 2.6 explains the underpinning theory.

2.2 EFFECTIVE BOARD OF DIRECTORS

Board effectiveness is explained as the degree the board is able to carry out its strategic and monitoring function (Levrua and Van den Berghe, 2007). Based on this definition, the effectiveness of board is related to its monitoring function which can further be describe as; when the monitoring function is good, then the boards is effective. To exercise good monitoring function, the board should be independent, segregate the function of the CEO and chairman of the board and conduct frequent board meetings. So when all of these three mechanisms exist, then it is assumed that the board is effective.

This is supported by numerous previous studies. For instance, Ogbechie and Koufopoulos (2010) documented that a higher proportions of outside directors as well as higher number of board meetings, the better the board of directors' effectiveness. Levrau and Van den Berghe (2007) also provided similar findings where they suggest that board composition is commonly viewed as an appropriate and adequate proxy for understanding board effectiveness, where they emphasized on the proportion of independent outside directors.

Furthermore, the existence of CEO duality signals the absence of separation of decision control and decision management, which constraint the board from exercising its monitoring function. Thus, Fama and Jensen (1983) suggested that the board is not an effective device for decision control unless it limits the decision discretion of individual top managers, which is by separating the duality of the function. Moreover, this CEO duality is less likely to be effective in monitoring management and ensuring a higher level of transparency which might be used to conceal fraud and incompetence (Gul and Leung, 2004).

Therefore, based on the above mentioned literature, effective board of directors can be assessed through its independence, CEO duality function and the frequency of board meetings which will be discussed in the following sections.

2.2.1 Board of Directors' Independence

Fama and Jensen (1983) outlined the role of organizational mechanism in controlling agency conflicts. They identify the board of directors as one of the most important of these organizational controls, and highlighted the importance of board independence in relation to the ratification and monitoring of management decisions. In addition, Fama and Jensen (1983) also stressed the importance of both inside (executive) and outside (non-executive) directors for effective boards, with the appropriate mix determining the board's effectiveness in monitoring management.

Various problems may be faced by a company if the firm's boards of directors are dominated by top management. These problems might arise from collusions and transfers of stockholders wealth. Hence, corporate boards generally include outside members who ratify decisions that involve serious agency problems and act as peacemakers in disagreements among internal managers.

According to Abdullah (2004), the board is the highest internal control system and the role of independent outside directors becomes crucial in monitoring the performance of management, including the CEOs. This is because, independent outside directors are valued for their ability to advise, to solidify business and personal relationships, and to send a signal that the company is doing well rather than for their ability to monitor. This makes the existence of outside directors as vital to the firm (Mace, 1986). Thus, this study will examine whether the independence of the board of directors influenced the effectiveness of company's internal control.

2.2.2 CEO Duality

The term CEO duality describes a CEO who also serves as Chair of the board of directors. CEO duality signals the absence of separation between control and decision management (Fama and Jensen, 1983). This is because the decision control is done by the board of directors headed by the Chairman of the board and the decisions management is done by the management team of the firm headed by the CEO. When the separation does not exist in a company, the powerful CEOs can organize the nomination process, selecting directors under their influence in order to contain the intensity of board monitoring. This concentration of power reduces the board monitoring effectiveness. As stated by Fama and Jensen (1983, p.304):

"Without effective control procedures, such decision managers are more likely to take actions that deviate from the interests of residual claimants. An effective system for decision control implies, almost by definition, that the control (ratification and monitoring) of decisions is to some extent separate from the management (initiation and implementation) of decisions".

As such, one way to separate the decision control and management processes is to have CEO – Chairman separation. The monitoring function of the board may be jeopardized in the absence of a separation between the chairman's role (as oversight and governance mechanism) and the CEO's role (as decision management) because the CEO has more discretion to manipulate financial reports (Finkelstein and D'Aveni, 1994). In such a firm, the CEO has more power over the board and firm without being supervised and evaluated by a chairman. This may lead to an ineffective board.

However, as argues by Haniffa and Cooke (2002), firms with duality status will face less interference in management and these firms can depend on a strong board to provide sufficient checks. In contrast, Saleh, Iskandar and Rahmat (2005) found that the discretionary accrual as a proxy for earnings management is positively related to the existence of CEO-Chairman duality. This might indicate that when the duality exists in a firm, the monitoring control of the boards is reduced, because included in the monitoring duty of the board is the need to review the financial performance of the company. Of course this will involve the use of financial statements and when the board is unable to detect the existence of earnings management, therefore it can be said that the boards are ineffective. Hence, this study will look into whether the existence of the CEO duality wills constraint the effectiveness of the company's internal control.

2.2.3 Board of Directors Meeting Frequency

To be considered as an effective board of directors (BOD), that board must be an active team which means in an accounting period, a number of BOD meetings should be convened to meet and discuss business matters which will later strengthen the company's internal control and improve the company's performance. This is because meeting frequency is often considered as a proxy to the level of monitoring activity delivered (Sharma, Naiker and Lee, 2009). So when a company has a high number of meeting frequency, it indicates that the company's level of monitoring activity is also good, and same goes to its effectiveness. This is supported by Laksmana (2008) where the researcher evidenced that meeting frequency can be considered as a proxy for the time Directors have to perform their duties and for the level of monitoring activity delivered.

Andres and Vallelado (2008) echoed similar views. They argued that, meetings provide board members with the chance to come together, and to discuss and exchange ideas on how they wish to monitor managers and company's strategy. Thus, the more frequent the meetings, the closer the control over managers, the more relevant the advisory role. This will lead to a more effective board of directors and might therefore enhance the internal control effectiveness.

In addition, frequent board meetings may be a signal of increased vigilance and oversight of the company's top management. This is because, findings by Chen, Firth, Gao & Rui (2006) showed that fraud companies have more board meetings, which suggest that the directors realize some acts or decisions are borderline legal and so there is more debate about them resulting in more meetings. Thus frequent meetings can be an indicator that the boards are diligent and effective as they conduct more meetings to analyse, discuss and create strategies to manage the frauds found and come out with mitigating actions. In the end, such a company is expected to have a better internal control and therefore the effectiveness can be enhanced. Therefore, this study is going to look into how a board's meeting frequency affects the company's internal control effectiveness.

2.3 EFFECTIVE AUDIT COMMITTEE

An audit committee plays a vital role in monitoring a company's internal control system as well as a company's operations with the aim of protecting the shareholders' interests. This committee is also involved in the development of the company's strategic plans and is expected to provide input and recommendations to the board regarding any financial or operational matters. Therefore, it is recognised that an effective audit committee would focus on improving the company's performance and competitiveness, particularly in a changing business environment which is beyond the control of the company (Cravens and Wallace, 2001). An effective audit committee is also expected to focus on the optimisation of shareholders' wealth and prevent the maximization of personal interests by the top management (Wathne and Heide, 2000).

The importance to have an audit committee in a company is to ensure those responsible for preparing the financial statements, namely the senior management and internal and external auditors are doing their jobs (Muhamad Sori, Mohamad and Ali, 2001). Therefore, the audit committee is a monitoring element that is essential for every company. Its presence will also ensure not only continuous communication between boards and external auditors, but also regular meetings conducted among the committee and the auditors to review the financial statements and audit process as well as the internal accounting system and control (Rahman and Ali, 2006). This committee thus plays an effective role in monitoring audit and financial function, as perceived by the Malaysian audit committee chairman (Muhamad Sori et al., 2001).

However, to be effective, the audit committee should be independent, be of the right size, and conduct frequent audit committee meetings. This is in line with the characteristics of an effective audit committee which were outlined by The Blue Ribbon Committee (1999). They suggested that the committee's characteristics should be is independent, expert, larger and active, which exhibit better monitoring duties of audit committee over the management performance.

The rationale is that independent directors serving on audit committees are more likely to be free from the management's influence, and committee members having essential skills will better understand and interpret information correctly. A larger committee will also have a wider knowledge and committees that meet more frequently will allow for monitoring duties (Karamanou and Vafeas, 2005). So, based on such literature, an effective audit committee can be assessed through its independence, size, and meeting frequency which will be discussed later in the following sections.

2.3.1 Audit Committee Independence

An independent audit committee is assumed to be able to provide a more effective monitoring role which will later enhance the internal control effectiveness of a company. The greater the audit committee's the greater its abilities to provide objectivity in monitoring the company. This is because, no personal or economic interest will be faced by the independent directors and no interest of such kind will interfere with their ability to question the management (Abbott, Parker and Peters, 2004).

Independent audit committees are also less likely to be associated with the incidence of internal control problems (Krishnan, 2005). However, her study was conducted prior to the enactment of SOX and surprisingly after the enactment, a study by Zhang et al., (2007) found no relation between audit committee independence and internal control weaknesses as did Krishnan (2005). This is because, SOX requires audit committees to be composed of all independent board members. Thus, this indicates that when an audit committee is comprised of independent members, the internal control weaknesses can be reduced or eliminated, which shows that the effectiveness of internal control is enhanced.

Hence, this study will further investigate whether an independent audit committee will have any associations with the effectiveness of internal control of Malaysian companies. An independent audit committee is also stressed by Bursa Malaysia listing requirement where it requires the board to establish an audit committee comprising of at least three members, a majority of whom are independent and all the members must be financially literate. Besides, the revised code also requires the audit committee to comprise fully of non-executive directors.

2.3.2 Audit Committee Size

An audit committee must have enough members to carry out its responsibilities in order to make an audit committee effective in controlling and monitoring of management's activities (Vinten and Lee, 1993). Sufficient members are needed so that the company will have an effective audit committee which will then help to improve the company's performance. However, having too small or too large of an audit committee will only makes the committee ineffective (Dalton, Daily, Johnson and Ellstrand, 1999).

An audit committee with only a small number of members will lack diversity of skills and knowledge, and later becomes ineffective. On the other hand, an audit committee with too many members tends to lose focus and be less participative compared to those of a smaller size. Thus, an audit committee with the right size will allow its members to use their experience and expertise in the best interest of stakeholders (Dalton et al., 1999).

Therefore, this study will look into whether the size of an audit committee will influence the effectiveness of internal control as a large audit committee is more likely than a small one to improve quality of internal controls, because increased resources and enhanced status will make the audit committee more effective in fulfilling its monitoring role (Zhang et al., 2007).

2.3.3 Audit Committee Meeting Frequency

A more active audit committee that conducts more meetings is expected to provide an effective monitoring mechanism. Effective monitoring mechanism means a company that has an effective audit committee will have an effective internal control. The total number of the meetings to be conducted will be determined by the complexity of the company's operation. At least three or four meetings should be planned to coincide with the audit cycle and timing of published annual reports in addition to other meetings held in response to circumstances that arise during the financial year (Malaysian Code of Corporate Governance, 2000).

Audit committee without any meetings or lesser number of meetings is less likely to be a good monitor. There are two potential monitoring advantages to be gained from assigning these board oversight responsibilities to a board committee, which are independence and board efficacy (Menon and Deahl Williams, 1994). Hence, the existence of an audit committee in an organization is very important, especially for large corporations in order to reduce the agency costs introduced by the separation of ownership. Menon and Deahl William (1994) also argued that, to be an effective monitor, audit committee must be active and that is why they used the number of audit committee meetings as a proxy for the level of audit committee activity. They stressed that audit committees that do not meet, or meet only a limited number of times, are unlikely to be effective monitors.

When the monitoring in a company is ineffective, problems such frauds can easily take place and may risk the overall business. A study of U.S public companies by Beasley, Carcello, Hermanson and Lapides, (2000) found that companies with fewer audit committee meetings had more fraud. They evidenced that the audit committee of the fraud companies met only once per year, and surprisingly twenty five percent of these fraud companies did not have an audit committee. Fewer frequency of audit committee meeting also lead to more suspicious audit switches (Archambeault & DeZoort, 2001), which might be an indication of poor management integrity or problems in a company's internal control. Suspicious audit switches might be a result of external auditor refuse to continue their service or the company itself does not want the same external auditor to