Mediating Effect of Enterprise Risk Management on Internal Audit and Organizational Performance: A Conceptual Framework

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Abstract— Enterprise Risk Management (ERM) is believed as an effective technique to manage the risk and is fast becoming the best practice standard. Moreover, past studies reported that organizations which have adopted a more integrated approach namely ERM in managing enterprise wide risks have experienced significant benefit relating to business performance. In fact, there is a general consensus by scholars and researchers that organizations employing ERM will enhance organizational performance. For that reason, the factors that influence ERM adoption and implementation should be taken into consideration. This study attempts to develop a conceptual framework by investigating the mediating effect of Enterprise Risk Management on internal audit and organizational performance among public listed companies in Malaysia.

Keywords — Enterprise Risk Management, Internal Audit and Organizational Performance

I. INTRODUCTION

In the last two decades, performance measurement of an organization has gained significant interest amongst both academics and practitioners [1]. Furthermore, most organizations would make sure that the performance measurement is done systematically and thoroughly [2]. This is because organizations strive to sustain and improve performance in order to attract investment from the investors and maintain good relationship with their stakeholders. Neely (2004) [3] concur and suggested that in order to increase market share and attract investors, it is crucial for the organization to perform well and have a good track record of business performance. However, today’s business environment has made it more difficult as risk has become the major factor in every business plans and decisions. Therefore, many organizations and stakeholders are showing more interest in risk management [4].

Risk management also has developed further with the emergence of a new concept known as Enterprise Risk Management (ERM). According to Lam (2000) [5] the traditional way in managing risk has not created effective outcome and because of that Enterprise Risk Management is swiftly becoming an effective practice framework. Furthermore, a general argument that organizations employing the Enterprise Risk Management will improve organizational performance has received a rising support [6].

The underpinning theory that supports the study is agency theory. Agency theory proposes a series of mechanism to reconcile the interest of shareholders and managers that aligns with the agent’s interest as well as the principal’s. These mechanisms include monitoring the agent’s behavior by adopting auditing and other governance mechanism [7]. Furthermore, Yatim (2010) [8] clarifies that the concept of risk management has become essential to corporate governance and is related to the organization internal control. Agency theory supports this study based on the fact that the implementation of Enterprise Risk Management will help an organization to improve the performance as well as maximize shareholder value [9] and [10].

This paper aims to come up with a conceptual framework that contributes to a better understanding of Enterprise Risk Management practices by investigating the practices of Enterprise Risk Management among Malaysian listed companies. Based on this, the objectives of this paper are as follows:

a) To examine the extent of Enterprise Risk Management practices among public listed companies in Malaysia.

b) To examine the relationship between internal audit and organizational performance.

c) To investigate the mediating effect of Enterprise Risk Management practices on internal audit and organizational performance.
II. REVIEW OF LITERATURE

A. Enterprise Risk Management

Knetchel (2002) [4] defined risk management as a continuous activity in reducing the impact that external drivers may have on the outcome of a conclusion that has been made. However, the scope and functions of risk management have moved parallel with the rapidly changing economic demands and globalization. ERM is the new risk management and has started to receive attention globally. The Committee of Sponsoring Organizations of the Treadway Commission [11] defines Enterprise Risk Management as follows:

“….a process affected by an entity’s board of directors, management and other personnel, applied in a 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.”

The definition of Enterprise Risk Management reflects certain fundamental concepts where it is said as:

- A process, ongoing and flowing through an entity
- People at every level of an organization will be affected
- Applied in strategy setting
- Applied across the enterprise, at every level and unit, and includes taking an entity level portfolio view of risk
- Designed to identify potential events that, if they occur, will affect the entity and to manage risk within its risk appetite
- Able to provide reasonable assurance to an entity’s management and board of directors
- Geared to achievement of objectives in one or more separate but overlapping categories.

B. Internal Audit and Business Performance

Institute of Internal Audit Malaysia has defined internal audit as “an independent, objective, assurance and assurance consulting activity to add value and improved an organization’s operation. It helps an organization accomplish its objectives by bringing systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control and governance processes” [12]. Internal audits are aggressively shifting their resource mix to assist the organization to enhance the business performance [13].

Hence, the majority of the internal auditors will acknowledge that their roles and responsibilities are the right choice for the risk management job as they already have good risk appraisal skill sets and most have a rationally wide understanding of risk philosophies [14]. Furthermore, Zarinah (2006) [15] during her speech stressed that internal auditors are involved in offering independent and objective view in ensuring whether risks are being sufficiently evaluated, controlled and monitored so that organizational objectives will be achieved. Therefore, internal auditors with their focus on risk management are crucial to the governance process and to sound financial reporting.

Alic and Rusjan (2010) [16] also found that the internal audit contributes to the achievement of business goals and company efficiency. Furthermore, internal audit also has more positive than negative effects on business performance.

Preposition 1: There is a positive relationship between internal audit and organizational performance

C. Internal Audit and Enterprise Risk Management

Internal auditing has moved to another level with the rise of Enterprise Risk Management [17]. Sarens and DeBeelde (2006) [18] supported and stated that an important step to this reframing of the internal auditor role accordance to risk management was the new definition of Internal Auditing issued by the Institute of Internal Auditor (IIA) in June 1999, which clearly states that “the internal auditing activity should evaluate and contribute to the improvement of risk management, control and governance”.

Furthermore, Hespenheide and Funston (2006) [14] also agree and they clarify that internal audit also has been asked out to assist in implementing Committee of Sponsoring Organization of the Treadway Commission (COSO). Besides, internal audit assists in giving advice on IT improvement, root out fraud, assist with Sarbanes-Oxley compliance and today another task has emerged which is Enterprise Risk Management. Moreover, Sarens and DeBeelde (2006) [18] stated that risk management globally has received an enterprise wide approach where internal auditors play a key role in providing both guarantee and consultation services particularly to risk management in the organization.

COSO also emphasized that the function of internal audit and Enterprise Risk Management are mainly to enhance corporate governance through the internal control system. On top of that, the internal audit functions are further expanding by including four additional elements which are controlled atmosphere, risk evaluation, information and communication and also risk observation [19]. Moreover, it is said that risk management is more inclusive than internal control because internal control is usually restricted to financial operations while risk management is enterprise wide [20].

In addition, various studies had explored the role of internal auditing with regard to risk management {[18], [21] and [22]} which all indicates that there is an increasing demand for internal auditing to be involved in risk management. Internal auditing also is believed to encompass a larger role in communication and training relating to the risk management in response to the development of Enterprise Risk Management [21]. Stewart and Kent (2006) [23] supported the statement where they found that there is an association between the use of internal audit and the organization’s commitment to resonance risk management. It
is said that the internal auditors help the organization to identify and evaluate risk as well as placing the work to the front line of risk management. As for that reason, internal auditors are ready to make a significant contribution towards the enterprise risk management process and also adding value to the implementation of enterprise risk management [17].

Preposition 2: There is a mediating effect of Enterprise Risk Management practices on internal audit and organizational performance.

III. PROPOSED FRAMEWORK

This paper will examine the extent of ERM practices among public listed companies in Malaysia. Based on the literatures there are various attributes that become the forces in the extent of ERM practices in an organization. These attributes include encouragement from the board of directors [24] and dedicated Chief Risk Officer (CRO) [25]. So, this paper examined the relationship between internal audit and organizational performance and also the mediating effect of Enterprise Risk Management on this relationship.

IV. METHODOLOGY

A. Sample and Data Collection Method

The population of this study comprises of eight industries listed on the main board of Bursa Malaysia. The sample size is 767 organizations consist of consumer products, construction, industrial products, infrastructure, plantations, properties, trading/services and technologies. The financial industry is excluded because due to differences in regulatory requirement and Enterprise Risk Management framework has been established in the industry. The unit of analysis is the multinational organizations listed on the main board of Bursa Malaysia. Questionnaires with measurement of a seven point likert scale ranging from “strongly disagree (1)” to “strongly agree (7)” will be addressed to the senior management who has direct dealing with Enterprise Risk Management practices in the organization.

B. Instrumentations

The following Table 1 indicates the measures of the study variables used in the study. The instrument items will be adopted from previous studies by [26], [11] and [27].

<table>
<thead>
<tr>
<th>Instrumentations of The Study Variables</th>
<th>Variables</th>
<th>Source of scale</th>
<th>Type of scale</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Internal Audit</td>
<td>Institute of Internal Auditors (2004)</td>
<td>7-points Likert scale</td>
</tr>
<tr>
<td></td>
<td>ERM Practices</td>
<td>COSO (2004)</td>
<td>7-points Likert scale</td>
</tr>
<tr>
<td></td>
<td>Organizational Performance</td>
<td>Hoyt &amp; Liebenberg (2008)</td>
<td>7-points Likert scale</td>
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V. CONCLUSION

As a conclusion, this paper attempts to develop a conceptual framework by explaining the mediating effect of ERM practices on variables of interests among public listed companies in Malaysia. This paper suggested factors that influence the extent of ERM practices, more specifically that the internal audit influence extent of ERM practices and this in turn affect the performance of the organizations. There are two hypotheses that have been developed under the proposed framework and need to be tested empirically. This paper is intended to contribute to the existing body of knowledge in the ERM area. This paper also will provide an insight to relevant government agencies to formulate new policies or strategies on matters pertaining to Enterprise Risk Management in Malaysia. Since this is a conceptual paper and, it is subjected to some limitations surrounding similar conceptual academic works.

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