

# DETERMINANTS OF INTERNAL AUDIT FUNCTION EFFECTIVENESS AND ITS IMPLICATION ON FINANCIAL REPORTING QUALITY

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***Abstract:** Effective internal audit function can support management to produce qualified financial reporting. The purpose of this study is to examine the influence of competency and objectivity of internal auditor toward internal audit function effectiveness and its implication on financial reporting quality. Survey was conducted on 87 companies listed in Indonesia Stock Exchange and analyzed using path analysis. The empirical results indicate that competency and objectivity of internal auditor have a positive and significant effect on internal audit function effectiveness and financial reporting quality. Furthermore, internal audit function effectiveness is significantly related to financial reporting quality.*

***Keywords:** competency, objectivity, internal auditor, internal audit function effectiveness, financial reporting quality*

## 1. INTRODUCTION

Investors in the capital market depend on the information presented by the management company, and used to assess the risk and future prospects of the investment (Healy and Palepu, 2001). Information needed by investors in making business decisions is the financial statements (Kieso *et al.*, 2012). According to FASB, financial statements are useful to investors, creditors, and other users in the process of making rational decisions related to investment, credit, and other decisions (Higson, 2003).

Financial statements are the output of financial reporting (Gibson, 2011). General purpose of financial reporting is to provide financial information to investors, creditors and other parties in the decision-making process related to the provision of entity's resources (Kieso *et al.*, 2012).

To improve the quality of financial reporting, an effective internal audit function is required (Collier and Ampomah, 2009). Internal audit function can be said to be

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effective if it can realize its role or achieve its goal of improving the quality of financial reporting through improving the governance, risk management, and internal control in the process of preparing the financial statements (Pickett, 2011).

The role of internal audit is to provide assurance that business risks are well managed and internal controls operate effectively. An important reason to have an effective internal control is to maximize the reliability and timeliness of information for making decisions (Collier and Ampomah, 2009). The internal audit activity must evaluate the potential risks associated with governance, operational, and organizational information systems regarding: 1) the reliability and integrity of financial and operational information; 2) the effectiveness and efficiency of operations; 3) preservation of assets; and 4) compliance with laws, regulations, and contracts (Pickett, 2011). Internal Audit said to be effective if it has conducted relevant audit over internal control and financial reporting in order to achieve the reliability of financial statements (Arens *et al.*, 2012).

Some factors that may affect the internal audit function is the competence and objectivity of the internal auditor (Messier *et al.*, 2008; Moeller, 2008; Arens *et al.*, 2012). According to Messier *et al.* (2008), the main issue of the effectiveness of internal audit is the competence and objectivity of internal auditors and their effect on the audit. Furthermore, according to Moeller (2008), compliance with internal audit professional practice standards published by the Institute of Internal Auditors (IIA), with an emphasis on integrity, objectivity, confidentiality and competence, is an effective way to assess the quality of internal audit.

Arens *et al.* (2012) stated that the effectiveness of the internal audit function can be achieved if the internal auditor:

- 1) Independent of the operating units being evaluated
- 2) Competent and well trained
- 3) Have performed relevant audit tests of the internal controls and financial statements.

The purpose of this study is to examine the effect of internal auditor competency and objectivity toward internal audit function effectiveness and its implication on financial reporting quality. This research is expected to contribute to answering the question of how effective internal audit function contribute in order to achieve qualified financial reporting.

The results of this study indicate that the competency and objectivity of internal auditors affect the effectiveness of internal audit function and financial reporting quality. The results also indicate that competency and objectivity of internal auditor have indirect effect to financial reporting quality with internal audit function effectiveness as mediator.

The remainder of this paper is organized as follows. The second section reviews the relevant literature and hypotheses development. The third section describes the

research design. The fourth section presents the results and discussions, and the final section provides the conclusions.

## **2. LITERATURE REVIEW AND HYPOTHESES DEVELOPMENT**

### **2.1. Competency**

Competence relates to the inherent characteristics of individuals regarding their performance to do some work (Spencer and Spencer, 1993). Competence is also related to the behavior, attitudes, and characteristics of the main personalities who have contributed to the person's ability to manage a job, as proposed (Levin *et al.*, 2011).

Knowledge and skills necessary to accomplish tasks that define an individual's job (Arens *et al.*, 2012). Moreover IIA (2012) stated that the knowledge, skill, and other competencies needed to perform their individual responsibilities.

According to Dubois and Rothwell (2004), competence can be measured by several characteristics, namely: knowledge, skills, aspects of self-image, social motives, traits, a mindset, a way of thinking, feeling, and acting. In line with the statement of Dubois and Rothwell, McShane and Glinow (2010) suggests that competence is measured by knowledge, skill, talent, personality, self-concept, and the values inherent in a person. This is in line with the opinion of Bernardin (2010) that the dimensions of competence are: 1) knowledges; 2) skills; 3) abilities. Further Hsieh *et al.* (2012) states that competence can be measured from the conceptual abilities, behaviors, knowledge, and skills.

Based on the statements above, the competence can be measured with the knowledge and skills (Dubois and Rothwell, 2004; McShane and Glinow, 2010; Hsieh *et al.*, 2012).

### **2.2. Objectivity**

Internal audit activity must be independent, and internal auditors must be objective in performing their work. Independence is the freedom from conditions that threaten the ability of the internal audit activity to carry out internal audit responsibilities in an unbiased manner. Objectivity is an unbiased mental attitude that allows internal auditors to perform engagements in such a manner that they believe in their work product and that no quality compromises are made. Objectivity requires that internal auditors do not subordinate their judgment on audit matters to others (IIA, 2012). The principle of objectivity is impartial and free from conflicts of interest (Prawitt *et al.*, 2009).

Objectivity in internal auditors activity can be measured by impartial, unbiased attitude and avoid any conflict of interest (IIA, 2012; Brandon, 2010).

### **2.3. Internal Audit Function Effectiveness**

Implementation of audit recommendations is highly relevant to audit effectiveness (Sawyer *et al.*, 2003). According to Mihret and Yismaw (2007), internal audit effectiveness means the extent to which an internal audit office meets its purposes.

The effectiveness of internal audit is the ability of monitoring activity in the organization, conducted by internal auditors which are independent and objective, to achieve organizational goals effectively (Sawyer *et al.*, 2003; Moeller, 2008; Arens *et al.*, 2012).

According to IIA (2012), the internal audit activity is effectively managed when:

- 1) The results of the internal audit activity's work achieve the purpose and responsibility included in the internal audit charter;
- 2) The internal audit activity conforms with the Definition of Internal Auditing and Standards; and
- 3) The individuals who are part of the internal audit activity demonstrate conformance with the Code of Ethics and Standards.

#### **2.4. Financial Reporting Quality**

Financial reporting is the process of making financial statement to provide financial information (Britton and Waterston, 2006). Further according to Gibson (2011), financial reporting is a process of preparation of financial statements that are intended to provide useful information for the parties interested in the business and economic decision making.

Financial reporting will be useful in making business decisions when providing high-quality financial information. Quality is correspondence between specifications required with specifications generated from products or services, so it has the ability to meet the expectations of users (Azhar Susanto, 2008; Stair and Reynolds, 2010).

Thus, the quality of financial reporting is the suitability of the financial information produced by accounting systems and is not limited to the financial statements to meet the needs of the parties concerned in taking economic decisions (Meigs *et al.*, 2006; Britton and Waterston, 2006; Stair and Reynolds, 2010; Gibson, 2011).

Financial reporting is based on the concepts defined by a coherent conceptual framework. The conceptual framework begins with identifying financial reporting purposes and then provide guidance on (1) the boundaries of financial reporting, (2) the selection of transactions (3) how it should be recognized and measured, and (4) how should be summarized and reported (Kieso *et al.*, 2012).

International Accounting Standard Board (IASB, 2010) describe the conceptual framework of financial reporting which consists of three levels. The first level identifies financial reporting purposes. The second level gives qualitative characteristics that make accounting information useful and elements of financial statements (assets, liabilities, and so on). The third level identifies the recognition, measurement, and disclosure of the concepts used in building and implementing accounting standards and certain concepts to implement the objectives. These concepts include assumptions, principles and constraints that describe the financial reporting environment.

Furthermore, Epstein and Jermakowicz (2010) stated that the qualitative characteristics of financial reporting consists of: fundamental quality (relevant and fair presentation) and enhancing quality (comparability, verifiability, timeliness, and understandability).

Relevant information is information that has predictive value, confirmatory value or both; in other words, the information is able to influence the decision of capital providers. Fair presentation implies that the decision usefulness of financial information shows the proper economic phenomena. Information can be compared when it can identify the similarities and differences between the two sets of economic phenomena. Consistency (use of accounting policies and procedures together in an entity from period to period, or in the period between entities) are needed so that information can be compared. Information can be verified when the information is free from material error. Timely means that information is available when it is still very useful for decision-making purposes. Information can be understood if it is classified, marked and presented clearly and concisely.

The concept of financial reporting quality can be measured by (Beest *et al.*, 2009; Epstein and Jermakowicz, 2010; Kieso *et al.*, 2012):

- 1) Fundamental qualities
  - (a) *relevance*
  - (b) *faithful representation*
- 2) Enhancing qualities
  - (a) *comparability*
  - (b) *verifiability*
  - (c) *timelines*
  - (d) *understandability*

## 2.5. Hypotheses Development

The main issues of the internal audit function is the competence and objectivity of internal auditors and their effect on the audit (Messier *et al.*, 2008). Compliance with the standards of professional practice of internal auditing issued by IIA, with an emphasis on integrity, objectivity, confidentiality and competence, is an effective way to assess the quality of internal audit function (Moeller, 2008). Moreover Arens et al. (2012) argues that the quality of the internal audit function can be achieved if internal auditors: independent of the unit being evaluated, have a competency and sufficient training and has been testing the relevant audits on internal control and financial reporting.

Internal auditors must have competence in performing their works so that the internal audit function can be effective (Moeller, 2008). Furthermore IIA (2012) states

that an effective internal audit will be generated by internal auditors who have a deep understanding of the culture, systems and business processes of an organization.

Audit quality will be difficult realized without objectivity and skepticism from the auditors. Auditors who not objective will lead to questionable audit quality (Mansouri *et al.*, 2009; Ryan *et al.*, 2001).

Several previous studies which explain that the competence and objectivity of the internal auditors affect the effectiveness of the internal audit function, performed by: Krishnamoorthy (2002), Desai *et al.* (2006), Brown (2006) and Soh *et al.* (2011).

Krishnamoorthy (2002) examined the interaction of objectivity, performance and competence of internal auditors in evaluating internal audit function. His research show that objectivity, performance and competence of internal auditors determine the strength of the internal audit function. Desai *et al.* (2006) examined the relationship between the specific factors used external auditor that affect the strength of the internal audit function. Their research showed that the internal audit function become more prominent in the organization when internal auditors have higher competence and objectivity.

According to Soh *et al.* (2011), the appropriate skills is important in performing activities of the internal audit function. Furthermore, according to Brown (2006) objectivity of internal auditors is the most important criteria to determine the effectiveness of internal audit function.

Prawitt *et al.* (2009) measured the internal audit function quality through the competence and objectivity of internal auditors in accordance with auditing standards that stated that the competence and objectivity of internal auditor are relevant to audit of financial statements. Internal auditor must have knowledge, skills, and other competencies needed to perform their responsibilities. The more competent internal auditor, the more likely to understand the factors that affect the accrual accounting and how it can be managed. Objectivity is important for the internal auditors ability to affect the company's accounting information quality. The more objective internal audit function, the more likely to find evidence of manipulation of accruals.

The primary role of internal audit function within the company is to provide assurance on internal control to maximize the reliability and timeliness of financial reports (Collier *et al.*, 2009).

According to Pickett (2011), internal audit function should evaluate risk exposures relating to corporate governance, operations, and information systems regarding the organization:

- (1) Reliability and integrity of financial and operational information;
- (2) Effectiveness and efficiency of operations;
- (3) Keeping the assets; and
- (4) Compliance with applicable laws, regulations, and contracts.

An effective way to assess the quality of internal audit function is to assess compliance with the standards of professional practice of internal auditing issued by IIA, with an emphasis on integrity, objectivity, confidentiality and competence of the internal auditor (Moeller, 2008).

Previous studies that examine the influence of internal audit function on financial reporting quality conducted by Prawitt *et al.* (2009), Al-Shetwi, *et al.* (2011), Arel *et al.* (2011), and Johl *et al.* (2013). Their results showed that internal audit function has effect on financial reporting quality.

Based on the previous description, the hypothesis proposed in this study are as follows:

- $H_1$ : competency of internal auditor affect internal audit function effectiveness
- $H_2$ : objectivity of internal auditor affect internal audit function effectiveness
- $H_3$ : competency of internal auditor affect financial reporting quality
- $H_4$ : objectivity of internal auditor affect financial reporting quality
- $H_5$ : internal audit function effectiveness affect financial reporting quality

### 3. RESEARCH METHODOLOGY

#### 3.1. Sample and Data Collection

The research was conducted on Companies listed at Indonesia Stock Exchange by the year of 2014. Samples obtained by using simple random sampling technique. The details of respondents as follows:

**Table 1**  
**Number of Respondents**

No.	Description	The amount of	%
1.	Number of questionnaires distributed	290	
2.	Number of questionnaires returned	87	30%
3.	Number of questionnaires processed	87	30%

#### 3.2. Data Analysis Methods

The research hypotheses are tested using path analysis. The linear regression model can be termed as a good model if the model meets the assumptions of data normality and free from classical statistical assumptions, both the normality, multicollinearity, autocorrelation, and heteroscedasticity. In this research, only part of the regression model assumptions will be tested. The autocorrelation assumption was not tested because data are collected and processed cross-sectionally instead of time series, which will not impair the autocorrelation. Thus, in this research the regression model assumptions were tested by the Kolmogorov Smirnov test for normality, the Gletjser

test for multicollinearity, and the value of Variance Inflation Factors (VIF), where the VIF value must be less than 10, for heteroscedasticity.

A regression equation to determine the effect of internal audit competency and internal audit objectivity toward internal audit function effectiveness and financial reporting quality is:

$$IAFE = b_1 IAC + b_2 IAO + e_1 \quad (1)$$

$$FRQ = b_1 IAC + b_2 IAO + b_3 IAFE + e_2 \quad (2)$$

where:

IAFE = Internal audit function effectiveness

IAC = Internal auditor competency

IAO = Internal auditor objectivity

FRQ = Financial reporting quality

#### 4. RESULTS AND DISCUSSIONS

Based on analysis from research data using SPSS, it can be said that data are free from classical statistical assumptions, both the normality, multicollinearity and heteroscedasticity. R square value for the effect of internal auditor competency and internal auditor objectivity on internal audit function effectiveness are equal to 0.675. It means that 67.5% change in internal audit function effectiveness explained by internal auditor competency and internal auditor objectivity. Furthermore, R square value for the effect of internal audit competency, internal audit objectivity and internal audit function effectiveness on financial reporting quality are equal to 0.846, which means that 84.6% change in financial reporting quality explained by internal audit competency, internal audit objectivity and internal audit function effectiveness. Statistical test results can be seen in table 2.

**Table 2**  
**Statistical Test Results**

<i>Dependent Variables</i>	<i>Independent Variables</i>	<i>R Square</i>	<i>Standardized Coefficients</i>	<i>Significancy</i>
Internal Audit Function Effectiveness	• Internal Audit Competency	0.675	0.628	0.000
	• Internal Audit Objectivity		0.273	
Financial Reporting Quality	• Internal Audit Competency	0.846	0.347	0.000
	• Internal Audit Objectivity		0.493	
	• Internal Audit Function Effectiveness		0.199	

Results of path analysis showed that the internal audit competency can impact directly to the quality of financial reporting and can also indirectly affect to the quality



of financial reporting through the internal audit function effectiveness as a mediator. The direct effect is equal to 0.347 while the indirect effect is equal to 0.125. The total effect of internal audit competency on financial reporting quality is equal to 0.472.

Furthermore, results of path analysis showed that the internal audit objectivity can impact directly to the quality of financial reporting and can also indirectly affect to the quality of financial reporting through the internal audit function effectiveness as a mediator. The direct effect is equal to 0.493 while the indirect effect is equal to 0.054. The total effect of internal audit objectivity on financial reporting quality is equal to 0.547.

Results of path coefficients in the structural model can be seen in Fig. 1.

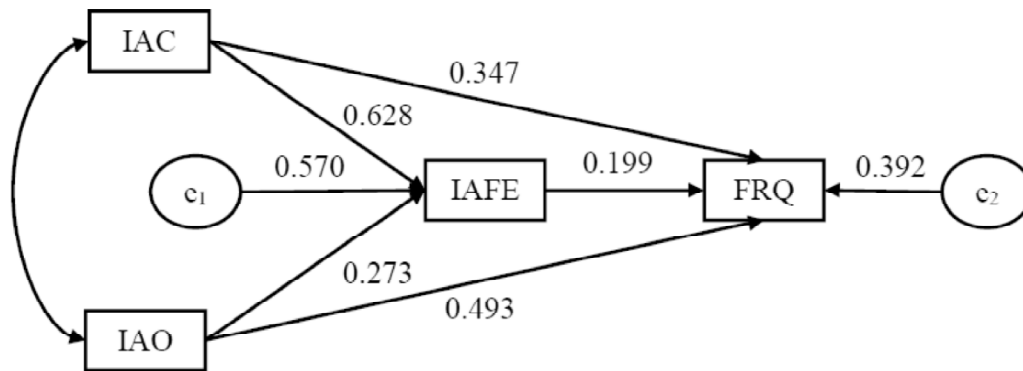


Figure 1: Results of path coefficients in the structural model

Based on results of study, the effect of internal auditor competency on internal audit function effectiveness is equal to 0.628 with  $t$  value = 8.065 (larger than critical value = 1.96). It means that internal auditor competency has positive and significant effect to internal audit function effectiveness. Therefore the first hypothesis of this research is accepted.

The effect of internal auditor objectivity on internal audit function effectiveness is equal to 0.273 with  $t$  value = 3.513 (larger than critical value = 1.96). It can be said that internal auditor objectivity has positive and significant effect to internal audit function effectiveness. Therefore the second hypothesis of this research is accepted.

This results, which showed that internal auditor competency and objectivity have influence on internal audit function effectiveness, confirm previous research conducted by Krishnamoorthy (2002), Desai *et al.* (2006), Brown (2006) and Soh *et al.* (2010).

The direct effect of internal auditor competency on financial reporting quality is equal to 0.347 with  $t$  value = 4.833 (larger than critical value = 1.96). It means that internal auditor competency has positive and significant effect to financial reporting quality. Therefore the third hypothesis of this research is accepted.

The direct effect of internal auditor objectivity on financial reporting quality is equal to 0.493 with  $t$  value = 8.545 (larger than critical value = 1.96). It means that internal auditor objectivity has positive and significant effect to financial reporting quality. Therefore the fourth hypothesis of this research is accepted.

The effect of internal audit function effectiveness on financial reporting quality is equal to 0.199 with  $t$  value = 2.626 (larger than critical value = 1.96). It means that internal audit function effectiveness has positive and significant effect to financial reporting quality. Therefore the fifth hypothesis of this research is accepted. This result confirm previous studies conducted by Prawitt *et al.* (2009), Al-Shetwi, *et al.* (2011), Arel *et al.* (2011), and Johl *et al.* (2013).

Moreover, according to results of study, the mediation effect of internal audit function effectiveness on the relation of internal auditor competency to financial reporting quality is equal to 0.125 with  $t$  value = 2.717 (larger than critical value = 1.96). The mediation effect of internal audit function effectiveness on the relation of internal auditor objectivity to financial reporting quality is equal to 0.054 with  $t$  value = 2.347 (larger than critical value = 1.96). It means that internal audit function effectiveness has a mediation effect on financial reporting quality for both of internal auditor competency and internal auditor objectivity.

## 5. CONCLUSIONS

Based on the results of study it can be concluded that internal auditor competency and internal auditor objectivity have a positive and significant effect on internal audit function effectiveness. Improving the internal auditor competency and internal auditor objectivity will improve the internal audit function effectiveness. Results of study also concluded that internal auditor competency and objectivity have a positive and significant direct and indirect effect on financial reporting quality, which internal audit function effectiveness plays a role as mediator. Furthermore internal audit function effectiveness has a positive and significant effect to financial reporting quality. Internal audit function effectiveness is important to enhance the financial reporting quality.

This study is only examine factors affecting internal audit function effectiveness and its implication on financial reporting quality. Therefore, the further research are expected to examine other variables that can also effect financial reporting quality, such as: good governance mechanism and accounting information system. The further research is also expected to use qualitative methods to discover new factors that can affect the quality of financial reporting.

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