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The Impact of Internal Audit Function in Enhancing the Financial Reporting Quality

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Abstract: Internal audit function is a specific unit designated to monitor the quality of financial reporting practices at a company. The monitoring task conducted by internal audit function is covering the internal audit's role and responsibilities; charter, audit plan and structure; skills and experience; and communication. The aim of this research is describing the important impact of internal audit function in enhancing the financial reporting quality. 87 companies listing at Indonesia Stock Exchange are already surveyed in 2015. Data are analyzed by multiple regression testing. The result shows that internal audit's skills and experience has significant impact in enhancing the financial reporting quality. It is recommended that internal audit unit must develop their employees' skills and experience in order to keep the financial reporting quality higher.

Keywords: Internal Audit Function, Financial Reporting Quality

JEL Classification: M410, M420

1. INTRODUCTION

Financial statement presents an adequate information needed by various parties to make their strategic decision timely and effectively. This financial statement must be audited first before it is published for external parties in order to give assurance that the financial reporting process is accordance with current financial accounting standards.

Nowadays Indonesia capital market is developed larger than before and supported by many mechanisms to protect current and potential players. Financial reporting of public companies is an important part within capital market activities for transparency principle application. Shareholders as investors will claim that they need a valid and accurate information ready punctually. So that they can participate in strategic decision making about company's fundamental changes, and also can calculate their shares of returns from the company fairly.

But there are many violations of transparency principle, for instance, misleading information produced by a low quality financial reporting. Nurhaida (2016) as Executive Head of Capital Market Monitoring at Indonesia Authority of Financial Services (AFS), said that in the first semester of 2016, Indonesia AFS conducted 59 audit in the capital market, which is 17 audit categorized as violations in information transparency of the public company. Based on the comprehensive audit result, 458 administrative sanctions are assigned by Indonesia AFS to capital market industry players with total fine punishment approximately Rp5.46 billion. This violation of transparency principle comes up with invalid information presented in financial statement which is contradicted with the reality and then misleads many users especially investors or shareholders of public companies.

The principle of transparency in capital market is important as a protection for public's demand on a high quality of financial reporting. Financial reporting quality of the company requires proper monitoring both internally and externally. Kagermann *et al.* (2008) explained that internal audit objective is evaluating control to get assurance that the financial reporting is held accurately and reliable. Consequently, internal audit function has a very important role in reassure the quality of financial reporting.

Audit intern function is part of integral mechanisms in effective good corporate governance system as the third line of defense for the company to support the first and second line of defense in order to combat accounting malpractices (Roche, 2005). Internal audit can be considered as a sound function, only if it gives assurance that the financial reporting has a high quality.

Bailey *et al.* (2003) states that internal audit function is the main part of solution to dissolve problems in business reporting system, accompanied by internal control and ethical behavior. The larger total audit coverage will preserve corporate governance by better monitoring in accountability and accuracy of transaction book keeping and financial reporting (Bailey *et al.*, 2003). Internal audit is functioned especially to oversee the financial reporting quality.

Burnaby *et al.* (2007) describes that internal audit function have an important role in the organization's integrity of financial reporting. The position of internal audit function gives advantage to support documentation and testing the key internal control related with financial reporting. Original mission of internal audit function is giving assurance on the reliability of financial reporting (Corafas, 2001).

Internal audit function is not only related with internal control for financial reporting both quarterly and annually, but it is also operated to identify key improvement opportunities related with financial reporting for long term value creation (Swanson, 2010). Internal audit performs procedures to give assurance to senior management and audit committee that control related with financial reporting which is proven effective (Vallabhaneni, 2009). Today, internal audit function is required to be robust with the intention to ensuring the fairness of financial reporting process (Swanson, 2010).

The aim of this research is getting empirical evidence that internal audit function gives an important impact in enhancing the financial reporting quality. This research is supposed to provide a real contribution in finding ways to make certain that internal audit run its monitoring function for a high quality of financial reporting.

This paper is organized as follows. The first section is an introduction depicts background of this research. The second section reviews the relevant literature and hypotheses development. The third

section describes the research design. The fourth section presents the results and discussion. The final section provides conclusions and recommendation.

2. LITERATURE REVIEW AND HYPOTHESES DEVELOPMENT

2.1. Internal Audit Function

Pickett (2010) states that internal audit function offers independent and objective appraisal service for the company and acts as assurance function that primary provides an independent and objective opinion to the organization on the degree to which the internal control environment supports the achievement of the organization's objectives. Internal audit function is organized to examine and evaluate organization's activities (Sawyer *et al.*, 2003; Moeller & Witt, 1999; Brink & Witt, 1982).

The objective of internal audit function is aimed to assist members of the organization in discharging of their responsibilities effectively by developing analyses, appraisals, recommendations, counsels and information concerning the reviewed activities (Brink & Witt, 1982). Sawyer *et al.* (2003) said that internal audit function will assist an organization in accomplishing its objectives by bringing a systematic and multidiscipline approach to evaluate and improve the effectiveness of organization's risk management, control, and governance process.

According to Pickett (2010: 313), internal audit function conducts independent objective assurance and consulting activities designed to add value for improvement of an organizations. Intern audit function will support the company to accomplish its objectives by bringing a systematic and multidiscipline approach to evaluate and improve the effectiveness of risk management, control and governance processes (Pickett, 2010; Reding *et al.*, 2009).

Internal audit function in this research context is defined as a function of internal audit unit which is doing various audit tasks and consultancy activities objectively and independently on organization's operation in order to make sure that the organization will gain its goals with a systematic and structural approach to evaluate and increase effectiveness of risk management, control and governance process.

2.1.1. Role and Responsibilities

Internal audit function's role and responsibility can be assessed by a deep understanding on responsibility and operation of the audit committee, so that audit internal function can interact easily and give report directly to the audit committee. Internal audit function has to understand the business and environmental risk of the company. All of governance process and control framework must be recognized by the internal audit function.

Combined assurance model conducted by the internal audit function must be known to accelerate communication with external auditor. Internal audit report must be submitted to the external auditor timely. Every misunderstanding between internal auditor and external auditor has to be solved directly. Audit plan is always under monitoring of the internal auditor and external auditor (King III, 2010; Coderre, 2008; Dittenhofer *et al.*, 2010; Moeller, 2009; Moeller, 2004; Paterson, 2015; Pickett, 2004; Pitt, 2014; Vallabhaneni, 2008).

2.1.2. Charter, Audit Plan and Structure

Internal Audit Charter has been discussed in many literatures (King III, 2010; Kagermann *et al.*, 2008; Cangemi & Singleton, 2003; Alkafaji *et al.*, 2010; Bailey, 2010; Bailey *et al.*, 2003; Moeller, 2009; Moeller, 2004; Pickett, 2004; Pitt, 2014; Swanson, 2010; Vallabhaneni, 2008). Appropriateness of Internal Audit Charter is reflected by well defining of role and responsibilities of internal audit function, includes the good relationship of internal audit function accordance with Internal Audit Charter. Internal audit must spent its particular time for a consultancy with audit committee informally. Internal audit report must be finished on time with good and relevance quality, so that it will give a high benefit for audit committee. Strategic position of internal audit function and its reporting line must be in line with the Audit Internal Charter. The executive chief of internal audit function must attend all audit committee meeting invitations. He must have a direct access and give a functional report to the audit committee head. He must attend all director meeting invitations too. He will have full of the information about company's strategy and performance within the director meeting.

Management's expectation on internal audit function must be stated properly in the Internal Audit Charter. It is important to develop an effective coordination between internal audit and management to prevent any disruption in normal activities. Internal audit function must provide information on any audit progress or special duty to the management. Internal audit function has to identify and give an early warning for any current issues, problem area, and tardiness. Internal audit function must develop a realistic idea and practical feedback for effective controlling. Its reported findings must be relevant, clear, constructive, detail, and timely. All findings must be discussed with management initially before it is delivered to the audit committee so that the management response is presented in internal audit report. Internal audit function must check the follow-up action on the previous recommendation for its implementation. Misunderstanding between internal auditor and management has to be dissolve quickly.

Working scope of internal audit function must be structured clearly in Internal Audit Charter. Internal audit function conducts its audit work in accordance with designated audit planning, range of time and budget. Internal audit function evaluates corporate's governance including ethics and gives appropriate information related with fraud, corruption, unethical behavior, and irregularities. Internal audit function assesses the objectivity and effectiveness of risk management and internal control framework. Internal Audit Charter must set that internal audit function has a proper access on any relevant information.

Internal audit must be planned well. Some literatures already discuss about it (King III, 2010; Pitt, 2014; Russel, 2007; Vallabhaneni, 2008; Kagermann *et al.*, 2008; Cohen & Sayag, 2010). Referring to the Internal Audit Charter, any audit process and methodology will be conducted in accordance with the good business, operation, compliance, and assurance of the company. The appropriate structure of internal audit is argued by King III, 2010; Bailey *et al.*, 2003; Pitt, 2014; Pickett, 2010; Kagermann *et al.*, 2008; Cohen & Sayag, 2010; Reding *et al.*, 2009; and Cangemi & Singleton, 2003. The company's organizational structure must enable the internal audit function get an independent position from the management, so that it can give assurance objectively, understand the business problem of company faster, and responses any business necessity in time.

2.1.3. Skills and Experience

Some experts (King III, 2010; Bailey *et al.*, 2003; Moeller, 2009; Moeller, 2004; Paterson, 2015; Pickett, 2004; Pitt, 2014; Swanson, 2010; Vallabhaneni, 2008; Cohen & Sayag, 2010; Kagermann *et al.*, 2008) say that skill is reflected by competency which is applied in a multientry of internal audit function assignment in accordance with its role and responsibility. Internal audit function must be supported by human resources with many professional experiences, interpersonal skill, seniority, and appropriate functional specification (information technology, risk management, finance, accounting including IFRS, taxation, and supply chain). Members of internal audit team must have a continuous education program to maintain and increase their quality. High competency and various experiences of internal auditor will bring the internal audit function to finish its work objectively in any judgment and finding related with audited activity and independently from management whose activity is audited (King III, 2010; Pickett, 2010; Reding *et al.*, 2009; Chambers & Rand, 2010; Kagermann *et al.*, 2008; Collier & Agyei-Ampomah, 2006)

2.1.4. Communication

Internal audit function must communicate timely, clear, constructive, complete, and objective (King III, 2010; Pickett, 2004; Pitt, 2014; Pickett, 2010). Timely communication will bring a quick response of internal auditor function on the audit committee's demand including specific investigation audit. Clear communication is followed by an ability to speak loud and frankly to audit committee. Constructive communication will solve any difficult debatable problem. Complete communication is a full explanation to the audit committee head about any significant findings and its progress in a year before the audit committee meeting. Objective communication will guarantee that internal audit function already monitors every unsolved problem and its recommendation appropriately.

2.2. Financial Reporting Quality

Financial reporting is a transaction between two parties, i.e. the issuers of a financial report, who control its preparation and the users of the report, who use it to improve their decision about the reporting entity as a whole (Rosenfield, 2006). Decision usefulness is the general objective of financial reporting, which is supporting all users to make a decision making such as investment or giving loan to the company. Deegan & Unerman (2008) states that stewardship is another objective of financial reporting which is assessing whether given resources are already managed well in accordance with their purposes. It is aligned with accountability concept defined by Gray *et al.* (1996) as the duty to provide an account or reckoning of those actions for which one is held responsible.

Those objectives of financial reporting are gained only if the financial reporting achieves certain requirement of quality. Quality is the degree to which a set of inherent characteristic fulfills a need or expectation that is stated, general implied or obligatory (Hoyle, 2008). Financial reporting quality is determined by its conformity with current applicable financial accounting standard. High quality of financial reporting is supposed to be able to get those objectives which the ultimate outcome of providing financial information is to improve the quality of decision making by external parties (Williams *et al.*, 2010).

Robinson & Munter (2004) explain that financial reporting quality comprises the overall quality of financial statements and related disclosures to ask how well the reported results present the operations and financial position of a company fairly. The Indonesian Board of Financial Accounting Standards already regulated qualitative characteristic of financial reporting in the financial reporting conceptual framework. There are relevance, faithful representation, comparability, verifiability, timeliness, and understandability (Mackenzie *et al.*, 2012; Beyersdorff *et al.*, 2013).

Information is relevant if it can influence users' economic decision making and support users to evaluate past event, current event, and future event, by confirming or revising an action based on users' evaluation result in the past (Kieso *et al.*, 2011). Relevance quality is including predictive value and confirmatory value.

Faithful representation is that all numbers and description in accordance with the real occurrence (Kieso *et al.*, 2011). Faithful representation quality is including completeness, neutrality, and free from error.

Kieso *et al.* (2011) defined comparability as indentified similarities and differences of economic event among companies. Consistency practice is aimed to get the comparability. Consistency is a condition of a company that using the same accounting treatment for similar event intermittently. Consistency makes user able to compare company condition from the beginning to the ending of period or interperiod.

Concerning with quality of verifiability, Beyersdorff *et al.* (2013) divides it into direct verification and indirect verification. Direct verification means verifying an amount or other representation through direct observation. Indirect verification means checking the inputs to a model, formula or other technique and recalculating the outputs using the same methodology.

Timeliness is the information readiness capacity for the user before it is useless to influence decision making (Kieso *et al.*, 2011). Understandability make user able to see the significance. Timeliness is gained if the information is classified, given a specific characteristic, clear and conscious presentation (Kieso *et al.*, 2011).

Beyersdorff *et al.* (2013) and Carmichael *et al.* (2007) affirm that financial reporting quality must inherent so that the information will be useful for capital providers. Furthermore, Gaffikin (2008) says that these characteristics are the attributes that make information useful to users. Consequently, Subramanyam & Wild (2009) calls these characteristic as desirable qualities of accounting information.

Financial reporting quality in this research contetx is defined as the required quality in a process of making financial report prepared for supporting users' decision making. A high quality of financial reporting will give a appropriate information for the best usefulness of general users, including investors, creditors and others.

2.2. Hypotheses Development

The internal audit of strategic goal is aimed to evaluate internal control for giving assurance that there is accuracy and relevance in the financial reporting (Kagermann *et al.*, 2008). Internal auditor has crucial role to get sure about the accuracy of financial reporting system (Kagermann *et al.*, 2008). Internal audit function is an integral part of effective governance system to minimize any accounting malpractices (Roche, 2005).

The importance of internal audit function in financial reporting is shown by the study result of Johl *et al.* (2013) in Malaysia, which concludes that internal audit attributes have an important role in financial reporting process. The same result is proven by Gras-Gil (2012) which researches banking industry in Spain and concludes that internal audit involvement in reviewing the process of financial reporting will bring a better financial reporting. Chelimo & Kariuki (2013) also get a similar empirical evidence that internal audit function influences the financial reporting in Eldoret Municipality.

The study of Gros *et al.* (2016) in German also get the similar evidence that internal audit function serves as an essential element of effective corporate governance and plays an important role in financial reporting. This is equivalent with the result of previous study in United States (Prawitt *et al.*, 2009) which adequate internal audit function contributes to the financial reporting quality because of detection and prevention of management's opportunistic or biased judgment. Abbott *et al.* (2016) also finds that internal audit function has an ability to foster higher quality financial reporting. Internal audit function has an important role as an effective financial reporting monitoring. The monitoring role of internal audit function is formed by internal audit's role and responsibilities; charter, audit plan and structure; skills and experience; and communication.

Accordingly, there are four hypotheses to be tested in this research, as follows:

- H₁: Internal Auditor's Role and Responsibilities has a positive impact on financial reporting quality
- H₂: Internal Auditor's Charter, Audit Plan and Structure has a positive impact on financial reporting quality
- H₃: Internal Auditor's Skills and Experience has a positive impact on financial reporting quality
- H₄: Internal Auditor's Communication has a positive impact on financial reporting quality

3. RESEARCH METHODOLOGY

Objects as the center of attention in this study are internal audit function and financial reporting quality. The explanatory method is executed to obtain a description, picture or depicting systematically, factual information about the nature of and the relationship between variables studied (Sekaran & Bougie, 2013). This research want to find empirical facts about internal audit function (internal audit's role and responsibilities; charter, audit plan and structure; skills and experience; and communication) as factors that can cause a particular phenomenon related to the low quality of financial reporting. So that, this research can identify the impact of internal audit function on financial reporting quality.

3.1. Sample and Data Collection

The entire group of people, events, or things that the researcher desires to investigate is known as population (Sekaran & Bougie, 2013). This study's population comprises of 511 listed corporations in Indonesia Stock Exchange for 2014.

Sampling is the process of selecting items from the population, so that sample characteristics can be generalized to population (Sekaran & Bougie, 2013). Sampling is already conducted carefully. It consists of decision in design choice and sample size (Sekaran & Bougie, 2013).

The sampling technique is probability sampling - simple random sampling. The sample is selected randomly without any group level concerns and every item has the same probability to be selected (Sekaran & Bougie, 2013).

The minimum sample size is 84, calculated based on Slovin equation as follows (Husein Umar, 2003):

$$n = \frac{N}{1 + Ne^2}$$

Where:

n = sampel size

N = population size

E = tolerable error term (10%)

87 companies are selected randomly for the sample in this research. Data are collected directly from 87 companies and also from the authoritative bodies (Indonesia Stock Exchange and Financial Service Authority). The data validity of financial reporting quality is maintained by three raters which is using only the same result of measurement.

3.2. Variable Operationalization

The variable operationalization of this research can be described at Table 1.

Table 1
Variable, Proxy, and Measurement

<i>Variables (Code)</i>	<i>Proxies (Measurement)</i>	<i>Scale</i>	<i>Item</i>
Role and responsibilities	Role and responsibilities	Interval	1 - 5
Charter, audit plan and structure	Appropriate charter	Interval	6 - 10
	Proper audit plan	Interval	11
	Suitable structure	Interval	12 - 15
Skills and experience	Competence	Interval	16
	Objectivity	Interval	17
Communication	Timely communication	Interval	18
	Clear communication	Interval	19
	Constructive communication	Interval	20
	Complete communication	Interval	21
	Objective communication	Interval	22
Financial Reporting Quality	Relevance	Interval	1 - 13
	Faithful representation	Interval	14 - 18
	Comparability	Interval	19 - 24
	Verifiability	Interval	25 -26
	Timeliness	Interval	27
	Understandability	Interval	28 - 32

3.3. Data Analysis

The purpose of this study is to examine whether internal audit's role and responsibilities; charter, audit plan and structure; skills and experience; and communication have an impact on financial reporting quality. The independent variable internal audit's role and responsibilities; charter, audit plan and structure; skills and experience; and communication is measured in interval scale. The dependent variable financial reporting quality is measured in an interval scale too. So, it already fits with the minimum requirement of regression.

The following cross-sectional regression model with an ordinary least squares (OLS) technique is used to test the impact of internal audit's role and responsibilities; charter, audit plan and structure; skills and experience; and communication on financial reporting quality.

$$FRQ = \alpha + \beta_1 RAR + \beta_2 CAS + \beta_3 SAE + \beta_4 COM + e$$

The proxy and measurement of each variable is defined in the variable operationalization (Table 1). STATA 12.0 is used as an analysis tool to develop the cross-sectional regression model. A robust option is already used for estimating the standard errors and passing the classic assumption test.

4. RESULT AND DISCUSSION

The multivariate regression analysis gives result as depicted in Table 2.

Table 2
Result of Multivariate Regression for Estimating FRQ
 N= 87

Item	Parameter	Estimate	Standard Error	$p > t $
Constanta	α	.9905220	.0399293	0.000 ***
RAR	β_1	.5393829	.0506847	0.465
CAS	β_2	.7911979	.0462964	0.442
SAE	β_3	.7511696	.0349851	0.083**
COM	β_4	.3526953	.0423699	0.488
R-Squared		0.1336		
Probability F		0.0699**		

As shown in Table 2, the F-statistic of the model is significant ($p < 0,10$) indicating that a subset of the independent variables does explain the variation in Financial Reporting Quality (FRQ). The value of R^2 is 0.1336 indicating that about 13 percent of the financial reporting quality variance can be explained by independent variables in the model.

Internal audit's skill and experience (SAE) is a significant variable which influences financial reporting quality (FRQ) at 10 percent level of confidence. The result suggests that internal audit's skill and experience is more likely to increase the financial reporting quality of the company. It supports internal audit's skill and experience as an important factor to be considered for enhancing the financial reporting quality. This result is in accordance with prior research conducted by Gros *et al.* (2016) which gives a practical implication

of interest to regulators and managers that the external certification of the internal audit function and internal audit related certification of internal audit function's employee may contribute to higher financial reporting quality. Findings of Abbott *et al.* (2016) support the similar result that the joint presence of competence and independence is a necessary antecedent to effective IAF financial reporting monitoring. The testing result of this study show that internal audit's skill and experience is an important determinat factor on the process of financial reporting to generate high quality information.

The regression result also indicates that internal auditor's role and responsibilities (RAR); charter, audit plan and structure (CAS); and communication (COM) are not significant in influencing financial reporting (FRQ). On the other hand, the positive coefficients of them are consistent with the prediction in the literature which implies that the whole of internal auditor's role and responsibilities; charter, audit plan and structure; and communication have a positive association with financial reporting quality. This result may be explained by the fact that internal auditor's role and responsibilities; charter, audit plan and structure; and communication are hard to measured accurately. So that, the real existence of them is difficult to be assessed. Clear stated role and responsibilities; charter, audit plan and structure; and communication of internal audit function as a normative guidance does not guarantee an effective audit internal function in financial reporting monitoring. Internal audit's role and responsibilities; charter, audit plan and structure; and communication need to be followed by real action explicitly, not just a good statement only.

5. CONCLUSION AND RECOMMENDATION

This study provides an empirical evidence on the important role of internal audit function, as one of corporate governance mechanisms, in ensuring the financial reporting quality. The finding shows that internal audit's skill and experience may increase the quality of financial reporting. In Indonesia, internal audit's skill and experience is proven as a significant factor that can influence financial reporting quality. Thus, companies should perhaps evaluate how to further improve the skill and experience of employee at internal audit function in order to enhance the quality of financial reporting. Improving internal audit's skill and experience is conducted by maintain their competence and independence, by external certification of the internal audit function and internal audit related certification of internal audit function's employee. The existence of high skilled and experienced employee at audit intern function equips their competence and independence with various formal means such as training, coaching, and education. All of this must be elaborated with various other factors which develop internal audit's skill and experience. The company must ensure that skill and experience is rewarded continuously and management's action really exists to support it.

There are some limitations in this study that should be considered when interpreting the results. First, with regards to the design of this study, the data are collected from internal auditor perception on their internal audit function. There is a possibility of bias that these perception does not reflect the actual practices. Further research is suggested to use other measurements by in-depth interview (360^o assessment, not only from internal auditor perspective but also includes audit committee, management, and external auditor perspectives) to depict a true fact from the company. Second limitation is the window period. This research is a cross section research that survey conducted in 2015. Thus, further research may perform a longitudinal analysis to capture more complex factors that influence financial reporting quality.

Another limitation is the measurement developed in this research. Probably, there are other aspects of internal audit function and financial reporting quality that have not been addressed by this study. Then, further research can explore other alternative measurements for internal audit function and financial reporting quality. Finally, there are various other determinant factors of financial reporting quality to be explored in future research.

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