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RESEARCH ARTICLE

FINANCIAL REPORTING QUALITY: HOW TO OPTIMIZE THE ROLE OF INTERNAL AUDIT

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Abstract

The purpose of the study is to investigate the role of the internal audit function (IAF) in improving the quality of financial reporting. This is because the effectiveness of the FAI's role is often questioned considering its status as an employee who must serve "two masters" namely the board of directors and the audit committee as representatives of the board of commissioners. On the other hand, financial statements represent reports on the performance and quality of the company's management. The research method uses quantitative methods with multiple linear regression analysis. The research data is based on a questionnaire survey with purposively selected respondents from accounting, finance, auditing, and audit committee practitioners. The research findings indicate that the competence and objectivity of the IAF have a positive effect on the quality of financial reporting. Thus, to enhance the quality of financial reporting, internal auditors must be able to improve their competence and objectivity. Meanwhile, the most important quality of financial statements is the fundamental qualitative characteristics of faithful or honest representation by management. The results of this study answer doubt about the unique role of the IAF as a servant of the "two masters", and implicitly the partnership with the audit committee enhances the check and balance function through the role of the IAF. The limitation of the study is that the low determinant coefficient which indicates that there are many other factors that affect the quality of financial reporting. For further research, it is recommended to add other factors and increase the number of sample respondents.

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Introduction:-

Fraudulent corporate financial reporting has always been an endless issue. In the 'supply chain' financial reporting, the chief executive officer (CEO) and chief financial officer (CFO) have the most influence on the quality of financial reporting and are also the main cause of fraudulent financial reporting (CAQ, 2010; 2013; Kepsu, 2012; Beasley et al., 2010). Therefore, many parties doubt the ability of the Internal Audit Function to protect the interests of investors. For example, Fraser and Lindsay (2004), Lenz and Sarens (2012) questioned the unique position of the IAF serving the "two masters" namely top management and the board of commissioners. In fact, internal auditors

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are recruited and dismissed by management, but on the other hand they have to oversee the activities of the internal control system and report to the audit committee. The results of previous research by Cohen and Sayag (2010) found that the effectiveness of IAF is largely determined by top management support, thus there is a potential risk of internal auditors being intimidated by management (Lenz and Sarens, 2012). Moreover, management often acts opportunistically which harms the interests of stakeholders (Prawitt et al., 2009; Kepsu, 2012; Beasley et al., 2010). In many cases, internal auditors are often considered unable to monitor management actions so that the role of the IAF is questioned in various international conferences and discussions organized by The Institute of Internal Auditors (OECD, 2009, SEC 2009, Swanson, 2010, in Lenz and Sarens, 2012). The gap between the definition and reality according to the perception of some auditees seems only rhetoric. Expectations of IAF's role as an assurance provider as well as a consultant on risk management, control and governance processes will not be fully implemented satisfactorily (Lenz and Sarens, 2012). Al-Shetwi et al. (2011) concluded that IAF is only symbolic to comply with the regulations of the capital market authorities so that it does not affect the quality of financial reporting. Lenz and Sarens (2012) emphasized that internal auditors should be able to carry out their duties without fear of losing their jobs.

However, the role of the IAF has become the center of attention after Cynthia Cooper was awarded the "persons of the year" award for her courage in revealing the Worldcom fraud case, so that stock exchange regulators in America suggested that all issuers registered in New York (NYSE) have an internal audit unit to strengthen the corporate governance system, governance and quality of financial reporting (NYSE, 2004 in Prawitt et al., 2009). The results of the PwC survey (2014) show that 71% of respondents believe that internal audit mitigates fraud risk beyond the whistle-blower system. According to Arens et al. (2012), the knowledge of internal auditors regarding operational activities and internal control is much better than the knowledge of external auditors so that they are able to help carry out the company's risk monitoring and control activities better (Dordević and Dukić, 2015; van Wyk, 2015), preventing errors and fraudulent financial reporting (Holt and DeZoort, 2006). The results of research by Wallace and Kreutzfeldt, 1991 (in Coram et al, 2008), Schneider and Wilner, 1990 (in Prawitt, et al, 2009) prove that internal audit is able to detect errors and irregularities in financial reporting so as to reduce the findings of external auditors. Lakovic et al. (2016) based on a survey of 24 companies proved that IAF has a significant effect on the quality of financial reporting. Gros and Wallek (2017) found that the IAF serves as an essential element of effective corporate governance and plays an important role in financial reporting.

In Indonesia, support for the existence of the internal auditor function is built through the professional consortium of The IIA Indonesia Chapter. Internal auditors are required to have an internal audit charter as a 'work contract' with the directors and commissioners and assist the audit committee in dealing with external auditors. Another thing that strengthens the role of the IAF is that the internal auditor submits reports to the president director and the audit committee. However, in terms of the quality of financial reporting in Indonesia, the World Bank (2010; 2011) and ADB (2014) found that most of the financial statements have not fully complied with the Statement of Financial Accounting Standards (PSAK), especially in terms of disclosing segment information and related party transactions. In addition, the Financial Services Authority (OJK) still finds many company delays in submitting their financial reports (OJK, 2014). According to Tang et al. (2011; 2012) the quality of financial reporting in Indonesia is in the low category compared to Asia Pacific countries and world countries.

Based on the unique role of the IAF and the importance of the quality of financial reporting, this study aims to confirm the role of the IAF on the quality of financial reporting.

Literature Review:-

Theoretical foundation

From the perspective of the entity theory, capital owners have a claim on resources in the entity's financial statements (IASB, 2008). For this reason, management as an agent has an obligation to convey quality financial information so that investors as principals put their trust in the entity (CAQ, 2013). Thus, management does not only present financial statement information, but the financial statements must be of high quality (Subramanyam & Wild, 2009; IAASB, 2011; CAQ, 2010). High-quality financial reporting produces complete, transparent, and error-free information that helps monitor performance and make investment decisions (Biddle, et al., 2009; Kalyebara & Islam, 2014; Subramanyam & Wild, 2009). The quality of financial reporting is expected to be able to overcome the problem of "insider" and "outsider" friction or information asymmetry, so that the risks faced by owners are focused only on investment risk and not on the company's financial reporting risk (Hubbard, 1990; IASB, 2008, 2010; Biddle et al., 2009).

The Role of the Internal Audit Function

The definition of internal audit has undergone a significant evolution. In 1947, the IIA focused the IAF's role on checking accounting records, detecting financial irregularities, and assisting external auditors (Swinkels, 2012; Moeller, 2009). In a further evolution, the internal audit profession is required to articulate modern developments (Coetzee and Bruyn, 2001; Hass et al, 2006), so that since 1999 until now IAF has been defined as "an independent, objective assurance and consulting activity designed to add value, and improve an organization's operations. It helps an organization accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control and governance processes (Coetzee and Bruyn, 2001; Pickett, 2010).

In the survey "Measuring Internal Auditing's Value" as part of the Common Body of Knowledge (CBOK) of the IIA, Chen and Lin (2011) concluded that the factors of independence, objectivity that are free from pressure to change reports, freedom of access to the audit committee, and use of audit technology become IAF's added value contributor to the organization. However, in relation to the work of external auditors and the quality of financial reporting, indicators of IAF effectiveness from the management side are measured by the decrease in the number and value of errors corrected by external auditors (Carcello et al., 2005 in Coram et al., 2008), the time spent by the auditors external audit (Lin et al., 2011), external audit fees (Sarkar et al., 2009; Prawitt et al., 2009), the ability to prevent irregularities or fraud, and improve the quality of financial reporting (Prawitt et al., 2009; Holt and DeZoort, 2006; Gros and Wallek, 2017).

On the other hand, from the external auditor's perspective, the effectiveness of the IAF's role is determined by two factors, namely competence and objectivity. Competence is measured by, among others, education level, experience, professional certificates, policies, programs, audit procedures, supervision and review of internal auditor activities, documentation quality and results of internal auditor performance assessments. While objectivity is measured by the status of the organization and the objectivity of internal auditors in determining the area to be audited (IAPI, 2011). According to Desai et al. (2005) between the components of competence and objectivity, the strength of the IAF is considered high if the objectivity of the IAF is more dominant. However, the results of research by Prawitt et al (2009) and Al-Shetwi et al (2011) show that both competence and objectivity of IAF are able to reduce the level of earnings management thereby increasing the quality of financial reporting.

Quality of Financial Reporting

Financial reporting is a representation of management stewardship regarding what has been done and at the same time as accountability for the management of resources entrusted by the owner to management (IAI, 2012). Quality financial reporting can mitigate the problem of information asymmetry (Healy and Palepu, 2001; Verdi, 2006), inhibit moral hazard (Biddle et al., 2009; McNichols and Stubben, 2008), and increase investor confidence (WorldBank, 2011; Herly, 2012).

However, in terms of quality measurement, Dechow et al. (2009) argues "there is no one universally agreed upon measure of FRQ", because of differences in preferences and depending on the specific needs of users of information on financial statements. For example Scott (2009) defines "Financial statements that are highly informative, ...precise, or high quality, since they convey lots of information to investors". Gerald (2008) states "By "high quality" reporting, we take it to mean relevant, meaningful, reliable, accurate and comprehensive reporting of management stewardship". However, another opinion states that the quality of financial reporting will only occur if managers do not have the intention and behavior to manipulate financial statements (Iriyadi and Yadiati, 2017). This is in line with the qualitative characteristics of the IASB reporting (2010) that "If financial information is to be useful, it must be relevant and faithfully represents what it purports to represent.

The IASB (2008; 2010) asserts that qualitative characteristics are attributes and concepts that complement each other to contribute to the usefulness of financial reporting information. Zheng (2010) believes that the best definition and measurement related to the issue of financial reporting quality is conformity to the qualitative characteristics of financial reporting.

The qualitative characteristics of financial reporting consist of two main factors: fundamental characteristics and enhancing characteristics. Fundamental characteristics include the relevance that financial statements must have predictive and confirmatory value and the faithful representation that financial statements are presented in a complete, neutral and free from error. Enhancing characteristics include that financial statements must have the

qualities of comparability, timeliness, verifiability, and understandability (IASB, 2008, 2010; Crowley and Germain, 2010).

According to Tasios and Bekiaris (2012) "A key issue that impacts directly to the nature of research in financial reporting quality is the measurement of the quality of financial reports". In relation to this measurement, the IASB-FASB (2008; 2010) has long advised researchers to use a more comprehensive measurement of financial reporting quality based on qualitative characteristics. However, there are still relatively few previous studies that use a proxy for the qualitative characteristics of comprehensive financial reporting. Some of them are Beest et al. (2009) and Tasios and Bekiaris (2012).

The Influence of the IAF's Role on the Quality of Financial Reporting

Referring to the definition of The IIA in 1999, basically IAF is expected to be able to carry out assurance tasks independently and objectively in evaluating and improving governance processes so as to provide added value and help companies achieve corporate goals (see Coetzee and Bruyn, 2001; Pickett, 2010). The quality of financial reporting itself is closely related to the intention and behavior of management in presenting accurate operational performance reports that make it easier for investors to predict cash flows. In other words, the quality of financial reporting will be achieved if managers do not have the intention and behavior to disguise or manipulate financial reports (Iriyadi and Yadiati, 2017). This is in line with the opinion of the IASB (2010), that "If financial information is to be useful, it must be relevant and faithfully represents what it purports to represent. Thus, IAF must be competent and objective in order to play a role in assisting management in presenting a quality financial report.

The results of The IIA's global survey covering 107 countries, including Indonesia, show that internal audit has an important role in financial reporting (Alkafaji et al., 2010). The results of the PwC survey (2014) show that 71% of respondents believe that the IAF has the ability to mitigate the risk of fraud. In many literatures it is stated that IAF is an important component in good corporate governance. This is due to the operational knowledge and internal control of the internal auditors exceeding the knowledge of the external auditors (CAQ, 2010; Cohen et al., 2004; Arens et al., 2012). According to CIMA (2008), even internal auditors are proven to be more successful in detecting and uncovering large cases of financial reporting fraud than external auditors. Prawitt et al. (2009) stated that basically IAF is more competent in understanding indicators of accounting irregularities so that it can reduce management's intention and aggressiveness in financial reporting, while IAF's objectivity is shown by their courage to report findings of irregularities so as to eliminate the impression that IAF is "controlled" by management. In other words, the IAF has an adequate and strategic role and position to influence the quality of financial reporting.

Based on the description above, the hypothesis of this research is as follows:

H1: The role of IAF has a positive effect on the quality of financial reporting

Research Methodology:-

The method used in this study is a quantitative method. Referring to the research of Prawitt et al. (2009), the role of IAF is measured by using the proxy of competence and objectivity. These two factors are very important because they are used as the main basis for consideration by external auditors in assessing the quality of the work of internal auditors (IAPI, 2011). However, to measure IAF competence, Cheetam and Chivers (1998) used measurement dimensions, namely personal, cognitive, functional, and ethical values. While the measurement of objectivity uses the dimensions of organizational status and various policies in maintaining the priorities of the audited activities. Overall, the measurement of the effectiveness of the IAF's role consists of 23 indicators adopted from various sources such as audit standards Section 322 of the IAPI (2011), instruments used by Cohen and Sayag (2010), Prawitt et al. (2009), and Gil et al. (2012). The quality of financial reporting is measured using a proxy for the qualitative characteristics of financial reporting sourced from the Conceptual Framework 2010 built by the IASB (2010). Overall, the measurement of financial reporting quality includes 21 indicators adopted from the instruments used by Beest et al. (2009). Each indicator uses five Likert scales. Collecting data by distributing 60 questionnaires to practitioners in internal audit, audit committees, external audit, and financial managers. Purposive sample selection is intended to obtain their expert knowledge (Sekaran and Bougie, 2010). To analyze the relationship between variables using multiple linear regression which was processed using SPSS statistical software.

Results:-

Reliability and validity

Based on the distribution of questionnaires to practitioners purposively, there were 24 respondents (40%) who met the criteria. The test results on the validity and reliability of the questionnaire instrument related to the role of IAF showed that all questionnaire items were valid and reliable. Statistically, the level of $df = 22$ with $\alpha = 0.05$ and the calculated r value is greater than the r table value of 0.344, while the reliability coefficient of Cronbach's alpha shows 0.972 or ≥ 0.60 . The results of the validity and reliability test of the financial reporting quality questionnaire show that not all questionnaire items are valid. After removing the two invalid items, all question items showed validity ($df=22$), r count ≥ 0.344 , and confidence interval $\alpha = 0.05$ and reliable with Cronbach's alpha value of 0.895.

Hypothesis test results

The results of the F-test (Table 1) and t-test (Table 2) show that the independent variable IAF has a positive effect on the quality of financial reporting (significantly $0.009 \leq \alpha = 0.05$). Thus, H_1 is accepted.

Table 1:- F-test.

Model		Sum of Squares	df	Mean Square	F	Sig.
1	Regression	664,159	1	664,159	8,319	,009 ^a
	Residual	1756,371	22	79,835		
	Total	2420,530	23			

Table 2:- t-test.

Model		Unstandardized Coefficients		Standardized Coefficients	t	Sig.	Collinearity Statistics	
		B	Std. Error	Beta			Tolerance	VIF
1	(Constant)	48,707	8,510		5,724	,000		
	Audit Internal_	,317	,110	,524	2,884	,009	1,000	1,000

a. Dependent Variable: Quality of Financial Reporting

Table 3 shows that the role of IAF is able to explain 27.4% of the variance in financial reporting quality ($R^2=0,274$).

Table 3:- Model Summary.

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate	Durbin-Watson
1	,524	,274	,241	8,93505	,848

The results of further data analysis showed that the IAF competency had a higher $r = 0.989$ value than the objectivity $r = 0.950$. Meanwhile, the fundamental characteristic, faithful representation, is a qualitative characteristic that has the highest correlation value on the quality of financial reporting ($r = 0.833$) compared to relevance ($r = 0.751$), understandability ($r = 0.746$), comparability ($r = 0.674$), and timeliness ($r = 0.614$).

Discussion:-

The results of this study provide evidence that the higher the level of competence and objectivity of the IAF, the higher the quality of financial reporting. The results of this study also respond to doubts about the IAF's unique role as a servant of the "two masters". In other words, the competence and objectivity of the IAF's role accompanied by support from the board of commissioners through the audit committee is able to create an atmosphere of "checks and balances" within the corporate governance structure, especially for management to improve the quality of financial reporting. The results of this study also indicate that the IAF competence factor is more dominant than objectivity, which is different from the results of previous studies by Desai et al. (2005). In terms of financial reporting quality, faithful presentation is the most important qualitative characteristic. In sum, it can be concluded that the quality of financial reporting is related to the competence and objectivity of IAF which encourages management's intention and behavior to present financial statements faithfully. This findings support the results of previous studies, such as Prawitt et al. (2009), Berhe et al. (2014), Gros and Wallek, (2017) that the role of IAF has a positive effect on the quality of financial reporting.

Conclusions, Implications and Limitations:-

The results of the study concluded that the competence and objectivity of IAF had a positive effect on the quality of financial reporting. The implication of this finding is that internal auditors need to continuously improve their competence and objectivity to be more able to play an important role in improving the quality of financial reporting which in turn enhancing the usefulness of financial statements for decision making. The limitation of this study is that the sample was determined purposively with a relatively small number of respondents. For further research, it is recommended to use data from more respondents and also add other variables.

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