

The Internal Audit Function and Its Effect on Audit Quality

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Abstract

This research aims to see the internal audit function and its effect on audit quality. This research uses quantitative research. The research data used in this study consisted of All Non-Financial Companies listed on the Indonesia Stock Exchange. After applying the sample selection criteria, finally 722 observations were obtained as the main sample in this study. This study uses multiple linear regression for analysis techniques with STATA 14.0 software. The results show that internal audit size has a positive and significant effect on audit quality as measure by earning management. Internal audit expertise has a positive and significant effect on audit quality as measure by earning management. Internal audit certification has a positive and insignificant effect on audit quality as measure by earning management.

Keywords

internal audit; size; expertise; certification; audit quality; earning management



I. Introduction

The rapid development of the times demands a faster exchange of information in the community, including stakeholders such as investors, governments, researchers, and other parties who need quality financial information that is used as the basis for decision making. This is because the financial statements themselves are the key for companies in assessing the going concern of a company that can be considered in making decisions. For good decision making, financial statement information must be well represented, relevant, understandable, comparable, timely and verifiable (Kaawaase et al., 2021). Quality financial reporting itself can help stakeholders, especially investors and companies, in allocating limited resources to achieve a goal (International Accounting Standards Board, 2013).

An audit is a stepping stone to corporate governance (Cadbury, 1992). Companies that have good governance will tend to produce quality audit reports (Lin and Liu, 2009). Based on research conducted by Fan and Wong (2005) revealed that companies with good governance will demand better audit quality which will have an impact on the value or image of the company itself. An effective internal auditor function will ensure good corporate governance by improving internal control. This is in line with the statement by the Institute of Internal Auditors (2005) which states that internal auditors have an important role as a significant form of internal control on the effectiveness of corporate governance finance companies such as Enron, Global Crossing, WorldCom, and many more (Khushboo and Karamjeet, 2021). This also encourages internal auditors to play their role in providing assurance and minimizing information asymmetry to stakeholders and other parties related to decision making (Al-Shetwi et al., 2011).

The motivation of this research is to look at the role of internal audit in carrying out internal control functions with the aim of minimizing the possibility of information asymmetry. This study aims to examine the relationship between the characteristics of internal audit or it can also be called the internal audit function and audit quality. This

study contributes to the literature related to the internal audit function by providing an overview of the advantages for a company to have a capable internal audit function.

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II. Review of Literature

Agency theory is a theory that provides an explanation of the relationship between shareholders and parties who carry out the company's management function. Conflicts of interest and information asymmetry between owners or principals and executives of the company which in this case management or agents give rise to agency theory. Jensen and Meckling (1976) explain that the relationship between the principal and the agent is that the principal provides responsibility and authority for decision making for agents in carrying out the company's operational functions. According to agency theory, agents as parties who have the authority to carry out company functions are often faced with conflicts of interest with principals. The conflict that occurs is referred to as agency problems, where the principal and agent have conflicting interests. Differences in interests will affect agents in making voluntary disclosures, namely agents will only disclose information that is considered beneficial to agents.

Initially, the internal auditor had a function in assisting management in making decisions regarding the business operations of a company, but since the rise of fraud scandals in the early 2000s, there has been a shift in focus to improve the process of good corporate governance and apply good accounting principles in the environment company. The existence of an internal audit itself is one of the main keys for a company in carrying out good governance. A good internal auditor function will ensure the continuity of the company's internal control which will later support the company in achieving the company's three goals which consist of the effectiveness of the company's operational activities, the reliability of financial reporting and compliance with applicable laws.

The internal audit function will assist management through evaluating the company's compliance with internal and external reporting requirements, reviewing the suitability of the accounting principles used by the company, evaluating the adequacy and effectiveness of the company's internal control over the financial reporting process, and providing information and insight on the strength of internal control. The quality of the opinion that audit quality has a relationship with earnings management practices used by the company which will later be audited by an external auditor. Audit quality is highly correlated with the company's implementation of low earnings management. Along with the increase in financial statement scandals, the internal audit function has received greater attention since fraud cases such as the Enron and WorldCom cases. This makes sense considering that internal audit has a function in evaluating the possibility of fraud and the possibility of non-compliance with regulations as well as risk mitigation and communicating to senior management levels (Institute of Internal Auditors, 2005). In selecting a public accounting firm, companies with good governance will tend to choose to use a more qualified auditor compared to companies that do not have good governance (Lin and Liu, 2009). Companies with good mechanisms will tend to choose auditors with good reputations such as big 4 public accounting firms. This is based on an increase in value when a company chooses to use a public accounting firm with a good reputation tend to attract investors to invest in their company.

Audit quality on the effectiveness of the internal control system, states that the quality of internal audit is determined based on competence and independence. The more

experienced internal audit, the more capable of producing good performance and the independence of an auditor seen from his position from the organizational structure, the higher the position of the auditor, the internal auditors do work more freely and subjectively. So that the supervision and implementation of the control structure can be described as the quality of internal audit has an influence on the effectiveness of the internal control system.

The problem of weak internal control and non-compliance with laws and regulations is due to management that has not been optimal in conducting supervision and control and has not complied with the preparation of the necessary policies. Weak internal control is of particular concern, the weakness of internal control can be caused by the non-optimal quality of internal audit and the lack of role of internal audit. Internal audit is a service that has an orientation to add value to management. Internal audit includes services for examining and assessing control, performance, risk, and governance of public and private companies.

The purpose and function of internal audit is to examine, assess, supervise, and assist management in carrying out their responsibilities in accordance with established procedures. Internal audit will provide assessments, views or suggestions that can help all departments. The purpose of the internal audit is to assist members of the organization in carrying out their responsibilities effectively. The internal audit function is one of the checks and balances requirements for the implementation of good governance. The internal audit function is carried out in a healthy and objective manner with the ability to identify risk control problems and the authority to follow up. From the quote above, it can be concluded that the purpose and function of internal audit is to evaluate the performance of all parts of the company or organization in creating the functions of each section effectively and efficiently which will be followed up according to the applicable authority in each company. The scope of the internal audit is to assess the effectiveness of the internal control system and the quality of implementation of the responsibilities assigned. Internal auditors must carry out activities (scope) namely examining and assessing controls over operational and accounting activities, checking books and other data produced by the company, checking the extent to which company assets are accounted for and safeguarded from various forms of loss, and examining the relationship between implementers and established policies.

III. Research Method

This research uses quantitative research. Quantitative research is the process of collecting and analyzing numerical data. It can be used to find patterns and averages, make predictions, test causal relationships, and generalize results to wider populations (Asyraini et al., 2022; Jibril et al., 2022; Otiva et al., 2021).

The research data used in this study consisted of All Non-Financial Companies listed on the Indonesia Stock Exchange. Population is a group or collection of objects or objects that will be generalized from the results of research (Pandiangan, 2015; Pandiangan, 2022). The population of this study was compiled from the Company's Financial Statements and OSIRIS with a total of 1,096 financial data. The sample is a part of the whole as well as the characteristics possessed by a population (Pandia et al., 2018; Pandiangan et al., 2018). This study applies sample selection criteria by removing some missing data. After applying the sample selection criteria, finally 722 observations were obtained as the main sample in this study.

This study uses multiple linear regression for analysis techniques with STATA 14.0 software. Multiple linear regression is a regression model that involves more than one independent variable (Octiva et al., 2018; Pandiangan et al., 2022; Tobing et al., 2018). Multiple linear regression analysis was conducted to determine the direction and how much influence the independent variable has on the dependent variable (Octiva, 2018; Pandiangan, 2018; Pandiangan et al., 2021).

IV. Results and Discussion

4.1 Descriptive Statistics Results

Table 1. Descriptive Statistics

	Mean	Median	Minimum	Maximum
JONES	0.103	0.083	0.001	0.358
IASIZE	6.387	3.000	0.000	77.000
IAEXP	0.835	1.000	0.000	1.000
IACERTIF	0.113	0.000	0.000	1.000
ROA	0.036	0.032	-1.465	0.716
FAGE	32.881	30.500	5.000	115.000
LOSS	0.221	0.000	0.000	1.000
COM	4.329	4.000	2.000	10.000
DIR	4.776	5.000	2.000	11.000
BIG4	0.407	0.000	0.000	1.000

Table 1 in this study shows the results of descriptive statistics that explain the statistical distribution of variables in this study. The first variable in this study is the dependent variable, namely the earnings management variable as measured by the JONES approach, the results of descriptive statistics show the smallest value of 0.001 with the largest value of 0.358. The mean value of the earnings management variable is 0.103 with a median value of 0.083. Furthermore, the IASIZE variable explains the size of the internal audit team, in the table above it is explained that the smallest internal audit team size is 0.000 and the largest is 77,000 with an average value of 6,387 and a median value of 3,000. The next variable in this study is IAEXP which explains the accounting education background with a minimum value of zero and a maximum of one, with details of 32 subjects in this study not having an accounting education background and 162 having an accounting education background. The next variable is IACERTIF which explains the certification that has been taken or followed by internal audit personnel, in this study this variable is explained by descriptive statistics, the value of the smallest is zero and the maximum is one, this variable has 22 internal audit personnel who have certification and 172 people do not. have internal audit certification. Furthermore, on the control variables in this study, starting from ROA which has a minimum value of -1.465 with a maximum value of 0.716 and an average value of 0.036 and a mean value of 0.032. The next variable is firm age or FAGE which explains the age of the company in this study with the smallest value being five years and the oldest being 115 years old and the average age of the company being 32,881 years and the median value being 30,500. The next control variable is the variable loss or losses experienced by companies that are the subject of this study, in the research period, there were 152 companies that experienced losses and 42 that did not suffer losses. The next variable is COM or the amount of commissioners in this study which has a minimum value of two and a maximum of ten with an average value of 4,329

and a mean value of 4,000. Furthermore, there is the DIR variable which explains the size of the board of directors of the companies in this study which have the smallest value of two and the largest of ten with an average of 4.776 and a median value of 5,000. The last control variable of this research is BIG4 which explains the companies audited by BIG4 and non-Big 4 where the companies audited by BIG are 81 companies and companies that are not audited by BIG4 are 113 companies.

4.2 Multiple Linear Regression Results

Table 2. Main Regression

	(1) EM	(2) EM	(3) EM
IASIZE	0.000* (1.80)		
IAEXP		0.013** (2.18)	
IACERTIF			0.002 (0.27)
FAGE	0.000 (1.68)	0.000 (1.72)	0.000 (1.63)
LOSS	0.002 (0.48)	0.001 (0.33)	0.002 (0.49)
COM	-0.000 (-0.55)	-0.000 (-0.72)	-0.000 (-0.07)
DIR	-0.001 (-0.90)	-0.001 (-1.30)	-0.001 (-0.82)
BIG4	0.010* (1.91)	0.011* (1.97)	0.011* (1.79)
_cons	0.175*** (19.68)	0.169*** (13.08)	0.177*** (18.61)
Industry Fixed Effect	Yes	Yes	Yes
Year Fixed Effect	Yes	Yes	Yes
r2	0.900	0.903	0.900
r2_a	0.892	0.894	0.891
N	194	194	194

V. Conclusion

The results show that internal audit size (IASIZE) has a positive and significant effect on audit quality as measure by earning management. Internal audit expertise (IAEXP) has a positive and significant effect on audit quality as measure by earning management. Internal audit certification (IACERTIF) has a positive and insignificant effect on audit quality as measure by earning management.

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