

# THE ROLE OF INTERNAL AUDIT, INTERNAL CONTROL SYSTEMS, AND CORPORATE GOVERNANCE PRACTICES TOWARD FINANCIAL REPORT QUALITY

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## **ABSTRACT**

Financial reporting quality is defined as the accuracy and completeness of the data in financial reports, including note disclosures. Quality reporting offers information that can be used to make decisions that is timely, accurate, and truly reflects the economic reality of the company's operations during the reporting period as well as the financial standing of the company at the conclusion of the period. Hence, the factors that influence and contribute to the quality of the financial report need to be identified to improve the quality of the report. Therefore, this study aims to identify empirical evidence of the factors that influence the quality of financial reports by using the variables of internal audit, internal control system implementation, and corporate governance practices. A conceptual model is then developed to analyse the quality of financial reports obtained from the role of the variables, and it is grounded in existing theories. This is to provide a scientific contribution to the field of public sector auditing and to find solutions to issues relating to enhancing the quality of financial reports by using the factors of internal audits, internal control systems, and corporate governance procedures. In addition, the findings of this study will help the regulators improve the quality of their financial reports so that fraudulent financial reporting can be avoided.

**Keywords** *Financial Report Quality, Role of Internal Audit, Internal Control Systems, Corporate Governance Practices, Malaysia*

## **1.0 Introduction**

The vision, procedures, and structures needed to ensure long-term sustainability are ingrained in businesses through good corporate governance practises. Additionally, it is essential to promote good corporate citizenship, which is a dedication to moral conduct in business operations, culture, and strategy (Malaysia, 2021). Investors, creditors, and other stakeholders are becoming more aware of how important environmental, social, and governance factors are to a company's success and long-term sustainability in today's globalised and linked world. The board should be aware that essential corporate governance principles, including efficient

controls, an ethical corporate culture, and openness, can lower risk, corruption, and mismanagement. Therefore, to ensure that businesses operate well and experience sustained growth, boards should comprehend and include these dimensions in their fundamental decision-making processes.

Beginning in 2023, the social, economic, and political climate around the world remained incredibly unstable (ACCA, 2023). Despite the fact that the COVID-19 pandemic crisis seems to be over, its physical and economic repercussions continue, and combined with the divergent economic recovery rates of the various countries. Moreover, they pose a threat to further polarise societies at a time when international cooperation is needed to address new global issues like the transition to a sustainable economy (International Monetary Fund 2023; World Economic Forum, 2023).

The other crises had been triggered by this issue. Financial reporting fraud is widespread around the world. For instance, the Global Economic Crime and Fraud Survey conducted by Price Waterhouse Coopers (PwC, 2018) found that 49% of financial reports provided by businesses fall short of the required level of quality. Additionally, the recent report by PwC, emphasises that firms are working hard to improve their technical skills and put in place tighter internal controls in order to reduce the incidence of fraud (PWC, 2022). On top of that, Mundy 2018, on this study found that due to their failure to recognise Satyam's overstated revenue, PwC was given a two-year ban from operating in India.

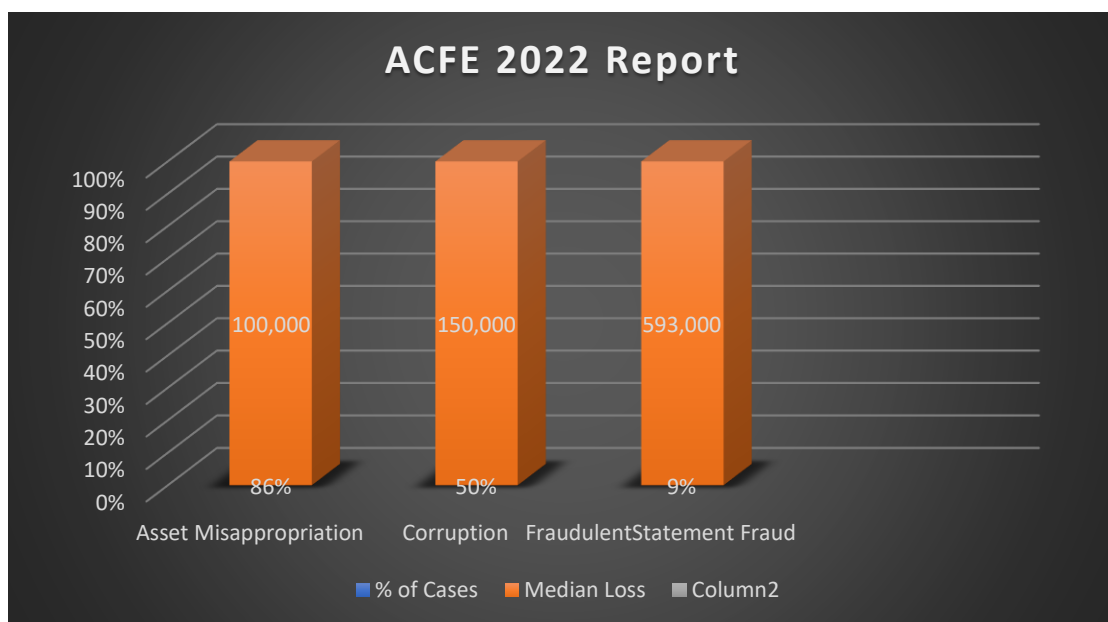


Figure 1: Financial Statement Fraud Schemes  
Source: Association of Certified Fraud Examiners (2022)

According to ACFE (2022) figures in their Report to the Nation, there are three basic categories of occupational fraud at the top level. Figure 1 above show the statistic from AFCE. Asset misappropriation, which involves an employee taking or misusing the employer's resources, is the most common, accounting for 86% of occurrences. However, these systems have the lowest median loss at USD 100,000 per case. Financial statement fraud schemes, by comparison, are the least common (9% of schemes) but most expensive (USD 593,000). In terms of frequency and losses, the third category, corruption, comprises offences such as bribery, conflicts of interest, and extortion. This type of scam occurs in 50% of cases and results in a median loss of USD 150,000.

Moreover, from the report, it shows that the highest average loss is due to fraudulent financial reporting. Fraudulent financial reporting is defined as major financial statement falsification that misleads financial statement users (Rostami & Rezaei, 2021; Tiffani & Marfuah, 2015). Material losses to the companies, a negative reputation towards the accounting profession, and a loss of public confidence in financial statements are all consequences of dishonest financial reporting (Ghorbani & Salehi, 2020). Accounting disasters such as Enron in the United States cost the business \$50 billion, its investors \$32 billion, and pension funds roughly \$1 billion (Spathis, 2002).

Apart from that, based to the 2018 conceptual framework, the goal of financial reporting is to give financial information that consumers may utilise to make decisions. Financial report information must be truthfully portrayed, relevant, intelligible, comparative, timely, and verifiable in order for valid judgements to be made. Financial reporting quality is useful in determining resource allocation decisions in the organisation (International Accounting Standards Board, IASB, 2013). It is emphasised that a firm's ability to source money externally and provide sufficient accountability is solely dependent on the accuracy of its financial reporting (Chan-Jane et al., 2015; Chen et al., 2011). Users of financial information make judgements based on the entity's prospects for future net cash inflows and management's stewardship of the entity's economic resources (IFRS, 2020). As a result, financial reporting quality is a global concern for all stakeholders, including shareholders, lenders, and suppliers, among others. (Kaawaase et al., 2021)

The financial management practises of government agencies are heavily reliant on publicly accountable financial accounts (Mardsemo, 2018; Rahim et al., 2021; Tete et al., 2022). The nature of financial statement information will be enhanced if financial statements are of high quality. Financial statements must comply with Government Accounting Standards, as stipulated by Government Regulation 71 of 2010. Financial statements are deemed to be as a good quality if the information contained within them is easily understandable, fits the decision-making needs of users, is free of misleading conceptions and material errors, and is dependable enough to allow comparisons with preceding periods (Sonjaya & Muslim, 2023).

## **2.0 Literature Review**

### **2.1 Role of Internal Audit**

“Internal auditing is an independent, objective assurance and consulting activity designed to add value and improve an organization's operations” (IIA, 2022). An Internal audit is a collection of processes involving data collection (audit evidence), analysis, and evaluation to obtain assurance regarding compliance or noncompliance with applicable standards. It consists primarily of the quantity and quality of evidence gathered to form an opinion or make a recommendation (Rensburg & Coetzee, 2016; Alqudah et al., 2023). Using a methodical, disciplined approach to assess and enhance the effectiveness of risk management, control, and governance systems helps a business achieve its objectives. An effective audit is an integral element of corporate governance, which plays a crucial role in assisting management and the board of directors in adding value and achieving the company's objectives (El-Sayed Ebaid, 2011).

Corporate governance and accounting harmonisation have been aided by the expansion of financial markets globally and the impact of investors seeking trustworthy information about the financial and economic standing of organisations (Moyes and Baker, 2009). The role of internal audit has grown in significance within the governance of organisations, and these new

initiatives have an impact on them (Archambeault et al., 2008; Jackson, 2007). Roussy (2013) characterizes the role of internal audit into two distinct roles: protectors (guardians of confidential information and shields) and helpers (supporting organizational performance and direction). Spira and Page (2003) contend that the internal audit's function has changed from that of controllers to that of value-added services, despite recent research on the subject (Hazami-Ammar, 2019). Internal audit traditional services are surpassed by value-added services that increase an organization's effectiveness, such as risk management (Al-Akra et al., 2016; Rijamampianina, 2016; Abuazza et al., 2015). According to Stewart and Subramaniam (2010), the role of internal audit is required to oversee the "reliability of financial reporting" (Pforsich et al., 2006; Oxner and Oxner, 2006; Rittenberg and Miller, 2005;) and adopt a risk orientation consistent with the strategic goals of the company. An effective internal audit can serve as a preventive measure against financial scandals within a firm. Conversely, a poorly performing internal audit can pose a significant risk to the organization.

Today, the function of internal audit has dramatically shifted from traditional roles of ensuring compliance and protecting assets to value-added assurance and consulting services (Ebrahimi et al., 2023). In the wake of the global financial crisis from 2007 to 2009, internal audit played an important role in the company's corporate governance, internal control framework, risk management, operational audit, and financial reporting procedures. Western nation's internal audit has made steady strides in actively offering their companies assurance and advisory services to help ensure compliance with relevant laws, rules, and regulations, including executive certifications of financial reports and internal controls. The usefulness of internal audits as advisors and consultants in the areas of quality and innovation, business alignment, risk assessment, talent model, stakeholder management, cost-effectiveness and technology appear to be supported by anecdotal evidence (PWC, 2014; (Mashayekhi et al., 2022).

While the scope and roles of the internal audit functions may differ throughout organisations, there is a discernible trend towards internal audit playing a more strategic and key role. With these modifications, organisations should concentrate on and expand their relationship with the growing internal audit department and its key stakeholders.

Asare et al. (2008) show that when management has a strong incentive to misreport financial information, internal auditors who are aware of this increase budgeted labour hours. According to this experimental research, aggressive accounting practices by management may be lessened with the support of internal auditing. It is reasonable to assume that internal audit participation in the financial reporting process will determine how effective this deterrence is. Through monitoring, a more involved internal audit can increase organisational transparency and increase the likelihood that biases in management decisions will be identified. Increased internal audit participation in the financial reporting process creates a more controlled atmosphere and lowers the likelihood of mistakes occurring accidentally or on purpose (Favere-Marchesi, 2013). Therefore, anticipate that the internal audit will be better able to offer financial information if it actively supervises the accounting process and is thus more likely to identify errors or fraud. In addition, financial reporting procedures are improved by internal audit's role as a watchdog over the company's financial reporting practices. Based on these arguments, the following hypothesis is developed:

***H1: Role of Internal Audit significantly influence Financial Reporting Quality.***

## 2.2 Internal Control Systems

The most widely used definition is the one provided by the Committee of Sponsoring Organisations (COSO, 2013), internal control is “a process, affected by an entity’s board of directors, management and other personnel, designed to provide reasonable assurance regarding the achievement of objectives in (1) the effectiveness and efficiency of operations, (2) the reliability of financial reporting, and (3) the compliance of applicable laws and regulations”. In any organisation, internal control is an important aspect to address as internal control assists to promote orderly, effective, efficient and economical operations as well as to safeguard resources against loss due to abuse, waste, errors, mismanagement and fraud (Ashbaugh-Skaife et al., 2009).

In other words, internal control can be described as the whole system of control, financial and otherwise established by management in order to conduct a business in an orderly and efficient manner. It involves the control procedure and control environment, all the policy and procedure adopted by the directors and top management of an entity to assist in achieving their objectives, including adherence to internal policies, completeness and accuracy of records, the safeguarding of assets, timely preparation of reliable financial information as well as the prevention and detection of fraud and error (Abiola, 2013).

The primary objective of internal control is to facilitate the effective and efficient management of an organization, with a focus on optimizing resource allocation and minimizing costs (Jamil et al., 2022). An effective internal control system facilitates organisations in achieving their objective of delivering financial information while safeguarding their assets and other valuable resources. Over the years, the importance of internal control within organisation gained significant attention as a key corporate governance mechanism. Regulators contend that increased examination of control systems is required as control weaknesses are the main factor of the large-scale fraudulent financial reporting (e.g. Enron, Lucent, WorldCom and HealthSouth, to name a few). A recent report conducted by the (ACFE, 2018) also revealed that lack of internal control as the highest factor that contributes to the occurrence of fraud.

This shows that internal control is one of the important aspects that require sufficient courtesy in an organisation. It is consistent with findings from prior literature that have recognised internal control as a crucial element in assuring of an organisation’s objectives in operational effectiveness and efficiency, reliable financial reporting and compliance with laws, policies, and regulations (Ashbaugh-Skaife et al., 2009; Choi et al., 2013; Mohd-sanusi et al., 2015; Spira & Page, 2003). In relating to fraud risk assessment, internal control is the most effective system for detecting fraud through monitoring and enhancing organisational and financial reporting processes as well as ensuring compliance with pertinent laws and regulations (Rae & Subramaniam, 2008; Spira & Page, 2003).

Research conducted by Zainudin & Hashim (2016), internal control determines the quality of corporate financial reporting. Premuroso (2012) discovered a considerable impact on the dependability of financial statements' internal control. Positive effectiveness considerably increases the trustworthiness of financial reporting quality, according to Wittayapoom (2012). According to Elbannan's (2007) theory, if internal control is implemented well, it can become more capable of meeting financial statements and the role of information quality evaluation. According to Altamuro and Beatty (2010), the banking industry's financial reporting is of higher quality when internal controls are monitored and reported on more frequently. Based on the above findings, it has been proved that the internal control system plays an important role

in ensuring the quality of financial reporting of an organization. Thus, the following hypothesis is developed:

***H2: Internal Control Systems significantly influence Financial Reporting Quality.***

### **2.3 Corporate Governance Practices**

Corporate governance refers to the systems, procedures, structures, or mechanisms deliberately with the aim of directing all business activities in meeting the organization's objectives, which is maximizing the shareholders' wealth (Adegbeie & Fofah, 2016). Corporate governance is believed to create great prospect for the organisation, especially in terms of investment (Ahmed & Hamdan, 2015). Corporate governance has a major influence on organisation's performance. The relationship between corporate governance and firm performance has been thoroughly researched, and evidence mostly shows a positive relationship. Corporate governance practices have a significant impact on corporate behaviour and decision-making (Mari & Towo, 2017). Effective corporate governance structures, such as independent boards of directors, effective audit committees, transparent disclosure practices, and shareholder rights, will improve the organisation's accountability, transparency, and the investor's confidence (Crow & Lockhart, 2016). One of the important measures look upon by the investors is the financial reporting quality, since they rely on financial reporting information to make financial decisions (Yeh et al., 2014). Al-Adeem & Al-Sogair (2019) assert that the quality of financial reporting is also about how the quality could be disclosed to the interested party to aid informed decisions. Hence high financial reporting quality will provide accurate information to the interested party to enable them to make the right decision. Hence, this study looks at how governance practices may possibly influence the level of reporting quality.

Houqe et al. (2011) examines whether corporate governance practices have an effect on the earnings quality in Bangladesh. Based on 648 firm-year observations, the result suggests that corporate governance mechanisms provide greater monitoring of financial reporting, and these mechanisms positively affect firm earnings quality. Another study by Haldar and Raithatha (2017) examined the impact of corporate governance practices on the financial reporting quality of the Indian companies using multiple regression model for 200 large listed Indian firms. Findings suggest that quality of governance practices significantly improves financial reporting quality of an organisation. The study builds a case for an urgent intervention for improving the existing governance standards to advance the quality of financial disclosure in an emerging market context. Based on the discussion above, the study would like to propose the second hypothesis of the study.

***H3: Corporate Governance Practices significantly influence Financial Reporting Quality.***

### **2.4 Financial Reporting Quality**

The primary goal of financial reporting is to offer information on economic entities, generally financial in character, that can be used to make economic decisions (IASB, 2008; Van Beest et al., 2009). Financial reporting offers information about the entity's assets, liabilities, equity, income and costs (including profits and losses), contributions by and distributions to owners, and cash flows (Van Beest et al., 2009). This information is typically provided in the form of yearly financial statements such as the statement of financial position, income statement or statement of comprehensive income, cash flow statement, and statement of changes in equity, as well as notes to the accounts (IASB, 2008, 2010). External auditors review these reports to ensure their dependability and credibility in the minds of users. However, an increasing number

of financial scandals has put severe doubt on the accuracy of audited financial reports circulated in our corporate world.

As a result, the concept of quality financial reporting has piqued the interest of researchers all around the world. However, there is no agreed definition of 'excellent financial reporting' among researchers, practitioners, or regulators (Pomroy & Thomson (2008). Audit committees and auditors to discuss the quality of the company's financial reporting procedures, not only their acceptability (SOX, 2002). However, the Act did not define 'quality' in financial reporting. The IASB (2008), on the other hand, has published a working definition of financial reporting quality. The Board defines excellent financial reporting in its conceptual framework as meeting the objectives and qualitative aspects of financial reporting (IASB, 2008; Van Beest et al., 2009).

High-quality financial reporting would boost accountability and good governance in government. Good governance, accountability, and financial performance are now critical for the long-term viability of autonomous public sector organisations (Garcia-Lacalle & Torres, 2021). As a result, the quality of financial reports is expected to lead to increased relevance and reliability of accounting and financial information, as well as the expansion of transparent accounting and financial information to facilitate superior monitoring of managers' accountability for appropriate disclosure (Pitenoei et al., 2021).

The quality of financial reports is critical in maintaining public trust by ensuring accountability and transparency of public funds, as well as promoting effective and efficient decision making. High-quality financial reports allow stakeholders to use such information in analysing economic performance and anticipate such information to aid them in determining the soundness of the reporting entity and making appropriate financial decisions (Kantudu & Alhassan, 2022). The information in the financial accounts must be provided in an acceptable, relevant, intelligible, comparative, timely, and verifiable manner in order to make a sound choice. As a result, the quality of financial reporting is particularly beneficial in making judgements about resource allocation in organisations (Sabauri & Kvatashidze, 2018).

## **2.5 Theoretical Foundation & Conceptual Framework**

According to the stakeholder theory, managers should make decisions that consider the interests of all parties involved in a company, including not only those with a financial claim but also those with other interests, including employees, consumers, communities, and government officials (Freeman, 1984). Moreover, from this theory perspective, an organisation should work to achieve numerous goals of a diverse range of stakeholders rather than just those of shareholders.

On top of that, according to Freeman (1984), when making strategic decisions, corporate organisations should give more thought to the interests of other stakeholders. The term "accountability" is related to the stakeholder theory and is defined by Peasnell et al. (1998) as the duty of one party to another in a relationship where one party entrusts another with carrying out specific tasks. Therefore, it can be stated that financial reporting quality could, in a timely manner, lessen information asymmetry between the organisation and its stakeholders and, as a result, enhance the relationships between them.

When a company has sound corporate governance procedures in place and an effective internal audit function, it can offer the various stakeholders with high-quality financial information. According to the stakeholder theory (Peasnell et al., 1998), managers are always required to

give the various stakeholders accurate information. On top of that, the theory highlights that, companies with high-quality internal audits and board members who are independent of management, have knowledge of financial issues, and can carry out their tasks are able to satisfy the interests of different stakeholders.

The conceptual framework created for this study is outlined in Figure 1 and is based on prior research and the hypotheses created in Section 2.0. In particular, role of internal audit, internal control systems, and corporate governance practices are regarded as latent variables that affect the quality of financial reports.

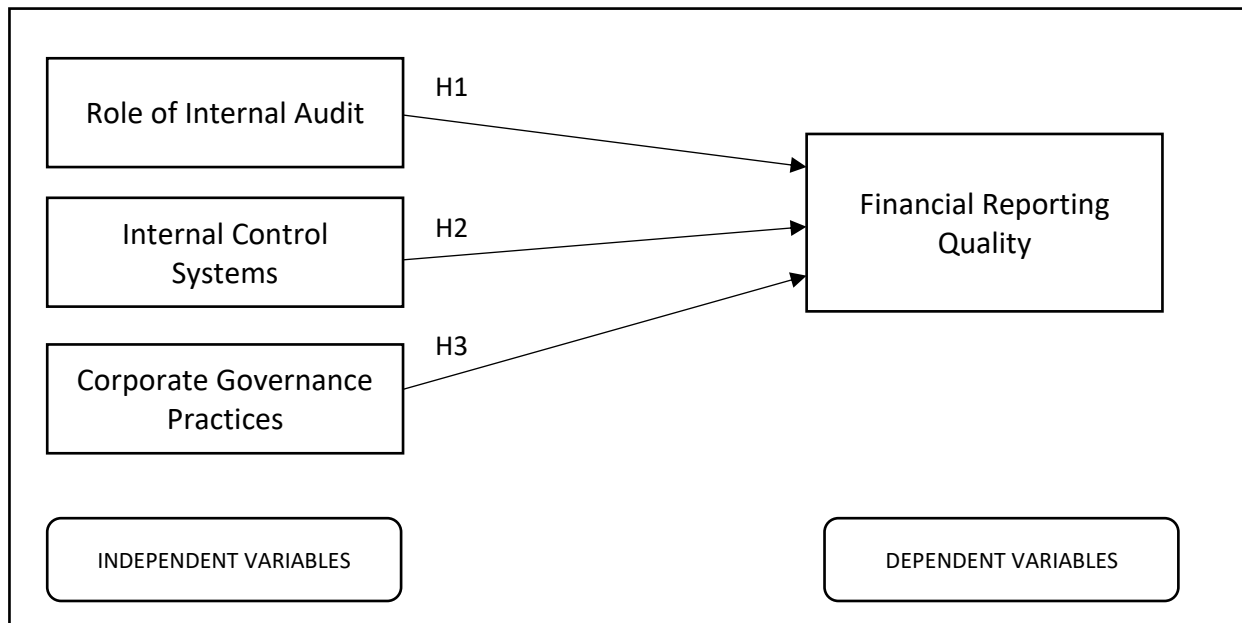


Figure 2: Conceptual Framework

### 3.0 Methodology And Measurements

#### 3.1 Methodology

This study used the Mbobo & Ekpo, 2016; Pham, 2021 scale to measure Financial Reporting Quality (FRQ). Mbobo & Ekpo (2016) and Pham (2021) conducted their studies in Nigeria and Vietnam, respectively. This scale might not be appropriate for the Malaysian research context. To modify the scale and customise the questionnaire for the Malaysian setting, we conducted quantitative research. To gather data measuring the components and assess the influence of the model's factors on the accuracy of financial reporting, the survey approach will make use of the Google Forms tool. Direct links to the survey will be sent to Malaysian respondents who work for public and private companies.

#### 3.2 Measurement

The purpose of the survey questionnaire was to gather information for measuring the variables in the study model. The respondents were asked to rate their opinions on a numerical Likert scale between totally disagree (1) and totally agree (5) as part of the control self-assessment approach.

The research instrument was created with reference to the conceptual framework's development. A questionnaire was created using the results of previous studies. There were

two primary elements to the questionnaire: measurement items and information about the respondents' demographics. The questionnaires have been adapted from previous research of Mbobbo & Ekpo (2016) and Pham (2021). The quality of financial reporting has been evaluated using a variety of measuring approaches in earlier studies. The most common of these are (i) qualitative characteristics model (Jones & Blanchet, 2000; Barth, Landsman & Lang, 2008; Van Beest et al., 2009); (ii) specific components measured in annual reports (Beretta & Bozzolan, 2004; Hirst et al., 2004); and (iii) accrual models (Jones, 1991).

Table 1: Measurement items

<b>CONSTRUCT</b>	<b>REFERENCES</b>
<i>Role of Internal Audit (RIA)</i>	Turetken et al., (2019)
<i>Internal Control Systems (ICS)</i>	Thabit et al., (2017)
<i>Corporate Governance Practices (CGP)</i>	MCCG (2021)
<i>Financial Reporting Quality (FRQ)</i>	Mbobbo & Ekpo (2016); Pham (2021)

The above table indicates the measurement items for all the independent variables examined in this study. It is adapted based on the previous studies to suit the context of Malaysian companies. Section A of the questionnaires is about demographic information. Section B of the questionnaires will ask about all the independent variables involved, e.g., the role of internal audits, internal control systems, corporate governance practices, and financial reporting quality (refer to Table 1). The questionnaire uses the English language as a medium to engage with the respondents.

This quantitative study used questionnaires, and the questionnaires were distributed to the accountants, auditors, and finance officers working in Malaysian private and public companies. A survey form was created using Google Forms, and the Google Form link was shared with all respondents via email, WhatsApp, and Facebook. In addition, the link provides a general description of the objectives of the study. This study collected data through online survey questionnaires. By using a purposive sampling method, the questionnaire has been distributed to all accountants, auditors, and finance officers working for a Malaysian public and private company.

#### **4.0 Conclusion**

In general, this kind of research aids researchers in considering the three elements of internal audit, internal control systems, and corporate governance practices in impacting the quality of financial reporting in Malaysian companies. In order to get a specific result, further research can be done on these three elements by carrying out an actual survey among private and public sector business organisations within Malaysia. Additionally, this study aims to support Malaysian business organisations in particular in supporting the production of high-quality financial reporting in order to ensure that fraudulent financial reporting will be minimised.

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