INPAC
JOURNAL OF INNOVATIVE PUBLIC ACCOUNTING AND COMPLIANCE

The Role of Internal Audit in Enhancing Good Corporate Governance

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ABSTRACT

This study aims to review previous research findings on the role of internal auditing in improving good corporate governance and preventing fraud through the implementation of risk management. The method used in this study is library research, which refers to various research findings and relevant literature. Internal auditors serve as independent supervisors who assess the effectiveness of internal controls and identify potential risks of fraud. Internal auditors are supervisors who examine all operational activities within an organization. Therefore, auditors must have a high level of theoretical knowledge and practical experience in order to recognize the signs of possible fraud schemes, thereby enabling the prevention of fraud within the organization. The results of the study show that the better the implementation of internal audit functions, the more effective the application of Good Corporate Governance in a company, thereby increasing the trust and integrity of the organization.

Keywords: Internal Audit, Good Corporate Governance, Fraud Prevention

A. INTRODUCTION

Effective corporate governance in a dynamic business and corporate environment has attracted public attention. This increased attention has also been accompanied by an increase in reports of fraud cases, which have caused public concern. This has made the internal audit function an important part of corporate governance. The definition of governance itself is a framework of policies, laws, and instructions that influence company management and control, thereby ensuring transparency and fairness in the company's relationship with its shareholders. According to Buallay, Hamdan & Zureigat (2017), the governance framework consists of external and internal contracts between employees and shareholders and includes the distribution of responsibilities, rewards, and conditions that help avoid conflicts of interest.

There have been many cases of large companies collapsing, for example in the United States, such as Enron, WorldCom, Global Crossing, Bernard Madoff's fraud, and in Indonesia, such as the case of Bank Summa. According to previous research, these cases occurred because the Good Corporate Governance mechanism was not implemented (Anugerah, 2012). The supervisory function should be key to avoiding such corporate collapses. Internal audit, as the executor of the supervisory function, has a major role in evaluating the effectiveness and efficiency of the regulations and procedures that have been implemented in the company. Through observation, research, and examination of the implementation of tasks, internal audit will assess whether the implementation is in accordance with standards and procedures.

Governance has four main components, namely the audit committee, external auditors, internal auditors, and management (Vadasi et al., 2020). Internal auditing was initially developed as a means of safeguarding company assets and monitoring company policies. In an increasingly complex and competitive business environment, internal auditors are considered part of top management and are expected to provide quality audits that add value to the organization. Their reports should be useful in helping management make improvements. The basic rules regarding corporate internal auditors in Indonesia are regulated in POJK No. 56/POJK.04/2015 Article 3, which states that issuers or public companies are required to have an internal audit unit. In this case, public companies in Indonesia are automatically required to place internal auditors in their organizational structure. In relation to corporate governance, internal audit plays an important role in evaluating effectiveness and recommending improvements to overall governance efforts within an organization. Thus, the existence of an internal audit mechanism will improve corporate governance oversight, which will lead to a reduction in profit management practices and improve the detection of fraud (Dzikrullah et al., 2020).

Research conducted by (Dzikrullah et al., 2020); Vadasi et al., 2020; Abdullah et al., 2018) states that good internal auditing can reduce profit management practices and fraud within companies. Vadasi et al. (2020) show that the level of internal audit professionalism affects the effectiveness of internal audits, because the contribution of internal audits to corporate governance increases for organizations whose internal audit functions comply with internal audit standards and whose internal auditors have professional certifications. According to Sarens et al. (2012), the internal audit function plays a key role in companies, contributing significantly to the realization of good governance mechanisms within the company. Goodwin-Stewart & Kent (2006) state that internal audits only have a small contribution to the formation of good governance within companies.

This study aims to examine previous research findings on internal auditing in improving Good Corporate Governance by preventing fraud in risk management. Based on the research findings that have been collected, it is stated that the internal audit function plays a major role in improving good GCG and can be used as a process for detecting, preventing, and anticipating fraud in company financial reports.

Previous studies on improving good corporate governance through fraud prevention in risk management have not been reviewed using library research. Therefore, this study uses the library research method to examine the findings of previous studies. This study can be used by researchers and other users as a reference in the process of detecting, preventing, and anticipating fraud in company financial reports by using risk management to improve good corporate governance.

B. THEORETICAL STUDY

Agency Theory

Agency theory is a concept of the relationship or contract between the owner of economic resources or shareholders (principal) and managers (agents). In this relationship, the principal is the party that delegates authority to the agent to make decisions and carry out interests in accordance with the wishes of the principal (Jensen & Meckling, 1976). The conditions of the principal-agent relationship can lead to agency problems that cause the principal and agent to have different objectives. In this case, the agent no longer works in the interests of the principal.

Agents with the aim of enriching themselves will try to take advantage of opportunities with the aim of taking policies outside the wishes of the principal. This can result in something called moral hazard, which can lead to information asymmetry between the agent and the principal. This information asymmetry is caused by situations where managers use information for personal gain, for example, when management chooses not to disclose certain information about the company's actual condition. Ultimately, principals who do not have access to all the information available when decisions are made by managers are unable to determine correctly whether the decisions made by managers are in line with the company's objectives or interests.

Agency theory explains the importance of aligning objectives by implementing certain mechanisms to transform the personal interests of agents into interests that are in line with the wishes of principals. Agency theory shows that companies need ownership control by providing internal supervisors such as audit committees and internal auditors or external parties such as external auditors to be an important factor in aligning the objectives of management and owners (Al-Shetwi, 2011). This theory can be used as a basis for the argument that a company needs tools or systems to control and supervise in a systematic and structured manner so that good corporate governance can be achieved. Internal audits can be positioned as a mechanism that serves to prevent information asymmetry between owners and management. The results of audits that have been carried out can be used as preliminary evidence in assessing the accuracy and effectiveness of company operations.

Fraud Triangle Theory

It is undeniable that all jobs in an organization are inseparable from activities that have the potential for fraud. The Fraud Triangle Theory is a theory that explains that fraud occurs due to three things, namely motivation, opportunity, and rationalization (Zeng et al., 2021). Motivation is the first component of this theory, which explains that a person who commits fraud usually starts because of an intention or impulse that arises in their heart due to internal or external factors (Schuchter & Levi, 2016). Generally, one might argue that motivation arises from dependence on goals that are determined individually or by a group. External circumstances can also change goals and, in addition, motivation can be modified to achieve the desired circumstances. This is one reason why some organizations with many opportunities have few cases of fraud. Often, those who commit fraud have an inner drive because of pressure from their superiors (Schuchter & Levi, 2016).

The second element in this theory is opportunity. Regardless of motivational factors, no form of fraud would occur if the opportunity did not exist. According to Benson et al. (2009), all forms of white-collar crime have an “opportunity structure” that consists of certain opportunity characteristics and depends on the type of fraud. This study shows that potential scammers will take action if there is an opportunity within a company. Opportunities arise when a company does not have good internal controls. Internal controls are a regulatory mechanism to detect, prevent, and detect fraud or errors. Internal controls can be established if the company's governance mechanisms support them. One of the organs within a company that plays a role in internal control is the internal audit function.

In addition, the third element of this theory is rationalization. Usually, scammers know how to combine your behavior with the law in accordance with perceived morality. In white-collar cases, a person tries to minimize bad feelings and tries to do so to show that your fraud is not too wrong, is more credible to yourself, and maintains a favorable self-image or self-image. (Shover and Hochstetler, 2006) and avoid shame or stigma from others (Lewi, 2002; Goldstraw-White, 2012). Cressy (1950) argues that rationalization "...is a reflection of contact with cultural ideologies that adapt conflicting ideas in relation to crime, on the one hand, and in relation to integrity, honesty, and morality, on the other. Disclaimers claim that they were influenced by uncontrollable circumstances, such as unavoidable market forces or a serious illness in a child or spouse, which could resolve the crime in different and more intelligent ways. In other words, rationalization is a process carried out by an actor. Fraudsters openly justify their mistakes in many ways.

C. RESEARCH METHODS

This study uses a qualitative approach with a library research method. This technique refers to the results of previous studies that have discussed the relationship between internal audit functions and good governance mechanisms and fraud prevention mechanisms. Library research is a study conducted by analyzing the content of previous literature that discusses similar topics (Sawarjuwono & Kadir, 2003). The study in this research includes books, national and international journal articles, and other relevant documents.

In this study, to accommodate potential variations, a combination of different keywords was used to find studies that examined the role of internal audit in establishing good governance mechanisms within companies and how internal audit can be used as a tool to prevent fraud. The keywords used included internal audit function, internal audit, corporate governance, good corporate governance, fraud, agency theory, and fraud triangle. The database used in this study consisted of articles in reputable journals taken from platforms such as Scopus, Clarivate Web of Science, Sinta, and Google Scholar. To find more research sources in this field, the references from related articles (Chen & Komal, 2018) were examined. The previous studies that were successfully collected were mapped and all the findings were linked to form a narrative that explained the research objectives.

D. RESULT AND DISCUSSION

The Role of Internal Audit in Improving Corporate Governance

The role of independent internal auditing is an important part of improving good corporate governance in companies. Independent internal auditors serve to oversee the running of the company and ensure that it has implemented the principles of Good Corporate Governance, which include accountability, responsibility, transparency, independence, and fairness (Wardoyo & Lena, 2010). This is an effort to create balance between stakeholders and other parties so that it does not cause harm to other parties.

Internal audits serve as a control infrastructure that can examine aspects of company operations, determine the accuracy of policies and procedures, assess whether they are adequate and functional, and identify whether new controls are needed to close gaps or correct errors (Joksimovic & Alseddig, 2017).

Corporate governance is considered a top priority in most public companies and in a number of non-public companies, as it involves a large number of stakeholders such as the Board of Directors (BoD), Executives, Non-Executives, Investors, Government and Academics (Koutoupis et al., 2018). Good Corporate Governance practices play an important role in maintaining the financial sector in a healthy and proper condition. Corporate failure in Good Corporate Governance practices can have a negative impact on debtors, other stakeholders, and the economy as a whole (Joksimovic & Alseddig, 2017).

Research conducted by Koutoupis et al. (2018) explains that the role of Good Corporate Governance must be encouraged to develop a more rigorous process in how they identify, assess, document objectives, risks, and controls. More emphasis should be placed on the consultative role rather than the compliance of internal and external audit bodies with the improvement of Good Corporate Governance statements. Executives need to shift their focus towards the effective presentation of statements related to Good Corporate Governance based on the collection and presentation of advanced data that will add value to various stakeholders. Internal auditors must be involved in the process of reviewing content for completeness, accuracy, relevance, comprehensibility, comparability, verification, and timeliness in Good Corporate Governance.

Another study conducted by Asghar et al. (2021) found that the quality of governance is one of the foundations that has the power to improve a company's performance, especially in the Asian economy. This shows that Good Corporate Governance can create a mechanism that is very helpful in achieving company goals. Governance mechanisms are very important for all businesses because they support the trust of creditors and all stakeholders in business actions. This activity is particularly significant for giant multinational companies due to the greater involvement of stakeholders.

In the context of Good Corporate Governance, highly effective internal audits play a key role in providing vital support to organizational management in fulfilling its responsibilities by ensuring adequate oversight of the organization's internal controls. In this regard, internal audits are seen as the “last line of defense” against improper Good Corporate Governance practices and financial reporting (Narcisa & Elena, 2017).

The role of internal audit is further strengthened by the fact that the function of internal audit is a “resource” for other governance actors (Gramling et al., 2004) because it contributes to the achievement of effective goals and performance. In this regard, (Lenz & Sarens, 2012) argue that the main contribution of the internal audit function to Good Corporate Governance arises through the relationship between the internal audit function and other governance actors, such as the audit committee, external audit, and management, while (Cohen et al., 2004) describe the complex interaction between these mechanisms as a “mosaic of corporate governance.” The role of the internal audit function is often discussed in the context of agency theory (Carcello et al., 2005; Christopher et al., 2009; Cohen et al., 2002; Paape et al., 2003; Sarens et al., 2012).

The Role of Internal Audit in Fraud Prevention: Risk Management

The best protection for a company against fraud is internal auditing in developing internal control systems. Internal auditing is the front line in monitoring the risk of fraud in a company. Internal auditors must have sufficient knowledge to identify signals that may indicate fraud, be alert to high-risk cases that could lead to fraud, and investigate cases to reduce or eliminate the possibility of fraud (Petraşcu & Tieanu, 2014).

Risks can threaten the existence of an organization; therefore, it is important to manage risks. The changing business environment, technological advances, and evolving regulations have changed most internal audit approaches (Abidin 2016). Internal audit is tasked with reviewing internal control systems, compliance, and risk management, which tends to increase accountability for recording, physical output, activity implementation, and financial reporting (Bananuka et al. 2018).

Leung et al. (2011) examined the accountability structure and relationship of internal audit management. This study identified reporting mechanisms, internal audit functions and relationships, including its contribution to Good Corporate Governance. However, there were some misalignments between the aspirations of internal auditors and their relationship with management. Meanwhile, the objectives of internal audit have been set with a focus on control, risk and governance. This study has highlighted the fact that there is a lack of correlation between the tasks performed by internal auditors and important internal audit objectives, with the exception of internal control and risk. The results also show that internal auditors have provided consulting and advisory roles in matters related to IT systems, strategic risks, and financial issues. Regarding the corporate governance process, the results of the study show that issues surrounding internal control, risk assessment, and management processes are considered key factors for internal audit to contribute to good corporate governance.

Abdullatif & Kawuq (2015) conducted research to explore internal audit practices related to risk management in Jordanian banks. The role of internal auditors in risk management in Jordanian banks was found to be limited. Internal auditors mostly dealt with risks related to compliance, while the least risks dealt with were related to Jordan's economy and culture. The findings suggest that internal auditors may not be aware of the importance of certain types of risks and the appropriate role for internal auditors in risk management.

Internal auditors are responsible for verifying the existence of recommendations made regarding good risk management. The risk management process and internal audit function are critical to the success and sustainability of an organization, and risk management is also a vital element based on uncertainty about events that impact the achievement of strategic objectives (Tamimi 2021). This shows that risk management can minimize the possibility of fraud occurring.

The primary responsibility for risk management lies not only with directors and senior management, but internal auditors are also seen as key contributors as consultants and providers of assurance on risk management processes and systems (Stewart & Subramaniam 2010). Internal auditors, as the third line of defense, are responsible for monitoring (auditing) managers to ensure proper risk management and internal control (Roussy & Rodrigue 2018).

Thus, the role of internal auditors is important for risk assessment and internal control practices. The inputs and outputs of this role can fulfill a role in the risk management system. The functional requirements of internal auditors for each company vary depending on the scale, complexity, and scope of the company, as well as cost and benefit considerations. Authority and responsibilities must be clearly defined by management. The authority granted must include the freedom of internal auditors to audit records, property, ongoing activities, and employees. Internal auditors must comply with rules and discipline and apply professional standards in supporting Good Corporate Governance (GCG) by being more realistic in business planning with several considerations and effective internal controls.

Fraud Prevention in Corporate Governance: Cases in Indonesia

Companies in the Asia Pacific region have several characteristics that pose challenges in reducing corporate fraud, particularly in Indonesia (Wu, 2005). According to research conducted by Jaswadi et al. (2022), many Asia Pacific countries have low corporate governance standards, which makes accounting fraud easier to occur. For example, although accurate financial reporting is essential for detecting bribery and fraud, accounting report manipulation is a common practice in Asian companies. Second, accounting practices in many companies are often of poor quality. On the other hand, companies may find it advantageous to adopt questionable accounting procedures because they can easily alter their financial documents to avoid extortion or protect themselves from government discrimination.

The case that occurred in Indonesia some time ago reflects the weak governance system of companies. The insurance case that experienced default during the pandemic indicated that one of the causes was Good Corporate Governance (Pratama, 2021). Finance Minister Sri Mulyani Indrawati also said that companies with poor governance generally involve management that leads to violations of regulations, so improvements are needed. The improvement of governance aims to ensure that the insurance industry continues to develop and that risks for its participants can be minimized (Respati, 2022). Cases caused by Good Corporate Governance do not only occur in insurance companies but also in several other companies.

Another case mentioned in the news article written by Purwanto (2021) discusses the case faced by Lippo in 2018, which was caught up in the Meikarta licensing bribery scandal. The case involving Lippo at that time caused the Lippo Group's shares listed on the Indonesia Stock Exchange (IDX) to plummet. The next case occurred at the state-owned enterprise PT Waskita Karya in the form of a fictitious project. Good Corporate Governance always plays a role and is an important solution to prevent fraud.

Cases that occur in Indonesia cannot be separated from the Fraud Triangle Theory and agency theory. The Fraud Triangle Theory is a theory that explains that fraud occurs due to three things, namely motivation, opportunity, and rationalization (Zeng et al., 2021). This opens up opportunities for perpetrators to commit fraud. When there is a weak governance system, it motivates perpetrators to commit fraud. They then follow through when the right opportunity arises and, finally, they consider whether their actions appear to be fraudulent, in the sense that their actions can still be rationalized.

Agency theory explains that there is a separation of functions between principals and agents in a company. This separation of functions can lead to information asymmetry, whereby agents, as the management, have greater opportunities to obtain information than principals who are outside the company. The implementation of good corporate governance can reduce information asymmetry, thereby ensuring the rights and relationships of stakeholders are protected (Anugerah, 2014).

Good Corporate Governance can be encouraged by internal audits that not only play an active role in monitoring business unit activities but also provide a consultative function within the company. The implementation of internal audits will have an impact on improving the application of good governance principles so that organizational goals can be achieved (Saptapradipta, 2019; Wardoyo & Lena, 2010). It can be concluded that internal audits that influence Good Corporate Governance can prevent fraud.

Therefore, the internal audit function must evaluate the effectiveness of the organization's risk management process by providing input or feedback through periodic reviews (audits) so that if the company has managed risk well, it can minimize fraud within the company. It is also appropriate for the internal audit function to identify and evaluate the risks and opportunities for fraud, train management on how to respond appropriately to events that trigger fraud with risk management, and help the organization coordinate risk management activities throughout the company. If the internal audit function coordinates more actively with other risk management groups and does not only act as part of the third line of defense, but also in an effort to achieve efficiency for the organization. However, the internal audit function should not set organizational risks, make decisions about appropriate risk responses, or take ownership (be responsible) for the risk management process because only management should take on this role.

E. CONCLUSION

Internal auditors serve as supervisors who examine the running of the company, policies, procedures, and make improvements if there are errors in the organization. Internal auditors must have a high level of theoretical knowledge and practical experience in order to recognize the signs of possible fraud schemes so that fraud can be prevented within the organization. Based on the mapping of previous research findings, internal auditors play a major role in shaping good corporate governance to achieve an organization's objectives. Internal auditors must also have professional standards, independence, and objectivity in implementing good corporate governance to detect fraud and manage risk. The results show that the better and more adequate the internal audit is carried out, the better the implications for the implementation of good corporate governance.

This study has several limitations, namely that previous studies have produced diverse findings indicating the role of internal auditors, but this study focuses only on the findings regarding the role of internal auditors in establishing good corporate governance within an organization, fraud prevention, and risk management.

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