

# The Role of Internal Audit in Corporate Governance Framework and Its Effect on Financial Statements Quality in Jordanian Company

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## I. INTRODUCTION

Recently, there was a huge interest by companies in developed countries in internal audit, this was represented in various aspects. one of those aspects the growing interest of companies to establish separate departments for internal audit and work to support human talent that was able to achieve the company's goals in the manner and required effectiveness. In this regard, More and more frequently, boards of directors from all kind of companies are charged with responsibility for the effectiveness of their organizations' internal control systems, in order to promoting effective corporate governance. In this case, the internal audit function plays a key role in assisting the board to discharge its governance responsibilities. (Florea, 2013).

Internal auditing (IA) serves as an important link in the business and financial reporting processes of corporations and not-for-profit providers. Internal auditors play a key role in monitoring company's risk profile and identifying areas to improve risk management (Goodwin-Stewart and Kent 2006). The aim of internal auditing is to improve organizational efficiency and effectiveness through constructive criticism.

Corporate governance represents a lot of different things depending on the organization in which it is applied. The definitions are sometimes different but, however, they need to be interpreted in their proper context. Corporate governance is one key element in improving economic efficiency and growth as well as enhancing investor confidence. Corporate governance involves a set of relationships between a company's management, its board, its shareholders and other stakeholders. Corporate governance also provides the structure through which the objectives of the company are set, and the means of attaining those objectives and monitoring performance are determined (Kirkpatrick, 2009)

Different groups define financial accounting quality in different ways. The Financial Analysts Federation (FAF), a branch of the Association for Investment Management and Research (AIMR), provides summary evaluations of disclosure practices for a sample of companies, based on their aggregate disclosure efforts over a fiscal year. Each year, about 400 to 500 companies are evaluated, based on various financial disclosures and statements, published information such as press releases and fact books, and direct disclosures to analysts. Lambert et al (2005) sees that enhanced financial reporting can have important economic implications such as increased investment efficiency. However, despite solid theoretical support for such a relation, there is little empirical evidence supporting these claims.

Many studies reveal that there is an effective Role for Internal Audit in Corporate Governance on financial Statements Quality, in this sense, Pizzini et al (2012) reveals that the availability of both external and internal auditing resources is an important consideration in determining the nature and extent of the IAF's role in the financial statement audit.

The current study also contributes to the literature by exploring the Role of Internal Audit in Corporate Governance Framework and its effect on financial Statements Quality. This study will preview the main literature review and studies that related to internal audit and financial statements quality.

## II. AIMS AND OBJECTIVES OF THE RESEARCH

A. *This study Aims At*

- 1) Highlighting the concepts of Internal Audit in Corporate Governance Framework and its effect on financial Statements Quality.
- 2) Emphasizing the general framework of Internal Audit in Corporate Governance.

- 3) Identifying the effect of Internal Audit in Corporate Governance on financial Statements Quality,
- 4) Exploring the correlation of effect for Internal Audit in Corporate Governance on financial Statements Quality,
- 5) Exploring statistical results regarding to the effectiveness of Internal Audit in Corporate Governance, and conducting recommendations regarding that.

### III. SIGNIFICANCE OF RESEARCH

#### A. *The Study Derives Its Significance From Many Facts*

- 1) The study will highlight theoretically the concepts of Internal Audit in Corporate Governance Framework and its effect on financial Statements Quality, in which can be quite clarified in the context of economic studies through previewing the main related literature.
- 2) Exploring the nature of Internal Audit in Corporate Governance, through analyzing the related elements and factors that affect the performance in Corporate Governance.
- 3) Seeking for identifying the effect of Internal Audit in Corporate Governance on financial Statements Quality, through previewing the points of view of different researchers and economists.
- 4) Finding statistical results regarding to the effectiveness of Internal Audit in Corporate Governance, and conducting recommendations regarding that.

### IV. RESEARCH QUESTIONS

#### A. *The study will Address the following Questions*

- 1) What is the Role of Internal Audit in Corporate Governance?
- 2) What is the effectiveness level of Internal Audit in Corporate Governance on financial Statements Quality?
- 3) Is there a positive correlation between Internal Audit in Corporate Governance and the elements of financial Statements Quality?
- 4) Is there a statistical effect for Internal Audit in Corporate Governance on financial Statements Quality?

These questions have motivated the researcher to conduct this to figure out the Role of Internal Audit in Corporate Governance Framework and its effect on financial Statements Quality.

### V. RESEARCH HYPOTHESES

In order to answer the study's questions, the researcher made the flowing hypotheses:

H1: there is a low level of effectiveness for Internal Audit in Corporate Governance Framework on financial Statements Quality.

H2: there is no statistical relation between the Role of Internal Audit in Corporate Governance Framework on financial Statements Quality.

H3: there is no statistical relation between the elements of financial Statements Quality and Internal Audit in Corporate Governance.

H4: there is a statistical effect for Internal Audit in Corporate Governance on financial Statements Quality.

### VI. CONCEPTUAL FRAMEWORK

In this section the researcher will emphasize the main concepts and definitions in the study

#### A. *Internal Audit*

Independent activity or type of work that is performed by an individual or individuals within the organization, in order to serve the administration of the organization. This can be achieved by assuring that all of internal control systems operate efficiently and effectively to achieve all the objectives of the regulatory system. This should be performed as defined by the management through using a planned method to evaluate and improve the effectiveness of risk management, supervision, and the process of cooperate governance (Al-Thuneibat, 2010, P;33).

#### B. *Corporate Governance*

Represents a variety of mechanisms, procedures, laws, regulations and decisions that include all discipline, transparency and justice. Thus, it aims at achieving quality and excellence in performance, by activating the administration's actions, economic unity, regarding to the exploitation of the available economic resources, in order to achieve the best possible benefits for all parties including; stakeholders and whole society (Al-Khatib, 2008, P.6).

### C. Financial Statements Quality.

This Term refers to the safety of the Financial Statements from any significant distortions, and to reflect fairly and the real company's financial core, which helps to increase the predictive ability of the company to assess the current and future situation (Hamdan, 2011, pp: 419).

## VII. LITERATURE REVIEW

The following section will shed the light on the previous literature review that discussed the Role of Internal Audit in Corporate Governance Framework and its effect on financial Statements Quality.

(2002) has conducted a study that aimed at identifying The Quality of Financial Statements through exploring Perspectives from the Recent Stock Market Bubble. Moreover, the study focused on the quality of financial reporting during the 1990s. The main question in which the study addressed: "Did reporting under U.S. GAAP perform well during the bubble, or is its quality suspect?. The study found that inevitable imperfections due to measurement difficulties are recognized, as a quality warning to analysts and investors. And a number of failures of GAAP and financial disclosures are identified which, if not recognized, can promote momentum investing and stock market bubbles.

Jantan et al (2005) have conducted a study aimed at determining whether the internal audit department of the companies listed in the Bursa Malaysia complies with the Standards for the Professional Practice of Internal Auditors IIA; and, to determine whether compliance to SPPIA will affect the quality of the internal control system of the company. The study found that management of internal audit department, professional proficiency, objectivity and review significantly influence the monitoring aspect of the internal control system. Scope of work and performance of audit work significantly influences the information and communication aspect of the internal control system while performance of audit work, professional proficiency and objectivity significantly influence the control environment aspect of the internal control system.

Verdi (2006) has conducted a study aimed exploring the relation between financial reporting quality and investment efficiency on a sample of 49,543 firm-year observations between 1980 and 2003. The study found that proxies for financial reporting quality are negatively associated with both firm underinvestment and overinvestment. Further, financial reporting quality is more strongly associated with underinvestment for firms facing financing constraints and with overinvestment for firms with large cash balances, which suggests that financial reporting quality mitigates information asymmetries arising from adverse selection problems and agency conflicts. Finally, the relation between financial reporting quality and investment efficiency is stronger for firms with low quality information environments.

Cohen & Sayag (2010) conducted a study aimed at identifying The Effectiveness of Internal Auditing through An Empirical Examination of its Determinants in Israeli Organizations. The study found that the importance of IA is demonstrated in the growing demand for this service in all organizations and in the rapid growth of its professional organization, the IA. Moreover the study found that IA effectiveness is a multidimensional construct. The quality of the internal auditor's work, the evaluations of the auditees and the added contribution of IA were found to be the three dimensions that encompass the concept of IA effectiveness.

Chen Etal (2010) conducted a study aimed at exploring the Financial Reporting Quality and Investment Efficiency of Private Firms in Emerging Markets. The study showed that FRQ is lower in countries with low investor protection, bank-oriented financial systems, and stronger conformity between tax and financial reporting rules. Using firm-level data from the World Bank. Also it found that the relation between FRQ and investment efficiency is increasing in bank financing and decreasing in the incentive to minimize earnings for tax purposes.

Hammond & English (2012) have conducted a study aimed at identifying the Priorities of the Internal Audit Function in Corporate Governance and its effect on financial statements. The study found that internal audit function itself should ensure that it stays up-to-date with its skill and resource sets. Moreover, it is critical that internal auditors are included in all relevant regulatory training programs.

Pizzini and others (2012) conducted a study aimed identifying the measures of internal audit function (IAF) quality and the IAF's contribution to the financial statement audit affect audit delay Results indicate that IAF quality is negatively associated with audit delay, suggesting that increases in IAF quality reduce external auditor effort. Audit delay is also significantly shorter when the IAF contributes to the external audit by independently performing relevant work, but not when IAF personnel directly assist the external auditor.

Florea (2013) has conducted a study aimed at presenting the concept of Corporate Governance and Internal Audit through relationship between these, and the role of Code of Corporate Governance. The study targeted three main categories of countries: countries in which Internal Audit is foreseen by Corporate Governance Code, countries in which Internal Audit is recommended by

Corporate Governance Code and countries in which Internal Audit is not foreseen. The study found that there are some attributes of corporate governance almost totally present in Corporate Governance Codes, like discipline, transparency, independence, accountability, responsibility, fairness or equitable treatment, social responsibility.

#### A. *Distinguishing Features of the Study from the Literature Review*

After reading and through examining previous studies that related to the subject of this study, which can be achieved by the researcher, the researcher found that the most important characteristics, which distinguish this study from the other previous studies, can be stated as follows:

- 1) The other previous studies were concentrating on discussing the internal audit in the companies that are complied with the Standards for the Professional Practice of Internal Auditors IIA. Other studies identified The Effectiveness of Internal Auditing through and its contribution to the financial statement audit.
- 2) This study discusses the Role of Internal Audit in Corporate Governance Framework and its effect on financial Statements Quality.

#### B. *Research Methodology / Design*

The research approach is based on quantitative data approach in order to investigate the research questions of this study. The researcher will built a questionnaires that included questions to achieve the study goals. The questionnaire will include many fields depending on the study variables which are (Internal Audit, Corporate Governance, and Financial Statements Quality).

The researcher will use the following statistical methods to analyze the study data, through using Statistical Package for the Social Sciences (SPSS) program:

- 1) Means
- 2) Standard division
- 3) Cronbach's Alpha.
- 4) T-test.

#### C. *Research Sample*

The study population of this study will be chosen in the future upon the research demands. The data for the empirical analysis were derived from the financial statements of these this sample.

#### D. *Theoretical Knowledge*

The theoretical knowledge for the study lies in the possibility that the reviewed literature will enrich the literature especially that concerned in Internal Audit in Corporate Governance and its relation to financial Statements Quality.

#### E. *Professional Knowledge*

The professional knowledge for the study lies in its expected results; the next institutions will benefit from the results of the study:

- 1) Arabic researchers.
- 2) Studies were conducted in this field.
- 3) Commercial banks.
- 4) Internal auditors.
- 5) Researchers in this area.

#### F. *Expected outcomes*

Through this study, the researcher will develop his knowledge and experience through investigating the role of internal audit in corporate governance framework and its effect on financial statements quality.

This research will reveal the concept of internal audit, and trying to identify it relation to the quality of financial statement. In addition, the research will be discussing the nature of Internal Audit in Corporate Governance and its effect on financial Statements Quality.



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