International Journal of Business and Technopreneurship
Volume 13, No 3, October 2023 [231-242]

The Effect of Internal Audit Function Characteristics on Market Value among Indonesian Public-Listed Companies

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Received 11th September 2023, Revised 4th October 2023, Accepted 30th October 2023

ABSTRACT

It is widely acknowledged that internal audits should have a value-adding component for all types of companies. This study systematically investigated the effect of internal audit function on the market value of public listed companies in Indonesia. The panel data technique used was based on the data extracted from 44 listed companies over five years (2015 -2021), with 308 observations. The empirical results revealed the Percent Audit Committee (PAC) has a significant and positive impact on market value. The Number of Certified Members (NCM) has no significant effect on market value, while the Percentage of Implemented Findings (PIF) has a significant and positive impact on the market value of companies. Size, leverage, and return on investment (ROI) have a significant impact on the market value of companies. The study offers extended implications in the empirical literature using a different measure of internal audit function characteristics from an emerging market perspective for different organisations. This study provides important implications for investors, managers, researchers, and auditors. Finally, the results of this research may be used by analysts, investors, and other strategic decision-makers in Indonesia to enhance the competitiveness and viability of the country's financial market. The findings will encourage policymakers to enact effective regulations, which could boost Indonesia's financial markets' efficiency and performance.

Keywords: Audits, Indonesian Public Listed Company, Internal Audit Function, Market Value, Panel Data Analysis

1. INTRODUCTION

The phenomenon that the characteristic of internal audit should add value to the company is a generally accepted principle. The scope of internal auditing also has grown significantly in recent years to cover more critical functions within organisations, such as risk management and internal control (Alzeban & Sawan, 2015). Internal audits are independent, objective assurance and consulting activities designed to add value and enhance the organisation's operations (Lin & Liu, 2009). The accounting literature has extensively emphasised examining the issue of internal audit function from various perspectives. Few studies have examined the effect of internal audit function on real earnings management practices (Alzoubi, 2019; Ghaleb et al., 2020), internal control quality (Oussii & Boulila Taktak, 2018), and audit outcomes (Dzikrullah et al., 2020). However, there are limited studies on the impact of internal audit function on market value. Many critical questions remain unanswered. What is the relationship between internal audit function characteristics and market value in Indonesia? Do internal audit function characteristics impact the market value of firms? Hence, we intend to provide answers to these critical questions in this study.

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According to Prawitt et al. (2009), internal audits are one of four mechanisms that promote corporate governance, along with executive management, board of directors, and external auditors. The study by Davidson et al. (2005) explains that the internal audit function alone is not practical enough to control earnings management if the internal audit has not played its role in corporate governance. The study argued that there is a lack of interaction between the internal audit function and the audit committee. The existence of an internal audit is expected to facilitate the effectiveness of the audit committee's function in accordance with the objectives of the audit function, which is the monitoring of financial reporting, which is the responsibility of the audit committee (Dzikrullah et al., 2020). The internal audit function, which has so far only focused on controls and operational risks, can be developed to monitor earnings management and financial reports (Bou-Raad, 2000).

The rise of financial scandals involving firm management makes internal auditors crucial in providing assurance and reducing asymmetric information to shareholders and relevant parties in decision-making (Al-Shetwi et al., 2011). The internal audit establishes the reliability, veracity, and completeness of financial and operational data from various organisational units, upon which suitable business decisions are made at all levels of management. Archambeault et al. (2008) conclude that an internal audit report can complement existing governance disclosures and increase stakeholders' confidence in governance quality and financial reporting reliability. Asare et al. (2008) reveal that internal auditors are sensitive to management's motivation to misreport financial information and, consequently, increase budgeted labour hours when management has a solid incentive to misreport.

The number of cases in Indonesia puts internal audits in a difficult position, take for example there are several cases involving such as bribery cases in Indonesia. This problem puts internal auditors in a bad position. This condition causes more and more parties to doubt the position of the internal auditor as a supervisor and business partner which should be the identity of an internal auditor (Novita, 2022). It is delivered through a consortium of professional internal auditors in Indonesia, mentioning that there are some things the findings are not conducted in terms of the internal audit function as non-fulfilment of the attendance at audit committee. The reach of the low percentage of audit plans is achieved, the lack of development of the personnel who work as internal auditors, and the inadequate number of staff members certified. The past two decades have borne witness to some of the most egregious accounting scandals in history, resulting in the loss of billions of dollars, the collapse of companies, and severe repercussions for countless individuals. Many of these scandals were instigated by the unchecked avarice of a select few, whose actions unleashed catastrophic consequences, leading to the downfall of entire enterprises and adversely impacting millions of people.

This article explores the five most significant accounting scandals of recent times in Indonesia. For example: PT. Kimia Farma, Tbk in 2001 Kimia Farma said it managed to reap a profit of IDR 132 billion. Later, Kimia Farma's stripes were exposed. In 2001, this pharmaceutical company only made a profit of Rp. 99 billion. PT. Indorama in 2004 manipulated profits by presenting an excessive net profit of Rp. 28.870 billion dues to a higher-than-expected inventory valuation, so the cost of goods sold that year was too low. In addition, PT. Hanson International Tbk records revenue upfront and does not include a sales and purchase agreement in the 2016 financial statements of MYRX. MYRX, is named after a company called PT Hanson International Tbk, is a code listed in Indonesian Stock Exchange (IDX). Moreover, Garuda Indonesia, Tbk in 2019, after discovering that Garuda Indonesia had accounted for revenue associated with its collaboration with PT. Mahata Aero Technology before the agreement was finalised, Garuda's Annual Financial Report for 2018 was deemed inaccurate. This had repercussions on Garuda's Profit and Loss Report. There are accusations of tampering with the 2019 annual financial statements affecting a company in the information technology services and trading sector, PT Envy Technologies Indonesia Tbk (ENVY), and its affiliated companies.

Examining the case examples mentioned earlier, it becomes pertinent to inquire into the efficacy of incorporating internal audit function attributes, particularly in manufacturing companies listed on the IDX. This is especially relevant given that certain manufacturing companies have engaged in earnings management practices. The attributes of an effective internal audit function offer a framework that not only aids in defining company objectives but also offers a mechanism for devising effective work monitoring methods (Lutfi et al., 2016) The issues that have developed lately are related to the global COVID-19 outbreak that has hit almost all over the world. There is a possibility of a decline in performance due to the influence of economic changes that are depressed due to COVID-19. The companies most affected are the manufacturing industry. The industry significantly contributed to Indonesia's Gross Domestic Product (GDP) last year, accounting for 19.62% of the 2021 GDP. This contribution surpasses that of trade, agriculture, and construction sectors.

Consequently, this study investigates the influence of internal audit function characteristics on market value. While prior studies have focused on separate components of internal audit function, this study addresses the impact of internal audit function characteristics (Presence at Audit Committee, Certified Staff Members, and Percentage of Implemented Findings) on the market value of public listed firms in Indonesia. The study contributes empirically to literature in multiple ways. First, the results indicate that internal audit function characteristics have a significant impact on the market value of companies in Indonesia. Second, the results of this study will also support investors, academic researchers, creditors, regulators, and other decision-makers. Third, the study would be helpful for investment decision-making by evaluating the internal audit function and discretionary accrual before investing, providing a clear picture of the possible income opportunity and minimising the risk of corporate failure. Finally, the results can provide important information for both shareholders and regulators, mostly in terms of whether their internal audit function can improve the market value of firms.

The remaining sections of this paper include section two, a literature review. Next, section three describes the research methodology, data, and variables, while section four analyses and discusses the results, followed by a conclusion.

2. LITERATURE REVIEW

To influence the firm's market valuation, managers become more motivated to modify the firm's reported earnings. For instance, managers could be engaged in earnings management to make sure that the firm's earnings harmonise with the market expectations via meeting or beating earnings expectations in advance (Beaver et al., 2003; Burgstahler & Eames, 2006; Daniel et al., 2008; Bartov & Cohen, 2009). Managers may manage earnings to meet the analyst's expectations by avoiding reporting lower earnings than expected (Glaum et al., 2004; Burgstahler & Eames, 2006). From the investors' perspectives, this behaviour can be justified via the value-relevance and the informative role of the accounting earnings (Burgstahler & Dichev, 1997; Houmes & Skantz, 2010). The internal auditor's function is a tool for management to assess the efficiency and effectiveness of implementing the company's internal control structure and then provide results in the form of suggestions or recommendations. An internal audit function should enhance internal control systems, thereby reducing information asymmetry between the agent and the principal and providing more reliable information (Sarens & Abdolmohammadi, 2011). Al-Thuneibat et al. (2016) argue that internal audit function is a comprehensive monitoring function that correlates with internal control components and can track all actions across all tiers of management. These arguments suggest that internal audit function is essential to corporate governance effectiveness and financial reporting quality. Furthermore, Afifa et al. (2023) reveal that the size of the audit firm and the tenure of the audit firm have a positive and negative influence on earnings management practices, respectively, but that industry-specialist audit firm has a negative and insignificant effect. In addition, the size of the audit firm has a positive and significant influence on the performance proxies of the company [i.e., return on assets (ROA) and return on equity (ROE)].

The study by Farkas et al. (2019) evaluates the internal audit function from the perspective of related parties, such as the audit committee, external auditors, and management. The results show that internal audit reports can be utilised by external auditors from Big 4 companies to ensure the consistency of their reports with company terminology. In addition, AlQadasi and Abidin (2018) found that companies that invest more in internal audit functions tend to invest also in external audit functions. This is due to the complementary concept that investment into a mechanism will have an impact on additional investment into other mechanisms. Siallagan and Machfoedz (2006) document that the existence of an audit committee positively influences earnings quality and the market value calculated by Tobin's Q. This provides evidence that the existence of an audit committee can increase the effectiveness of company performance. El-Sayed Ebaid (2011) explores the nature and characteristics of the internal audit function in Egyptian listed firms and assesses its ability to fulfil its role in corporate governance. The study's findings reveal that many Egyptian listed firms have internal audit functions, but the internal audit function in these firms is less mature. The internal audit function has low levels of organisational independence, management support, and qualification of internal audit staff.

Dzikrullah et al. (2020) found that the size of the internal audit team, as a corporate oversight mechanism has a positive and significant relationship to the magnitude of external auditor fees, audit quality, and the tendency of companies to choose auditors with big names (Big 4 companies). In addition, this study found that internal audit also has a negative and significant influence on the tendency of companies to accept going concern audit opinions. Chan and Li (2008) examined the effect of audit committee characteristics on market value with empirical evidence that the existence of independent directors and audit committees increases market value. Meanwhile, Baxter and Cotter (2009) also find empirical evidence that there is a relationship between the accounting expertise of audit committee members and earnings quality. Meanwhile, the characteristics of other audit committees studied were not significantly related to earnings quality. Ghaleb et al. (2020) investigate the role of internal audit function on real earnings management (REM) practices. Using a sample of 1,056 observations from an emerging market, Malaysia, the results suggest that internal audit function has a significant negative relationship with REM practices.

Oussii and Boulila Taktak (2018) reveal that internal control quality is significantly and positively associated with internal audit function competence, internal audit quality control assurance level, the follow-up process, and the audit committee’s involvement in reviewing the internal audit program and results. The findings have significant implications by recognising the impact of the internal audit function characteristics on internal control quality. In addition, Qin (2007) examines the effect of audit committee financial expertise on earnings quality with empirical evidence that companies with audit committees with accounting capabilities are more likely to have high earnings quality. In addition, the size of the audit committee with accounting expertise positively affects earnings quality. Krishnamoorthy (2002) empirically tested the relationship between the composition and size of the audit committee on financial reporting quality. The results revealed that board composition, the size of management commitment, institutional ownership, and the percentage of audit committee members having expertise in accounting or financial management is positively related to quality financial reporting and related to market value.

However, it should be noted that most of the previous studies documented mixed results among the internal audit functions in companies both in the same country and in different countries. The reason for this difference in results is due to the small number of samples or the study period in which they mostly saw several years. While this difference might be due to differences in methodological choices from this study or from another point of view, this might be due to intrinsic measurement errors in discretionary accruals compared to their counterparts from financial quality measurement methods.

Of course, we must consider differences in the environment, market size, and other factors that cause an influence. Therefore, the difficulty in making comparisons between previous studies depending on the fluctuations in the results is the motivation for this study. This researcher tries to develop from some of the results of previous studies by bringing up new variables and new models in the stages of the research process. The results of this study are expected to later become a new theory that can explain the influence of the internal audit function itself.

3. MATERIALS AND METHODS

3.1 Data

The data used are cross-sectional and time series data, inter-company financial statements from 2015-2021. The author uses secondary data sources, namely data collected by researchers from various existing sources obtained from the financial statements of companies listed on the Indonesia Stock Exchange, totaling 44 companies. The data obtained were selected from companies listed on the Indonesia Stock Exchange and published complete financial statements and companies with internal audit reports for 2015-2021. Based on the above criteria, the number of samples used in this study was 44 manufacturing companies, limited to the availability of the data.

The PER is used to proxy the market value. It is one of the market value ratios used by fundamental analysts in analysing their investment decisions. This ratio relies on financial market data, such as the market price of a company's common stock. The formula (1) is illustrated below:

$$\mathrm{PER} = \frac{\text{Market Price Per Share}}{\text{Earning Per Share}}$$

The PAC is measured as a committee that works professionally and independently formed by the board of commissioners. The NCM is estimated as the experts and senior practitioners in the field of internal audit. In addition, the PIF is calculated by the percentage of total audit findings (Ghaleb et al., 2020). Company size is a scale on which the company's size can be classified, which will affect the ability to bear the risks that may arise from various situations the company faces (Prasetyorini, 2013). ROI measures the company's ability with the overall funds invested in assets used in the company's operations to generate profits. The ROI is measured as the earning after interest and tax divided by total assets. The formula (2) is illustrated below where, ROI is Return on Investment, EAIT is Earning After Interest and Tax and TA is Total Assets:

$$\mathrm{ROI} = \frac{\text{Earning After Interest and Tax}}{\text{Total Assets}} \times 100\%$$

3.2 Model Specification

The study used the GMM model estimation to capture the unobserved specific effects and control for a simultaneity bias caused by the possibility that some of the explanatory variables may be endogenous. The system GMM estimator has proven to perform much better (less bias and more precision), especially when the time series are persistent (Arellano & Bover, 1991). The GMM estimator offers significant benefits over other estimations such as OLS, fixed, and random effects models. It addresses the problem of endogeneity and serial correlations among the variables (Roodman, 2009). In estimating the dynamic panel regression model. The baseline regression formula (3) is written as:

$$〚PER〛\_it = β\_1 〚PER〛\_(it − 1) + β\_2 P〚AC〛\_it + β\_3 〚NCM〛\_it + β\_4 〚PIF〛\_it + β\_5 〚SIZE〛\_it + β\_6 〚DER〛\_it + β\_7 〚ROI〛\_it$$

Where, PER is the price-to-earnings ratio; PAC represents the Percent Audit Committee; NCM denotes the Number of Certified Member; PIF is the Percentage of Implemented Findings; SIZE denotes the logarithm of total assets, DER denotes the total debt-to-equity ratio, and ROI represents the ROI. Before estimating, we carried out the Sargan-Hansen test to check for overidentifying restrictions and whether the instruments are correlated with the error term. The results reveal that the model and overidentifying restrictions are correctly specified. The Arellano-Bond test is also conducted, and the result shows the absence of a second-order serial correlation in the model.

3.3 Descriptive Statistics

The descriptive statistics of the data are discussed in Table 1. It is reported that the PER variable has a minimum value of 1% and a maximum value of 1481.8%. Meanwhile, PER has an average value of 5.25%. The PAC variable has a minimum value of -2.22 and a maximum value of 94.28. Meanwhile, PAC's mean and standard deviation are 5.836 and 2.2051, respectively. The NCM variable has a minimum value of 3.000 and a maximum value of 8.000. The average value is 5.6727. The PIF variable has an average value of 6919.87%, with a minimum value of 2114% and a maximum value of 9658%. The firm's average size value is 16.4675, with a minimum value of 0.2300 and a maximum value of 31.000. The debt-to-equity ratio has a mean value of 77.95%, with minimum and maximum values of 8.00% and 455.00%. The ROI has an average value of 645.69%, with a minimum and maximum value of 0.13% and 3002.00%, respectively.

Table 1 Descriptive Statistics

	PER	PAC	NCM	PIF	SIZE	DER	ROI
Mean	5.2575	5.8369	5.6727	69.1987	16.4675	0.7795	6.4569
Maximum	14.818	9.2800	8.0000	96.5800	31.0000	4.5500	30.0200
Minimum	0.01000	-2.2200	3.0000	21.1400	0.23000	0.0800	0.0013
Std. Dev.	3.4897	2.2051	1.0434	15.0906	7.4569	0.7303	6.4737

Note: PER = price to equity ratio. PAC = Percent Audit Committee. NCM = Number of Certified Member. PIF = Percentage of Implemented Findings. SIZE = logarithm of total assets. DER = debt to equity ratio. ROI = return on investment.

3.4 GMM Model Analysis

The GMM model estimation was employed in this study to control individual heterogeneity, serial correlation, and endogeneity problems (Roodman, 2009). We conducted the Sargan-Hansen test, and the result reveals that the over-identifying restrictions are valid, and the model is well-specified. According to Table 2, the equation's estimate findings utilising the GMM model for market value (PER) in manufacturing companies listed on the Indonesian Stock Exchange showed that the lag variable is highly significant at a 1 percent level. Therefore, the selection of dynamic model specifications has been validated, and the results can be interpreted.

Table 2 Results of the Model

Var	Coef.	t-stats
L.PER$_{t-1}$	2.3420	3.4172***
PAC	3.4567	2.2358**
NCM	-75.38	-3.357***
PIF	9.358	3.644***
SIZE	6.428	2.972***
DER	3.374	3.345**

Var	Coef.	t-stats
ROI	2.826	4.765***
_cons	90.355	2.267**
AR1	-1.2766 (0.0251)	
AR2	-2.3254 (0.3241)	
Hansen test	66.5213 (0.3519)	
Year effect	Yes	
F test	525.23 (0.0000)	
No. of instruments	24	
Observations	308	

4. RESULTS AND DISCUSSIONS

This research implicitly assumes that the proportion of PAC and PER practices is significant and positive. Thus, the audit committee's function increases the market value of firms. The findings contradict the signalling theory, which holds that an audit committee strengthens the board's role in minimising and monitoring opportunistic management behaviour when they have the legal authority to control and compensate managers, such as the CEO (Hashim & Devi, 2008). Several studies, including Raghunandan et al. (2001), Krishnamoorthy (2002), and Anderson et al. (2003), examined the relationship between two audit committee features, namely the composition and size of the audit committee and financial reporting quality. The audit committee's composition is determined as the sum of audit committee members on the board of directors to the total number of audit committee members.

In contrast, the audit committee's size is measured as the total number of audit committee members. Three studies consistently conclude that the greater the percentage of audit committee members who are also board members, the more rigorous the oversight and the better the quality of the financial statements generated. However, there are conflicting findings regarding the size of the audit committee. According to Raghunandan et al. (2001) and Krishnamoorthy (2002), the size of the audit committee is positively related to the quality of financial reporting. As such, Anderson et al. (2003) argued that the larger the audit committee, the lower the quality of financial reporting because the audit committee's size indicates the committee's ineffectiveness. The study by Phan et al. (2020) documented that the quality of external audits improves a company’s performance because of investor perception. They also believe that companies that are audited by big-audit firms would provide reliable, proper, and genuine financial reports, hence increasing overall investor trust in these companies.

The result revealed that the NCM negatively and significantly affects PER. The result shows that an increase in NCM leads to a decline in PER. These findings are consistent with the notion that boards may be less successful at monitoring CEO conduct without certified internal auditors. Several studies, including DeZoort and Salterio (2001) and Baxter and Cotter (2009), examined the effect of audit committee members' independence and expertise in accounting and finance on earnings quality. The findings of this study indicate that the more experience independent commissioners have and the more acquainted they are with financial reporting audits, the more rigorous their supervision during the financial statement preparation process to produce high-quality financial reports and earnings. According to Teoh and Wong (1993), an independent audit committee and expertise in accounting and finance indicates that the company's perceived legitimacy and earnings quality are higher and genuine, and high-quality earnings will elicit a more robust response.

Consistent with the third hypothesis's expectations, the findings indicate a positive and statistically significant association between PIF and PER. This result implies that the increase in the PIF leads to an improvement in the market value of firms. This commitment is motivated by the frequency of PIF, which is perceived as a critical way of enhancing board effectiveness (Xie et al., 2003). Furthermore, the size has a significant and positive effect on the market value of companies. This implies that an improvement in the size of companies leads to a rise in market value. Previous studies argued that larger companies have more complex operations and more stockholders than smaller companies and are more capable of managing earnings (Alzoubi, 2019). Similarly, leverage has a significant and positive impact on the market value of companies. The finding implies that an increase in leverage (debt to equity ratio) improves the market value of a firm. The ROI has a positive and significant effect on market value, suggesting that an improvement in ROI will increase the market value of a firm. The findings are in line with Sarens and Abdo Mohammadi (2011).

5. CONCLUSION

This study examines the effect of internal audit function characteristics on market value among Indonesian public listed companies. Our study uses the GMM estimator technique to provide a robust empirical result. The study found that PAC positively and significantly affects market value. In contrast, the NCM has a negative and significant impact on the market value of firms. The PIF positively and significantly affects market value. Our findings shed light on effective internal audit function in assuring internal control quality and the financial reporting process. The results of the present study make several key contributions. This study shows that improving a firm’s internal audit function technical competence and work performance will strengthen internal controls. It, therefore, helps managers to improve the quality of financial reporting by firms.

One of the most significant and substantial academic contributions of this study lies in the aptitude to link the internal audit function characteristics and market value. The peculiarity of the contribution embedded in this study suggests that each component of internal audit function characteristics (percentage of the audit committee, number of internal auditors, and percentage of internal auditor function) are distinctively motivated and clearly has a significant influence on the market value of firms. Given the obsolescence of studies in emerging markets and the variation in the results of previous studies, this study adopts agency theory assumptions and the notion that dealing with the characteristics of a firm's internal audit function as a comprehensive package (i.e., complementary groups) is preferable to individual investigations. This study extends previous research by examining the characteristic roles of boards of directors individually and as a ‘bundle’ group. The results of this research may be used by analysts, investors, and other strategic decision-makers in Indonesia to enhance the competitiveness and viability of the country's financial market. The findings will encourage policymakers to enact effective regulations, which could boost Indonesia's financial markets' efficiency and performance. These results may assist investors in making more informed decisions by providing them with a framework for identifying market value indicators and proxies for internal audit functions that can forecast business success.

However, our study is subject to a few limitations. First, the sample size of our study is relatively limited. All the observations are from listed manufacturing companies with complete data for the selected period and do not reflect the whole market; generalising the results is limited to similar sectors in the markets with the same institutional setting, such as Indonesia. Second, this study does not consider other factors in calculating internal audit functions. Therefore, future research can consider a different measure of market value and the impact of other corporate governance variables, such as CEO characteristics and audit committee activity, on firms' market value and profitability.

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