Enhancing management integrity through auditability concept: a literature review

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Abstract

Purpose – The purpose of this paper is to highlight the importance of auditability concept as one of the corporate governance indicators that could increase the management integrity practices and public confidence toward the organizations. Nowadays, most business organizations having issues related to the complexity of the transactions, which make it difficult to collect audit evidence and eventually may affect the company's good governance. This paper highlights the importance of management integrity practices through auditability concept that needs to be emphasized in today's business environment. Auditability is the ability of the organizations to provide accurate adequate records to be audited by auditors.

Design/methodology/approach – A number of databases in fields such as social sciences and economics were used to acquire literature on the topic.

Findings – A discussion on the auditability concept through auditability triangle and auditability model and how management could strengthen the governance practices.

Originality/value – This paper provides new inputs to related parties in preparing more comprehensive guidelines on the implementation of auditability practice among the management as to increase the public confidence on the reported financial statements.

Keywords Corporate governance, Integrity, Auditability, Internal control system

Paper type Conceptual paper

Introduction

The issue of inadequate audit trails due to the complexity of a businesses and its transactions has highlighted the importance of the auditability concept, which could impact integrity practice among management. Management with higher levels of integrity will disclose any information to be audited. On the contrary, those who lack integrity will only produce minimal information requested by the auditor.

On the other hand, auditors are responsible for determining the overall response when addressing the assessed risks of material misstatements at the financial statement level (ISA 240 and ISA 330). When determining how to address risks, the auditor needs to evaluate the selection and application of accounting policies by the company, particularly those policies related to complex transactions. The audit procedure of evaluating complex transactions requires auditors to consider circumstances that may indicate the possibility that the financial statements may contain a material misstatement due to error or fraud (Paragraph 29 ISA 240). The difficulty for auditors is

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that, when searching for adequate evidence, the audit process may be delayed, which might reflect the ineffectiveness of a company when it comes to maintaining its records for the audit purposes.

Most business organizations today are facing issues related to the complexity of transactions due to the current business environment. Transactions appear overly complex, involving multiple companies within a consolidated group or multiple unrelated third parties, and this scenario becomes even more complicated when business transactions in different countries are involved. The nature and complexity of accounts may be affected by inappropriate journal entries or adjustments. It also requires auditors to consider those accounts which contain complex or unusual transactions that could be an indicator of misstatements in financial reporting.

When considering the assessments of any misstatements during audit work, internal control systems need to be efficient and effective. The effectiveness of an internal control system helps an organization minimize all the risks, particularly for auditors. An internal control system put in place for financial reporting has long been recognized as an important factor for a company to ensure the reliability of financial reporting. Among the indicators for an effective internal control system are transactions being recorded properly and on a timely basis. For a complex or an unusual transaction, the management needs to prepare and provide an adequate audit trail or additional evidence that may be necessary to convince the auditors in forming their opinions.

Audit trails should be easy to assess, depending on the complexities involved in the particular transactions; for example, conducting an audit trail on an invoice issued by a vendor would be a relatively simple process. An audit trail usually begins with the invoice receipt and the transaction is then followed back through accounts payable and finally to the check or electronic payment that was made to settle the amount. However, an audit trail may contain many more steps and be difficult to follow, depending on the complexity of a specific transaction.

Current studies, such as those conducted by Rendon and Rendon (2015) and Weigand *et al.* (2013), allege that the ability of the companies to provide an adequate audit trail or additional evidence that may be necessary are not seriously being emphasized, particularly in today's business environment. In fact, the need for companies to provide additional evidence is increasingly being demanded in line with the increase in the modern financial scandals. Therefore, this paper is meant to contribute to the understanding and knowledge of the auditability concept within the context of a company's internal control system and corporate governance.

The remainder of this paper provides a review of the auditability concept, describes the relationship between auditability, internal control system and corporate governance, and explains the auditability challenges in current times. Finally, the paper ends with the conclusion.

Auditability concept

Auditability is the root of financial reporting as an organization needs to establish the data collection practices and systems of documentation to make them auditable by the external auditor. An auditable organization is an organization in which the evidence of the integrity of its control processes is readily available. It can be measured by the level of the accuracy of the records and the effectiveness of internal control (Carpenter and Ladson, 2005). Auditability is the process of making things auditable which requires an organization to actively manage an institutionally acceptable knowledge management system supporting its governance of processes and practices. The auditability concept can be measured when the organization has an ability to keep and record all the audit trails, i.e. provide accurate and adequate information about transactions. The auditability concept can be further explained by the auditability triangle and the auditability model.

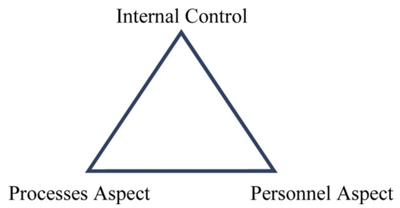
Auditability triangle

The auditable triangle, explained by Rendon and Rendon (2015), states that the function of auditability is to incorporate an aspect of a governance system which emphasizes effective internal controls, capable processes and competent personnel. An organization is highly encouraged to equip and enhance its capabilities in the three aspects of the auditability triangle to maintain the auditability concept in the organization, as shown in Figure 1.

First, internal control refers to the objective of enforcing internal control policies to ensure compliance with the organization's guidelines, policies and procedures, as well as monitoring enforcement and reporting material weaknesses. In developing the internal control, the organization needs to ensure the risks that surround the processes are well covered. For example, internal control regarding the preparation of financial statements needs to include the segregation of duties and review functions to ensure the numbers are not manipulated.

Second, the processes aspect refers to the capability of the organizational processes for performing the functions that are required during the preparation of financial statements. The preparation of the financial statements is typically discussed in terms of the processes, which include identifying transactions and events, recording in journals, posting into ledgers, adjusting entries, finalizing financial statements and closing entries. In this regard, the processes involved in preparing financial statements need to be continuously measured and enhanced to prevent the occurrence of error or fraud.

Third, the personnel aspect refers to the competency of selected personnel when performing functions entrusted to an employee within an organization. Personnel competency that is required includes the necessary education, training and experience of staff which should be relevant and adequate for them to perform the roles and duties entrusted to each member. For example, when performing the function of preparing the financial statements, the personnel competency required might include the relevant staff member(s)having an accountancy education background and training as well as experience in bookkeeping and financial analysis.



Source: Rendon and Rendon (2015)

Figure 1.
Auditability triangle.

It is noted that these three aspects, i.e. effective internal control, capable process and competent personnel, will support the auditability of the company as they complement each aspect. For example, good internal control needs capable processes and competent personnel to ensure its effectiveness.

Auditability model

The auditability model, first introduced by Weigand *et al.* (2013), is based on the agency theory. The agency theory explains the relationship between two parties, the principal and the agent, and is concerned with resolving problems that can exist in agency relationships due to unaligned goals or different aversion levels toward risk. The principal delegates a certain level of control to the agent with the objectives for the agent to safeguard the organization and optimize its values. The agent accounts for the results of the objectives with certain statements that will be reviewed by an external auditor as an independent party. The external auditor gives their opinion to the principal as to whether the statements prepared by the agent give a true and fair view on the objectives given by the principal.

The auditability model further explains the responsibilities of the agent as well as the financial system directing and managing a company. The responsibility of the agent, i.e. the board and management of an organization, should confidently ensure a preparation of true and fair financial statements, keeping records in such a manner as to enable them to be conveniently and properly audited and to be able to explain the transactions and financial position of the organization. The board needs to give an opinion on whether the reported financial statements provide a true and fair view of the business's results and whether the accounts have been kept in accordance with applicable approved accounting standards.

The agents are also required to maintain a financial information system, as this is responsible for accumulating and analyzing financial data used for financial planning, transactions bookkeeping and preparing the financial statements. This system has a core function that consist of general ledger keeping, budgetary accounting, accounts payable and accounts receivables and a non-core function incorporating the payroll system, cash management and budget planning (Diamond and Khemani, 2006). A good financial information system will provide excellent audit trails for the auditors and thus make financial information a vital part of internal control and governance systems within an organization. The financial information system interacts with the company's internal control which plays a crucial role in corporate governance, allowing the board to ascertain that the internal control measures that govern the preparation of the financial statements can be checked tested and certified (Gronlund *et al.*, 2010).

In completing the assurance aspect, the auditability model also highlights the responsibility of the external auditor to the stakeholders of the organization that they have audited, especially to the principals, i.e. the owners or shareholders of the organization. The responsibilities of the auditor are stated under Sections 165A and 174 Companies Act (1965) and are clarified as stating their opinion about whether the organization has kept proper accounting records and documentation during the audit period. The auditor also needs to state whether the financial statements have been audited in accordance with the Act and the organization appeared to have been able to meet its liabilities and has continuity in the business. The management with high auditability practice will ensure that the auditing process is conducted by an external auditor.

Auditability and internal control

Managers need to understand internal control when preparing the organization to be auditable which automatically increases auditability level. Effective internal control within an organization may produce a good audit trail, a chain of evidence that is the path of an original source document to its financial record within the accounting records. With the very complex modern business environment, an audit trail can be produced either via paper or electronic system. To establish an audit trail, all transactions and routine and non-routine actions need to be documented.

In many ways, audit trails can often be effective tools for overseeing a business's or an organization's finances as well as their other resources. Audit trails are a reliable way of finding out whether transactions are being conducted smoothly and truthfully, while keeping the minimum necessary number of steps in the process. If discrepancies are discovered in a company's financial data, an audit trail is the best way to determine where information is missing or where improper actions have taken place. A reliable and easy-to-follow audit trail is an indicator of solid internal controls instituted by affirmative action and forms the basis of objectivity.

Internal control structure should comprise five main components of control to achieve the company objectives: control environment, risk assessment, control activities, information and monitoring. The control environment consists of integrity, ethical values and competency of the employee, management's philosophy and operating style. The risk assessment process is to identify and analyze relevant risks on objective achievement, forming the basis of the plan as how to manage specific risks. As the business environment continues changing, mechanisms are needed to identify and deal with risks that are associated with the change that are occurring. The control activities are policies and procedures that lead the management to derive the objectives while information must be identified, gained and communicated in a form and timeframe that enables staff to effectively carry out their responsibilities. Finally, an internal control structure that has been established should regularly be monitored to achieve the company's objectives.

Past studies have found that a company's auditability positively influences its internal control systems (Raja Ahmad *et al.* 2015; Shamsuddin *et al.*, 2015). The higher level of ability to provide evidence in convincing auditors has a positive relationship with the internal control systems within the company. Raja Ahmad *et al.* (2015) explored the level of risk management and internal control disclosures among Malaysian listed companies and most communicate their risk management and internal control to the shareholders and stakeholders, reflecting good compliance levels among publicly listed companies. In addition, there are also significant relationships between board characteristics and risk management and internal control among Malaysian publicly listed companies.

Shamsuddin *et al.* (2015) examined the perception of managers to the factors that have affected the effectiveness of the internal audit function in Tenaga Nasional Berhad, one of the Malaysian Government Linked Company. Of a total of 400 questionnaires distributed, 114 questionnaires were successfully collected, and the findings indicate that managers have a high level of perception about the effectiveness of internal control.

The effectiveness in the internal control systems enhances a company's auditability in convincing auditors during their audit works (Shamsuddin *et al.*, 2015).

Studies provided in this section focus on the relationship between internal control and management functions in providing auditability. The internal control, such as control activities, control environment and risk assessment, are elements that would assist an organization in preparation before an auditing process started. In addition, auditability and a company's corporate governance may assist in building reliability into a company's financial statement.

Auditability and corporate governance

Corporate governance is normally set by management as a control mechanism to ensure that a company is auditable and information in financial statements offers a true and fair view as well as being important to assist in preventing fraud. The existence of corporate governance will provide the guidelines as to how a company can be directed or controlled and can also fulfill its goals and objectives in a manner that adds to the value of the company and is also beneficial for all stakeholders in the long term.

The governance structure specifies that the distribution of rights and responsibilities among different participants in the company, i.e. board of directors, managers, shareholders, creditors, auditors, regulators and other stakeholders, and specifies the rules and procedures for making decisions. Governance provides a structure through which corporations set and pursue their objectives and is also one mechanism for monitoring the actions, policies and decisions of corporations.

Katieno (2013) divided corporate governance into seven functions: oversight, managerial, compliance, internal audit, legal and financial advisory, external audit and monitoring functions. Oversight functions are when a board of directors provides strategies advice to management and oversees managerial performance and macro-managing has been applied to avoid micro-managing. Managerial functions depend on the alignment of management's interests with those of the shareholders while compliance functions are when laws, regulations, rules, standards and best practices have been developed by the state and federal legislators, regulators, standard-setting bodies and professional organizations to create a compliance framework for public companies in which to operate and achieve goals.

Internal audit functions have been built within an organization to ensure and help guide the company in the areas of operational efficiency, risk management, internal controls, financial reporting and governance processes. Legal and financial advisory functions are in place to assist the company and its directors, officers and employees in complying with applicable laws, other legal obligations and fiduciary duties to ensure rules and regulations have been followed by employees. External auditor functions lend credibility to the company's financial reports and thus add value to its corporate governance through their integrated audit of internal control over both financial reporting and financial statements. Monitoring functions where shareholders, particularly institutional shareholders, empowered to elect and remove directors.

Challenges to auditability

This section focuses on the potential challenges that managers should consider to enhance the application of the appropriate auditability concept. According to the Government Accountability Office (GAO) (2011), there are a few challenges that organizations may need to address to reform financial management.

The first challenge is committed and sustained leadership, and the GAO states that, in every organization, there are challenges within the senior authority and, subsequently, it is crucial that a company's present activity be regulated throughout the office, at all working levels with the goal that the company's intended achievements should be accomplished. According to Hanapiyah (2015) leadership is the ability to inspire people, instill passion and also give direction to an individual or group of individuals. Therefore, in order for the company or organization to survive, its leaders need to be maintained and sustained which is one of the key challenges that every company should address.

The second challenge is having an effective plan in place for strengthening a company's internal control. In every organization, internal control is the most important thing; if the internal control is weak, then an organizations' performance might be unstable. According to GAO (2011), it is not an easy task to develop and implement a comprehensive plan that identifies the internal control's weaknesses, but it is critical to fully resolve the long-standing shortcomings of a company. Steady management monitoring is required for internal control to be successful.

The third challenge is maintaining a competent financial management workforce. According to GAO (2011), effective financial management always requires a knowledgeable and skilled workforce that includes fully trained and certified individuals in accounting that have adequate knowledge in accounting practices and standards, and experience in information technology. It is imperative that organizations provide adequate and proper training for staff to ensure that staff possesses adequate skills and knowledge. In addition, every organization also needs to hire and retain a skilled workforce to ensure success in becoming an efficient, effective and accountable business operation as a whole as well as aiding respective departments develop strategic plans.

The final challenges are accountability and effective oversight. To monitor the progression of organizations and to hold individual staff members accountable for progress, managers and oversight boards need to be reliable, valid and have meaningful metrics to measure the performance and not to ensure the results of the corrective actions are maintained (GAO, 2011). It has also been stated that the effective monitoring and oversight of progress by the leaders will bring the effective and successful implementation the organizations. The oversight board as well as individual members are accountable for carrying out their own responsibilities to execute all plans.

Conclusion

Auditability is the ability of management to prepare and provide an adequate audit trail or additional necessary evidence that could strengthen internal control systems and a company's governance. This paper highlighted the importance of understanding the concept of auditability among managers, which could strengthen the governance of a company and also emphasized that adequate internal control enhances auditability levels and strengthens corporate governance. Researchers have highlighted that, by improving factors of corporate governance, such as practices of strategic planning and fraud control, the practices of integrity among managers of the company have improved with significant positive relationships (Said *et al.*, 2016).

The auditability triangle and auditability model are applicable and may enlighten the auditing process since they provide a better understanding of the concept of auditability. This paper will also contribute to the body of knowledge in respect to the auditability concept for the application in auditing work but it may have some limitations as the findings of this conceptual paper may not be generalized to other settings or other groups of professions. Both quantitative and qualitative studies might be considered to further explore the effect of auditability in enhancing integrity practices among management.

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