

### **The Internal Audit and Financial Reporting Quality**

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#### **ABSTRACT**

The fundamental reason for the examination is to explain the relationship between the Internal Audit Functions (IAF) and the nature of financial reporting quality in the segment of the Pakistan textile. Samples of 100 internal auditors of fifty different textile units which are located in the Punjab province are taken for this study. The data was collected by (Questionnaire). The study provided the findings that when the IAF and external audit have strong relationship with each other by having regular meetings and more collaboration in the preparation of the annual audit, the textile units showed high quality in the financial reporting. The results of the study propose that there is certain relationship exists between the IAF commitment during the time spent the money related accounting and the nature of the budgetary reporting. The discoveries of the study prescribe that IAFs play an essential part in the way of the financial reporting. The major limitations of this research are cost, time, research culture and the scarcity of the internal auditor.

**Keywords:** Internal audit, Textile, Corporate governance, Financial reporting, Pakistan

#### **INTRODUCTION**

Financial testimony plays an important role in the globalization of the financial markets, one purpose of the financial reports to influence the investors, because investors believe on the financial reports and invest the capital. The investors want the reliable information related to the financial reports and the economy of the country. Corporate governance depends on the both economy and the financial status of the industry. The competition environment to capture the investors and increase the rank of industry these things affects the Internal Audit Function (IAF) (Adbolmohammadi, 2009) therefore, we require putting the values in the internal audit department and playing an important role in the society and the organizations (Roth, 2000).

Some researchers such as Cohen (2004) have found a strong relationship between the external auditors, internal auditors and the senior management of the company. According to the institute of the internal auditors (IIA,

2009), the internal auditors of the organization perform the job as the consultant of the organization by suggesting major improvements such as the organization risk management course and the procedure of the governance of the organization. The Sarbanes Oxley Act (SOX) working in the USA recommends that every organization should verify the internal control system of the organization with providing the improvements to the senior management and they should mention these improvements in the annual report of the firm. Competing environments where companies are trying to capture more investors and also in search of the increased industry ranking, IAF are affected greatly by such environment (Adbolmohammadi, 2009). Therefore, it is suggested to worth the internal audit department of the company that play a vital role in the progress of the company as well as the society (Roth, 2000).

This study tried to find the association between the IAF and financial reporting in the textile sector in Pakistan. Previous studies which tried to find the relationship between the two were conducted in different segments but ignored the textile sector in Pakistan but the crisis in world stresses to find the relationship in the textile sector too. Textile industry needs to reconstruct the confidence of the financial specialists in capital market and this study focus in the textile industry in the Pakistan. Therefore, it is important to investigate the influence of the more conspicuous IAF involvement in book-keeping and financial reporting of the textile industry to clarify why they should have to put their resources into the IAF assure the greater reliability in the quality of the reporting of the financials.

In this study, the textile industry literature was based on the association between the financial writing quality and also corporate governance of the mills which are related to the IAF. The results of this study are important for the textile industry which can serve a number of people which includes the board of the directors, shareholders, stakeholders and management of the textile mills as number of companions are interested in the quality of the

financial reporting of the textile mills. This study is organized in different steps. First of all, a theoretical system is made along with review of the up-to-date observational studies. Then the methodology of the study is presented which give the information about how the information are collected about the study and also how the variables of the study were measured. We analyzed the data and then finished with important implications. The textile industry of the Pakistan is very important to the nation as well as to the economy of the country. The Pakistan ministry of the Finance's economic survey of 2013-14 reported that there the industry representatives about 40% of the state's machine-driven work power, produces 54% of tariff revenue and archives for 9.5% , organizes 75% of its industrial base of the total GDP.

"Impact of internal audit on the financial reporting quality" has so many objective but we focus on the main three objectives. To find out the relationship between internal audit and financial reporting quality. To find out the relationship between external auditor and internal auditor because the external auditor carries out the work of internal auditor. To find the association between the internal audits function (IAF) and financial reporting in the textile sector in Pakistan.

The limitation of this examination is cost, time, research culture and the shortage of the internal auditor. This research work can't be led on a more extensive level because of deficiency of funds. Time is another limitation. The research society does not exist in our Pakistan, particularly in textile areas; internal auditor is not willing to take part and reveal data amid the study. Collection of key data from textile segment of Pakistan is as usual difficult. Employees were hesitant to give data because of individual and management society prevails in the organization.

#### LITERATURE REVIEW

This literature study is vital because we look to the auditor or internal auditor plays in the organization. Most important the researcher use the two theory number one researcher use the term of agency theory (Xiangdong, 1999) and the next theory transaction cost theory explain by SpraaKman, 1997, but in every task in the organization the internal auditor show the demonstrate in management and the other hand governance of the organization. Dittenhofer (2001) did his work to define the internal audit effectiveness and define the basis rule to show them to achieve the effectiveness in the internal audit task performs in the organizations.

Sawyer (1995) and Van Gansberghe (2005) explained the same point of view the interest to do something to increase the standing of the internal audit quality and effectiveness to achieve the textile segment .If the internal audit is effective its show the level of the performance and the importance of the task perform in the organizations. In the textile industry of Pakistan in which internal audit play an important role to find out the errors and fraud on the basis of daily working perform in the organization. Internal audit is show the positive relationship between the organization and its performance, or also improve the level of the services in the organization. Gansberghe (2005)

found out the significant point of view to enhance the effectiveness of the internal audit quality. Correspondingly, Ziegenfus (2000) highlighted that internal audit effectiveness enhance due to evaluate the concert and persistent the services of the activity. The term of the internal audit is a method to value-added internal audit process.

Gupta (2001) identified eight factors that useful in internal audit function. Within the financial sectors the risk management, inner control and the most particularly monetary reporting are the solid standardizing inclination towards fortifying. And the next most important and not ignore is corporate governance, and the background of Pakistan also assume a vital part in the budgetary segments. King (2007) doing a work on the Corporate governance all over the world and show the details of the small shareholder interest that expected to the organization and the other hand show the basic rules made for the organization should follow because the corporate governs and the financial reporting has a positive relationship.

According to Monterrey Mayoral and Sa'nchez-Segura, 2008, conclude the positive relationship between the corporate administration and the monetary reporting quality, and remember the corporate administration ought to bitterly. National and the global level take after the rule to catch the abnormal state budgetary reporting quality; Arena (2006) likewise center to control the nature of money related reporting. Then again a large portion of the studies demonstrate the relationship between the inner reviewer financing and the other side outside examiner both are assume an imperative part in the nature of the monetary reporting (Felix, 2001), and the greater part of the analyst concentrate on the issue of work sharing, participation, data and the abuse aide of the speculators Krishnamoorthy (2001) Also, couple of researcher does an exploration on the association on inward inspector in the last yearly reports of the association or the keeping money industry (Felix, 2001). Some analyst center that interior reviewer might be a reason for the inconsistencies in the business (Moyes, 2009). Notwithstanding, this investigation focuses on the relationship the IAF and the way of the financial reporting quality in the Pakistani Textile segment. In Pakistan if the great administration it's might enhance the significance and the part of the inward examiner in the textile business. The IIA, 1999 (Institution of internal auditors) has focus on the audit effectiveness related to the organization means that to say the internal auditor in the textile industry should be a effectiveness in the job he explained the world of effectiveness "An internal auditor independent, objective assurance and consulting activity to designed to added the value and improve the organization operations. It helps an organization accomplish its objectives by bringing a systematic and improve the effectiveness of risk management, control, and governance process". This statement gives the conclusion that internal auditor responsibility about the past to enhance future results to help evaluated work all the more adequately and effectively (Nagy, 2002).

If we talk about the internal auditor in textile industry of Pakistan should necessary improve effective and efficient

services delivery? Van distinguished (Gansberghe, 2005) discernments and possession; association and administration system; enactment; enhanced polished methodology; calculated structure; furthermore assets as elements impacting inside review viability. Dittenhofer (Dittenhofer, 2001) has likewise discover the internal auditor quality is kept up it will be productive to method and operations of the auditee, in this manner inner review adds to viability of the auditee and the association in general.

Xiangdog (1999) did work on "Agency theory" and also highlight the internal auditor activities and also look the different angle to the art of audit as "internal audit plays in an economy" according to the writer the internal auditor has a high advantage as compared to the external auditor in sense of obtaining of information on the initial stage, gain the quickly information and finding the problem on the earlier stage. And the recommendation is valid in the textile industry of Pakistan as compared to the external auditors. Spraakman (1997) applying the hypothesis of exchange cost financial matters, showed how inner review suggestions are critical to the administration of government associations. Internal auditor focus on the plan, execute and objectively meaningful communication to the subordinate.

Adams (1994) focused on the agency theory explain to maintain the management should developed the strong department of the internal audit in the organization level, because if the internal audit has done work as an independent then the other side the numbers of the investors increase due the fare financial reporting. The four factors which are interrelated to each other because a dynamic process and the result of the above factors interplay each other. One factors show the effect on the other factors because intercalated to each other. Audit effectiveness has depended on the audit quality and the management support, because the management support has played a vital task in the unit of audit. If we talk about the Pakistan's textile industry in which management does not supportive to the internal auditor in the work place, without the management supportive the internal auditor not in position to sustain the financial reporting quality. If we look the power of the management of the textile industry in Pakistan in which the management allocate the resources in term of money and the time etc.

DeFound, (1991) and Francis (2005) found out the audit committee and the size in the organization point of view. He developed the impact on the meeting of the audit committee, he argues that if the size if the audit committee is large they also demand high talent and managerial skills or also high grip on the organization environment. If the size of the committee is large then not demand of the meeting among the committee. If we look committee and the meeting both has indirect relationship if the large member committee then the number of the meeting also reduces because the accuracy of the audit works increase, demand of meeting reduces. According to Sharma (2009) has situate out the has a positive relationship between the review advisory group and the bookkeeping specialists in the review board, implies that to says the bookkeeping specialists if accomplish additionally meeting with the

review council demonstrate the more exactness and the unwavering quality of the review working, in this manner we say the review panel has a positive relationship between the quantity of the meeting. Willekens (2004) the writer give the same point of view that financial reporting quality depends on the successful audit board. Audit committee ensures the reliability of the financial reporting and the strong internal manage and the functional risk management for the organization. On the off chance that, the inside inspector is guarantee the nature of the reporting it's demonstrate that shares holder appealing, and security of the shareholder, on the benefit of the association explained by DeZoort et al., 2002. Various scrutinizes have demonstrated that a persevering review board of trustees can decrease money related cheats and upgrade the nature of bookkeeping data (DeFound, 1991). In addition, the hugeness of organizations having persistent corporate review boards of trustees has been underlined by numerous administrative powers. The nature of money related reporting in which the interior inspector guarantees the monetary proclamation plan by the administration free from mistakes. This act of doing work related to the financial reporting quality DeAngelo, (1981) and Watts and Zimmerman (1986) auditors filled all the requirement of the job not just focus traditional way on observing. In the sectors of textile is commissary to match the papers figures with the physical existence. In every sector in Pakistan the auditor reputation matters. Weber at give the relationship of the stock price Weber (2008) and the audit quality he believes that the stock price reflect the quality of the financial reporting. Teoh (1998) says that the stock returns are often examined in studied investigating the effect of the audit failure on audit reputation.

#### RESEARCH METHODOLOGY

This research has use the primary data collection method applies on the textile industry of (Punjab) Pakistan. The data was gathered by personal contacts, physically and self-managed survey (Questionnaire).

The sample size contained 100 internal auditors from textile business situated in Punjab. The textile segments were partitioned into five general classes i.e. Ginning, Spinning, Weaving, Finishing, and articles of clothing. There was gathered from the internal auditor of spinning, weaving, and articles of clothing on the premise of two phase examining. In first stage, built levels on the premise of turning, weaving, and completing association in Punjab, and after that chose 50 associations by the random sampling. In the second stage, internal auditor chose from the over the 50 textile factories.

The inquiries were asked on the basis on the two angle perspective. In the first place the questionnaire asked on the five point Likert scale from the internal auditor. And 2 points utilize the "YES" or "NOT" given the choice to internal auditor to choose single.

#### Theoretical Framework & Hypothesis

The corporate governance linked to develop the higher level of the financial reporting quality. The financial reporting high quality plays an important role to influence the investors in the firms or the other side the assets of the

firms also increase profitability also going to increase (Cohen, 2004).

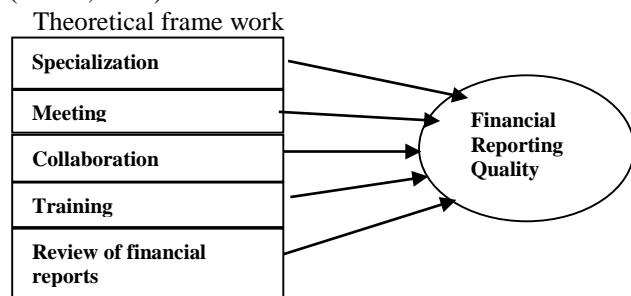


Figure 1: Theoretical framework

The initial segment demonstrates the relationship between the interior and the outside review monetary reporting. Some studies attempt to build up the relationship between the inside and the outside auditor of how to impact the financial reporting quality (Felix, 2001). Some readings exhibit that the "outer inspectors dependence on the interior evaluator" unmistakably the outer examiner attempt to take after the inward reviewers doing as of now work on the money related reporting. Some studies says that the interior review assume an essential part in the money related reporting quality and the 2nd point focus on the typical words cooperation, miss leads the investors, degree of the work sharing and miss-guide to the Boards of directors. Some researcher believes that internal auditor assume an imperative part in the budgetary reporting or effectively assume a critical part in a starting corporate administration (CNMV, 2010). If we look to the other side most of the researcher believes that internal auditors irregularities in the financial reporting (Moyes, 2009).

After reviewing the literature on internal audit and the financial coverage excellence, followings hypothesis have been developed to check the impact of internal audit on financial reporting quality.

**H1:** Specialization and financial reporting quality has a positive relationship

**H2:** Meeting and financial reporting quality has a positive relationship

**H3:** Collaboration and financial reporting quality has a positive relationship

**H4:** Training and financial reporting quality has a positive relationship

**H5:** Review of financial reports and financial reporting quality has a positive relationship

Variables are included to measure the financial reporting quality on the five point Likert scale and the Time put on the finance audit, compliance audit, operation audit and the management audit are asked to the high time or other hand low time on upper audits. And other variables are asked specialist audit education is compulsory in our organization in term of "YES" or "NO".

No optional data source was used for information gathering. Just survey was used for data gathering. Surveys were by and by dispersed to inward inspector material associations. Information was assembled from 50 unmistakable associations working in Punjab. A blend of turning, weaving, and shading associations has decided for information gathering. The scales use in dismembering the

survey contact are Likert scale (five centers answer scale). Respondent's backing in this study was willful.

## RESULTS AND DISCUSSIONS

### Regression Analysis

Coefficients clarify the relationship between the ward and the free variables in this circumstance we mastermind the autonomous variable to solid or feeble association with ward variables. Coefficients clarify the relationship between the ward and the free variables in this circumstance we mastermind the autonomous variable to solid or feeble association with ward variables.

Table1

Model Summary

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate	Durbin-Watson
1	.890a	.792	.781	.28710	1.837

a. Predictors: (Constant), Review, Meeting, Collaboration, Training, speculation

b. Dependent Variable: Reporting quality

The above table 1 shows that the value of the R-square which is 0.792 (0.792\*100) 79.2% it means that the different independent variables takes a significant change in the value of the dependent variable. It is considered as a good sign for the research the more the value of the R Square means that the more variation is present due to the independent variables. The value of the Durbin Watson (1.837) shows that there is non-auto colinerity among the variables it means that the increment in one variable doesn't affect the value of the other variable.

Table2

Regression Results

Model	Un. $\beta$	Std. $\beta$	coeffis $\beta$	Std. Coefft $\beta$	t	Sig.
1						
(Constant)	.241	.205			1.17	.242
Specification	.235	.043	.349		5.456	.000
Meeting	.163	.046	.175		3.521	.001
Collaboration	.186	.046	.208		4.036	.000
Training	.194	.046	.256		4.181	.000
Review	.179	.040	.257		4.506	.000

The above table 2 shows that the value of the significance for the variable specialization is (0.000) which means this variable having the impact over the dependent variable which is the financial reporting quality. The value of the Beta for that variable which is the (0.345\*100) 34.5% shows that this variable having the more impact over financial reporting quality while the other variables having the least impact over the financial reporting quality. The second variable which is the meeting which having the significance value which (0.001) means that this variable also the impact over the financial reporting quality. The value of the Beta which is the (0.175\*100) 17.5% it means that this variable having the least impact over the financial reporting quality. The third variable which is the collaboration which having the significance value which (0.000) it means that this variable having the impact over the financial reporting quality. The value of the Beta which is the (0.208\*100) 20.8% which means that this variable having the impact over the financial reporting quality. The fourth variable which is the training also having the significance value which is the (0.000) which means that this variable having impact over the financial

reporting quality. The value of the Beta which is the (0.256\*100) 25.6% which means that meeting variable having the impact over the financial reporting quality. The last variable which is the review which having the significance value (0.000) it means that this variable having the impact over the financial reporting quality. The value of the Beta which is the (0.258\*100) 25.8% it means that review on the internal control given about the internal auditors having the impact over the financial reporting quality.

The regression analysis shows that the independent variables which are the specialization of the internal auditors, meeting with the other members of the organization, collaboration with the members of the organization, review on the internal control on the organization and the training given to the other members of the organization having the impact over the financial reporting quality. It means that if the organization wants to improve the financial reporting quality then these factors must be kept in mind by the top management of the organization.

**Table 3**  
*Correlation Analysis*

		Spe cula tion	Meetin g	Colla borati on	Train ing	Revi ew	Repor ting Qualit y
<b>Speculation</b>	Pearson Correlation Sig. (2- tailed)	1					
<b>Meeting</b>	Pearson Correlation Sig. (2- tailed)	.267 **	1				
<b>Collaboration</b>	Pearson Correlation Sig. (2- tailed)	.329 **	.153 .129	1			
<b>Training</b>	Pearson Correlation Sig. (2- tailed)	.617 **	.204* .042	.335* *	1		
<b>Review</b>	Pearson Correlation Sig. (2- tailed)	.496 **	.302** .002	.347* *	.419* *	1	
<b>Reporting Quality</b>	Pearson Correlation Sig. (2- tailed)	.750 **	.431** .000	.525* *	.685* *	.663 **	1
	N	100	100	100	100	100	100

The above table 3 shows that the Pearson correlation between the specialization and the meeting is (0.267) it means that the specialization having the moderate positive relationship with the meeting at the level of the significance 90%. The value of the Pearson correlation between the specialization and the collaboration is (0.329) which means that these two variable having the moderate positive relationship with each other. The value of the Pearson correlation between the specialization and the training is the (0.617) which means that these variables having the strong positive relationship with the each other. The last value of the Pearson correlation between the specialization and the review is (0.750) which means that these variables having the strong positive relationship. It means that if the internal auditors review the internal control system of the organization than the financial reporting quality is better.

**Summary**

The above table shows that there are different independent variables in the current study and according to

the above table it means that these variables having the positive relationship with each other.

**Table 4**  
*Summary of Results*

Hypothesis	Result
<b>Hypothesis 1</b> There is a positive relationship between specialization and financial reporting quality	<b>Accepted</b>
<b>Hypothesis 2</b> There is a positive relationship between meeting and financial reporting quality	<b>Accepted</b>
<b>Hypothesis 3</b> There is a positive relationship between collaboration and financial reporting quality	<b>Accepted</b>
<b>Hypothesis 4</b> There is a positive relationship between training and financial reporting quality	<b>Accepted</b>
<b>Hypothesis 5</b> There is a positive relationship between review of financial reports and financial reporting quality	<b>Accepted</b>

**CONCLUSIONS**

This research has analyzed internal audit function of the 50 textile industry. The study examines the relationship between financial reporting quality and the internal auditor function and the function reporting, which has clear practical consequences ensuring to the presentation of new bearings on straightforwardness, uprightness and nature of money related reporting and corporate organization. In the financial crises the part of the internal auditor has a basic part in the corporate governance. Focusing now on specific parts of the definite affirmation, my results shows that the relationship between the IAF and outer review is more vital, with more customary gatherings and more conspicuous participation in setting up the yearly review, material range have higher quality money related reporting. Our discoveries prescribe a positive relationship between the IAF consideration in the monetary accounting process and money related reporting quality. From a more broad perspective, these outcomes propose that IAFs assume an imperative part in the quality of reporting, a basically untouched, however possibly encouraging, and range for future examination.

The concentrate bolsters higher quality financial reporting happens when the IAF gives additional time and assets to financial reviews. Better reporting additionally comes about because of finding a way to guarantee the exactness and unwavering quality of bookkeeping records and financial reporting quality. If within analyst has a more imperative relationship of the IAF in the control and faithful nature of money related reporting upgrades its quality. The proposition adds definite verification to the theoretical structure, fulfilling the primary target of the hypothesis development.

**Suggestion and Future Research Directions**

Financial reporting quality can improve by the corporate governance and the senior management to verify the activities of the internal auditor. Past studies have found a relationship between deficiencies in organization and poor money related reporting quality. Better organization is associated with higher quality cash related reporting (Cohen, 2004). Textile industry of Pakistan should try to focus of the relationship of the internal auditor and the management staff because the management performance in

the hand of internal auditor. Both of the internal auditors and the management of the organization should be independent. And the internal auditor should focus on his jobs rather than focus on the management. The present governance system gives importance to the good relationship between the internal auditors and the external auditors. There is need of the high quality audit in combination of the increasing compliance charges which give importance to the benefits of competent combination of two audit roles. There are professional audit principles which permit to rely on internal audit work which is subjected to the valuation of the internal auditing functions. There is no such examination which has tried to analyze the presence of the IAF in the monetary book-keeping process which have indicated fabulous governance financial scope

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