

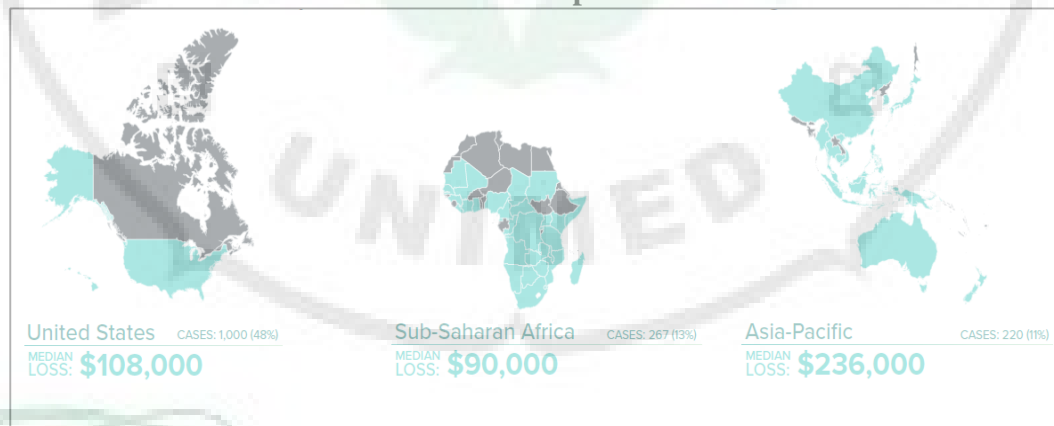
CHAPTER I

INTRODUCTION

1.1. Research Background

The recent years have been marked by a succession of high-profile financial scandals. There are 2,690 global cases of occupational fraud in 23 industries according to Association of Certified Fraud Examiners¹ (ACFE, 2018). Based on ACFE survey entitled “Report to the Nations: Global Study on Occupational Fraud and Abuse”, the cases created ± USD 7 billion in total losses. The true global cost of fraud is likely magnitudes higher, especially when factoring in the indirect costs, such as reputational harm and loss of business during the aftermath of a scandal.

Figure 1.1
Countries with Reported Cases



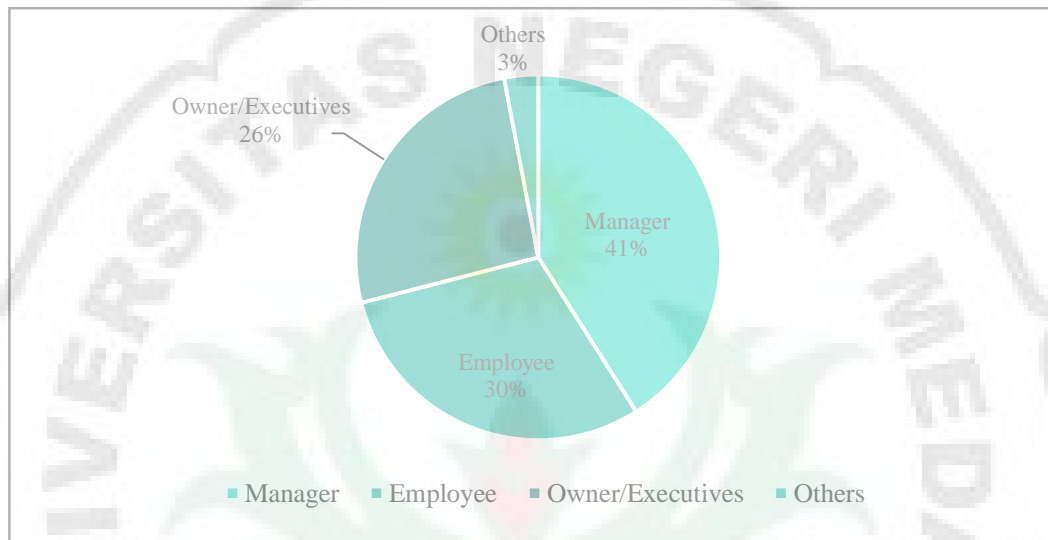
Source: Association of Certified Fraud Examiners, 2018.

Asia-Pacific is the third largest region where 11% of global fraud cases occurred (220 cases) after United States (48%) and Sub-Saharan Africa (13%). Indonesia is the third largest fraudulent country among others in Asia-Pacific (13%) after China (22%) and Australia (17%).²

¹ Association of certified fraud examiners (ACFE) is a provider of anti-fraud training and education.

² Source: ACFE, 2018.

Figure 1.2
The Perpetrator's Level of Authority



Source: Association of Certified Fraud Examiners, 2018.

Mostly perpetrator's level of authority relate to occupational fraud is manager (41%), employee (30%), owner/executives (26%), and others (3%). Executive is the least perpetrator but they created the highest losses. However, the fraud perpetrators are dominated by the managers in general.

Hung (1998: 107) argue that institutional force exerted on executives from within the organization can be explained in terms of managerial hegemony. The board is simply a 'rubber stamp'³, with strategic decision being dominated by the professional manager. The attitude of not getting involved unless the trouble occurred is certainly the board characteristic (Mace, 1971) previous to the recent wave of corporate scandals. Drucker (1981:107) said that the board of directors is an impotent ceremonial and legal fiction. Within the perspective, governance is just a supporting role, if not one of the rubber stamp.

³ A person or organization that gives automatic approval or authorization to the decisions of others, without proper consideration (Oxford Dictionary of English).

In the other hand, internal control weaknesses were actually responsible for nearly half of frauds (30%), override of existing controls (19%), and lack of management review (18%)⁴. It has drawn attention on the need for effective internal control (Endaya and Hanefah, 2016; Sultana *et al*, 2015; Khlif and Samaha, 2014 in Oussii and Taktak, 2018). Internal control as the representation of holistic activities inside an organization should have been administered in order to achieve efficient and effective operational control purposes, financial report credibility, and the obligation towards laws and regulations (COSO, 1992).⁵

The increasing number of business failure have encouraged companies to emphasize the internal control system, especially on the operational environment (Jokipii, 2009). The effective internal control system will minimize the risks (Spira and Page, 2003). The executives is recognized as the ultimate responsible to maintain the internal control system but internal audit unit has the legitimate role in the discharge of this responsibility (Institute of Internal Auditors, 2004).

In Indonesia, all public listed companies must establish an independent Internal Audit Unit following Law No. 40/2007 on Limited Liability Companies; Law No. 8/1995 on the Capital Market; OJK Regulation No. 56/POJK.04/2015. It aims to provide continuous review of the effectiveness of internal control, risk management, and governance processes (Institute of Internal Auditors-Australia, 2014) based on analysis and assessments of data and business processes (Burton, *et al*, 2012).

⁴ Source: Based on 'Global Study on Occupational Fraud and Abuse' (ACFE, 2018).

⁵ Committee of Sponsoring Organizations of the Treadway Commission (COSO) released its *Internal Control—Integrated Framework* (the original framework) in 1992.

From the agency theory perspective, Internal Audit Function⁶ is considered as a pivotal monitoring mechanism within the corporate governance mosaic which aims to reduce information asymmetry problems between the principals and the agents (Sarens and Mohammadi, 2011; Goodwin-Stewart and Kent, 2006; Fadzil et al., 2005; Adams, 1994 in Oussii and Taktak, 2018). Agency theory advocates that the senior management invests in the IAF to show Board of Directors the governance is adequately functioning.

ACFE (2018) states that the most common anti-fraud control is internal audit department cite 73%. In fact, the tips⁷ were the most common means of detection (40% cases). It is more than internal audit department (15%) and management review (13%) combined. It means that the existence of Internal Audit Function related to the internal control is questioned.

There are few studies focusing on examining the effect of IAF and internal control quality to date. To name a few are Lin *et al.* (2011) and Oussii and Taktak (2018) that underlining the important role of IAF in strengthening the quality of internal control. To the author's knowledge, there has none of relevant study found in Indonesia's context.

Overall, the study is designed to investigate the effect of IAF characteristics on internal control quality in Indonesia Public Listed Company. The theory underlying the study is agency theory. In additional, the study uses the quantitative based approach using survey's instrument. Therefore, it is expected to have

⁶ It is shorted to IAF. The abbreviation will used in the discussion.

⁷ The tip is known as whistleblower. Employees provide over half of tips, and nearly 1/3 come from outside parties.

profitable results to add literature and insight from the other perspective, extant future research, and contribute important implication for regulatory bodies who are concerned with the internal control quality such as Board of Commissioners, Board of Directors, managers, audit committees, and etc.

Hence, based on the background above, this study entitled **“The Effect of Internal Audit Function Characteristics on Internal Control Quality in Indonesia Public Listed Company”**.

1.2. Problem Identification

Depending on the research background, internal control is the representation of holistic activities inside an organization. A simple lack of controls is the main factor that enabled the fraud to occur. Specifically, because of the management pursuing their own interests of performing poorly. Then, the board of directors under the board of commissioners' approval establish internal audit unit to maintain the internal control but in practice, its role is still questioned related to internal control quality.

1.3. Research Limitation

Based on the identified issues, determining the effect of internal audit unit is limited to Indonesia Public Listed Companies. It focuses on internal audit function characteristics and internal control quality. Internal control quality is seen from six factors namely: organization, role, responsibilities; risk management; overall monitoring; IT functions and organization; system characteristics; and IT monitoring control. Internal audit function characteristics are break-downed into six variables namely; organizational status; audit committee involvement in

reviewing IAF's program and processes; competence; internal audit investment; quality assurance and improvement program as well as follow-up on internal control deficiencies.

1.4. Research Question

Based on the following problem statement, the research question is whether organizational status, audit committee's involvement, competence, internal audit investment, internal audit quality control assurance and improvement program, and follow-up internal control deficiencies affect internal control quality.

1.5. Research Objective

The research aims to investigate the effect of IAF organizational status, audit committee's involvement in reviewing IAF's program, IAF competence, IAF investment, internal audit quality control assurance and improvement program, and follow-up internal control deficiencies on internal control quality.

1.6. Research Benefit

This research will be useful theoretically nor practically. Theoretically it will enrich the literatures. Practically it will be important implications for regulatory bodies who concern on internal control quality, such as the Board of Commissioners, Board of Directors, managers and audit committees, and other parties. Individually, it will be useful for researcher to obtain experiences and insights.