



**INTERNAL AUDIT, INTERNAL CONTROL
EFFECTIVENESS, CORPORATE GOVERNANCE
STRUCTURE AND FINANCIAL REPORTING QUALITY:
INVESTIGATING THE INTERNAL LINE OF DEFENSE OF
MANUFACTURING FIRMS IN CHINA**

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**Internal Audit, Internal Control
Effectiveness, Corporate Governance
Structure and Financial Reporting Quality:
Investigating the Internal Line of Defense
of Manufacturing Firms in China**

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Presentation Outline

- Background of Study
- Research Methodology
- Research Findings
- Conclusions
- Research Limitations and Recommendations for Future Studies

Background of Study

- Extant literature has shown that managerial opportunism activities would often deteriorates the financial reporting quality.
- For example, managers could inflate reported earnings via favourable accounting choices and reverse the earnings in later years or intervene by adjusting reported accounting numbers through operational decisions, including manipulating sales revenue and cutting valuable investments such as R&D.
- Earnings management \longrightarrow stakeholders from understanding the firm's actual circumstance and performance.
- Therefore, having a strong and effective line of defence, namely, internal audit, internal control, and corporate governance structure is vital to financial reporting quality.

Background of Study (cont..)

Financial Reporting Quality

- One of the prominent challenges of the company is to maintain and improve their financial reporting quality.
- Highly depends on the internal line of defence (also can be called as internal mechanism) would ensure the production of high quality of financial reporting.



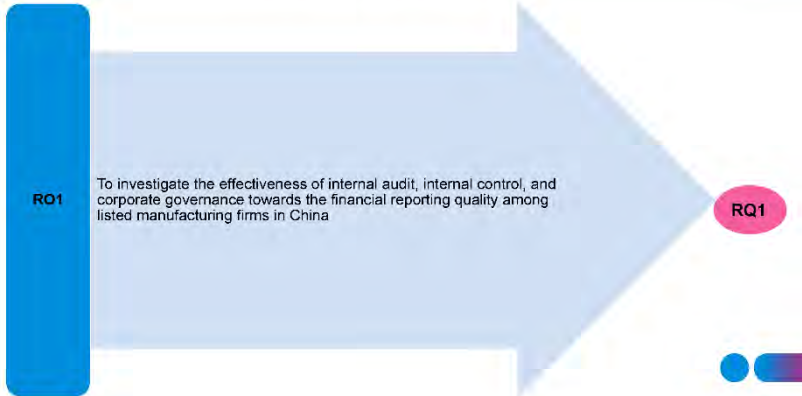


Background of Study (cont..)

Relevant issues: What factors affect financial reporting quality?	
Internal Line of Defence	<ul style="list-style-type: none"> • <i>Internal audit</i> • <i>Internal control</i> • <i>Corporate Governance</i>



Research Objective



Research Findings

Table 4. Results of Binary Logistic Regression analysis

Variable	B	S.E.	Z value	Wald χ^2	Prob.	Exp(B)	95% CI for Exp(B)
IA	0.384	0.125	3.078	9.474	0.002	1.469	1.150 – 1.874
IC	5.182	0.545	8.492	89.339	0.000	174.426	59.883 – 508.061
CG	0.026	0.012	2.125	4.517	0.034	1.027	1.002 – 1.052
Lev	-0.019	0.006	-2.271	5.195	0.023	0.981	0.965 – 0.997
ROA	0.013	0.011	1.138	1.29	0.259	1.013	0.991 – 1.036
Growth	-0.005	0.003	-1.549	2.399	0.121	0.995	0.986 – 1.004
Size	-0.143	0.182	-0.784	0.616	0.433	0.867	0.606 – 1.239
Constant	-2.248	8.17	-1.025	1.05	0.308	0.059	0.006 – 19.396

Dependent variable: Financial Reporting Quality

McFadden R-squared: 0.486
 Cox & Snell R-squared: 0.332
 Nagelkerke R-squared: 0.604

Conclusions



- Based on Agency theory this paper aims to investigate the effectiveness of internal audit, internal control, and corporate governance towards the financial reporting quality among listed manufacturing firms in China.
- This empirical study shows that **Internal Audit, Internal Control Effectiveness and Corporate Governance** positively affect the Quality of Financial Reporting.
- The disclosure system of internal audit, the subordination mode of internal audit, the size of internal audit department, effective internal control, and the improvement of corporate governance are related to the level of higher financial report quality.



Research Limitations

- Methodological limitations – Data were manually collated from CSMAR Database, WIND Database and the information disclosed by Shanghai Stock Exchange, which is difficult to obtain.
- Some variables might **need to be observed in the long run observation.**



Recommendations for Future Study

- Future studies:
 - Sample size should be expanded, the time span should be increased.
 - Future research can use factor analysis method to determine the most representative alternative indicators to measure internal audit according to the weight.

