

Outsourced Internal Auditing and Financial Statements Creditability: A Review

การตรวจสอบภายในโดยผู้ให้บริการภายนอกและความน่าเชื่อถือของงบการเงิน: ทบทวนวรรณกรรม

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Abstract

This academic article aims to review the past studies about the firm's rationale and determinants of outsourced internal auditing function (IAF) and factors that indiscriminate the external auditor's independence and objectivity which advocate the financial statements' creditability among in-house developed or outsourced IAF. Initially, IAF is non-value added activity which a firm tends to transfer to outsourced entity like external auditors for cost saving. Some argue that IAF performed by its external auditors is skeptical to auditor's objectivity and independence but there are some studies to present that IAF either in-house or outsourced still promotes the external auditor independence and objectivity. Specifically, the firm's financial statements with higher inherent risk will be more creditable if they hire experienced outsourced IAF.

Keywords: Internal Auditing Function, Outsourced Internal Auditing Function, Financial Statements Creditability

บทคัดย่อ

บทความนี้เป็นบทความวิชาการเรียบเรียงจากงานวิจัยในอดีต มีวัตถุประสงค์เพื่ออธิบายเหตุผลและตัวบ่งชี้การจัดให้มีการตรวจสอบภายในโดยผู้ให้บริการภายนอก รวมไปถึงปัจจัยที่ส่งผลให้การตรวจสอบภายในโดยหน่วยงานภายนอก หรือการว่าจ้างบุคคลภายนอกที่จะทำให้ความเป็นอิสระและความเที่ยงธรรมโดยผู้สอบบัญชีไม่แตกต่างกัน แต่เดิมการตรวจสอบภายในโดยผู้ให้บริการภายนอกเพื่อ

ให้บริการ เช่น ผู้สอบบัญชี ด้วยเหตุผลเพื่อลดค่าใช้จ่าย ซึ่งมีผู้แบ่งว่า การถ่ายโอนงานดังกล่าวไปให้ผู้สอบบัญชีอาจส่งผลต่อความเป็นอิสระและความเที่ยงธรรมของผู้สอบบัญชีได้ แต่จากการวิจัยในอดีตกลับพบว่า การตรวจสอบภายในที่ปฏิบัติโดยหน่วยงานภายในหรือการว่าจ้างบุคคลภายนอก กลับไม่ส่งผลต่อความเป็นอิสระและความเที่ยงธรรมของผู้สอบบัญชีโดยเฉพาะอย่างยิ่งงบการเงินของกิจการที่มีความเสี่ยงสูงจะยิ่งมีความน่าเชื่อถือเพิ่มขึ้นหากการตรวจสอบภายในจัดทำโดยบุคคลภายนอกที่มีประสบการณ์

คำสำคัญ: การตรวจสอบภายใน การตรวจสอบภายในโดยผู้ให้บริการภายนอก ความน่าเชื่อถือของงบการเงิน

Introduction

Nowadays an organization has experienced new challenges for their operations such as sellers can deal with their buyers from any area in the world via online with a fingertip, new products developed with more complicated features just to serve some unique needs for smaller markets or evolved methods to reduce any non-essential costs. Currently, businesses have options for their fundraising either through the channel of borrowing from financial institutions or the issuance of stocks to share the firm's ownership. Nevertheless, to raise funds from the public, those people need to have trust in that business as well. The essence to strengthen trust for the money owner is the credibility of the investee's financial statements. There are many mechanisms for promoting the financial statement creditability but one of them is the effective internal control system.

The internal auditing function (henceforth IAF) is one of the instruments in the internal control system to detect irregularities in timely manner, as well as the quality of the external auditing performed by a highly independent auditor. Porter (2011) regarded IAF as a supporting activity in the value chain analysis framework similar to procurement, technology development, human resource management, and firm Infrastructure. Indeed, the functions of these supporting activities assist the primary activities in delivering value from producer to the customer's hand, although they are not income-generating activities. Therefore, they are classified as non-value added activities which many

businesses do not hesitate to transfer these non-value creating functions to outside people who are outperformed or specialized in these services at a lower cost instead of performing by themselves. Hence, it leads to the question of whether the goals of the enterprise will still be achieved as ever, if we transfer these activities to be performed by an outsourced entity. Will the financial statements still be reliable or not?

This paper contributes to the related literature in two ways. Firstly, this article is the first article that collects a series of historical studies which focus on the effectiveness of IAF and the reliability of financial statements. It also illustrates factors that contribute to the effectiveness of IAF. Secondly, this article synthesizes the past studies related to outsourced internal auditing. It analyzes outsourced IAF both in the dimension of the determinants of outsourced or in-house decision criteria and also the following consequences if the entity chooses either outsource or in-house.

The remainder of this paper proceeds as follows. The next section presents IAF initiation and its functions including the role of IAF in business environment today. Section 3 discusses the financial statement creditability. Section 4 discusses why some firms outsource this function. Section 5 discusses the relationship between auditor independence and financial statement creditability. Section 6 speculates on potential direction for the future research and conclusion in section 7 respectively.

IAF Initiations and its role today

IAF was originated after the European accounting system and auditing was introduced into the United States in the 18th century. When the trade and commercial system grew up with the bigger scale of business entities, the internal assurance instruments were needed to assure the accuracy of financial information provided to management and the efficiency of work performed by employees. In the first stage of its introduction, IAF was responsible for keeping tracks of business functions or activities and reporting some facts about operations to management when they are doubted. After The Institute of Internal Auditors (IIA) was established, the scope of IAF was altered to cover in financial area but in the role of external auditor's assistant such as reviewing financial statement or performing financial related tasks like bank reconciliation (Ramamoorti, 2003). To establish the good governance and maintain the adequacy of internal control system, corporates are required to initiate IAF, e.g. the Stock Exchange Commission in U.S.A. promulgated rules in 2002 and the Stock Exchange of Thailand stated the responsibilities of audit committee in initiating the internal control and IAF in the listed company in 2005.

IAF as an instrument of good governance

Good governance means a relationship in supervision and the mechanism to regulate people in the organization in making decisions which include: (1) determining objectives and main goals; (2) formulating strategies, policies, and approving plans and budgets; and (3) monitoring, evaluating and overseeing reporting of results. Corporate Governance creates value for sustainable business as well as the confidence of investors. The board should determine governance procedures for the following outcomes: (1) Competitiveness and performance with a long term perspective; (2) Ethical and responsible business; (3) Good corporate citizenship; and (4) Corporate resilience (Stock

Exchange of Thailand, 2017). The principles of promoting good corporate governance consists of 3 components:

(1) Internal control system: The internal control, according to 1992 COSO (Committee of Sponsoring Organizations of the Treadway Commission) framework, could be defined as:

“A process effected by an entity’s board of directors, management, and other personnel, designed to provide a reasonable assurance regarding the achievement of objectives relating to: (1) operation efficiencies and effectiveness; (2) reliability of the reporting system; (3) compliance with laws and current regulations. (Committee of Sponsoring Organizations of the Treadway Commission [COSO], 1992)”

COSO 1992 Framework stated that there are five elements of the control system: (1) Control environment; (2) Risk Assessment; (3) Control Activities; (4) Information and Communication; and (5) Monitoring Activities. Notwithstanding, COSO just released the most recent 2013 Framework which still keeps these five elements as the key constituents of the firm's control system (COSO, 2013). In addition to 1992 Framework, the new modified 2013 framework explicates more directions and explanations of each element above to be more consistent with the changing business environment such as the control environment. Management is required to demonstrate commitment to integrity and ethical value, exercise oversight responsibility, demonstrate commitment to competence, and enforce accountability (Provasi & Riva, 2015).

Udeh (2020) found that timely 2013 framework adopters exhibited fewer instances of auditor-reported material weaknesses in comparison to late-adopters and because of the strength of internal control components in the 2013 framework, the timely adopters represent a marginal increase in the number of auditor-reported material weaknesses in the post-2013 framework period.

(2) Enterprise Risk Management (ERM): Risk management is the formulation of guidelines and processes to identify, assess, manage and monitor risks related to the activities, entities, or operations of the organization, including determining the methods of managing and controlling risks to an acceptable level of management. ERM can be considered in two dimensions:

2.1) Elimination or reduction of factors that prevent the organization from achieving its objectives. This would protect the value that the organization has from being compromised.

2.2) Looking for opportunities to create advantages in business, which is to create value for the organization. Risk management is similar to the implementation of internal controls in that it is identified, assessed, and provided a means to manage risks, but the process of risk management concerned many external uncertainties which a firm would be assigned a broader perspective on risk management. By looking at the risks resulting from external factors, and also the opportunities for the business from the uncertainties that may arise, and it is the responsibility of the executives of the entity to take care.

From the past studies, it was found that risk management and internal auditing have a low level of correlation. Indeed, both activities are imperative to businesses. This may be because both activities require a high degree of independence and are free from the influence of all firm's stakeholders. Both activities wanted to build trust in risk assessment for ERM activities and independence in assessing the adequacy of the internal control for IAF. Nevertheless, both activities contribute to the improvement of the quality of the financial statements of the entity (Saleem, Zraqat, & Okour, 2019; Wadesango & Mhaka, 2017).

(3) Internal Auditing (IAF): Internal audits play a role in ensuring that appropriate internal controls are appropriate and those controls are implemented within the organization as well as having an appropriate risk management system to protect against the abuse of the power. From the fact that the entity has provided an internal control system to monitor their firm's risk, internal auditors would be the people with the responsibility to detect any activities that function against the internal control system as established for the owner and shareholder to have confidence in firm operation.

Expanded scope of IAF

The Institute of Internal Auditors (IIA) defined the new scope of IAF in professional practices framework as:

“the independent objective assurance and consulting activities perform to support the value creation and improve organization’s operation and also promote organization to improve its effectiveness in risk management, operation control and governance process.”

In the new revised definition, some IAF characteristics were revolutionary changed. IAF can be performed by outside entity, but the quality of outsourced IAF is still needed to be obtained. New role of IAF is customer-focused actions which provided assurance and consulting activities. IAF's purpose explicitly concerns value creation, operation improvement and support in achievement of the organization's overall objectives (Ramamoorti, 2003).

Subsequently, IAF expanded its scope into both financial and operating areas with more depth and detailed tasks during the 20th century evolution. IAF objectives include to evaluate the adequacy in internal control and reliability of financial reports, to ascertain the compliance of project or plan as intended, to safeguard the company's assets from misuse or fraud, and also to appraise the quality of

task performed by employees (Moeller, 2005; Omolaye & Jacob, 2017). IAF plays a crucial role in governance process. Management usually uses IAF as the means to ensure that (a) risks are effectively monitored and measured, (b) organizational operations are under control and effectively and efficiently processed (Joksimović & Alseddig, 2017; Vadasi, Bekiaris, & Andrikopoulos, 2019).

IAF is part of the corporate governance process. It is responsible for evaluating the effectiveness and efficiency of the internal control system. Since the objectives of the internal control system have expanded the scope of governance in order to supervise both financial reporting dimension and operation dimension, therefore, IAF is needed to develop the process for auditing both in financial reporting and its operations as well.

Financial statement creditability

When we are talking about the credible financial statements, it is undeniable to refer to the qualitative characteristics of financial statements. Fundamental qualitative characteristics are the attributes that make financial information useful to users and distinguish useful financial reporting information from information that is not useful or is misleading (Dennis, 2018).

Fundamental qualitative characteristics consist of

- Relevance - people would change the decision if they acknowledge the incremental information. The information will be valuable if it has predictive value, confirmatory value, or both.
- Faithful representation - The entity's financial information must be presented accurately, and objectively and to be the representative of the firm's economic phenomena without prejudice. To be a faithful representation, information must be complete (all information necessary for a user to understand, including descriptions and explanations),

neutral (no bias, information must not be manipulated in any way and therefore supported by the exercise of prudence), and free from error.

Many aspects contribute to the reliability of the financial statements. Internal supporters could come from the audit committee's attribute (such as audit committee financial expertise (Gerayli, Pitenoei, & Abdollahi, 2021; Kusnadi, Leong, Suwardy, & Wang, 2016), audit committee independence (De Vlaminck, & Sarens, 2015)), the board of directors' attribute (such as board size, board independence and CEO duality (Phuong, & Hung, 2020), the proportions of the non-executive directors as well as the independence of non-executive directors (Ibrahim & Jehu, 2018)). Moreover, the external side comes from the external auditor (auditor industry specialization, and audit tenure mediating effect with audit quality (Qawqzeh, Endut, Rashid, & Dakhlallh, 2020).

IAF also plays a crucial role in promoting the creditability of financial statements. IAF which could detect fraud and sign to the stakeholders need to have some notably constituents. Turetken, Jethefer, and Ozkan (2020) reviewed 3,097 publications from 37 journals published between the year 2000 and March 2019. They found that the factors that influenced IAF effectiveness can be categorized in two sides: supply side and demand side. (Table 1)

Normally, IAF mainly assists in supporting the credibility of the financial statements (Kewo, & Afah, 2017; Tambingon, Yadiati, & Kewo, 2018), but there are also some evidences indicating that the effectiveness of internal controls can reduce the level of earnings management (Ghaleb, Kamardin, & Al-Qadasi, 2020) while the number of meetings between audit committee and IAF will reduce the discretionary accrual (Alzoubi, 2019).

Qualitative characteristics of financial statements are the attributes that make financial information useful to users. IAF is one of the essential

mechanisms in promoting the financial statements creditability. In order to strengthen IAF to be more efficient and effective, the firm has to emphasize all factors that encourage the IAF effectiveness both in supply side such as IAF independence, IAF competence, etc. and demand side such as the management support, the cooperation with audit committee, etc.

Why firm outsourced IAF?

Obviously, it would imply that outsourced IAF can save the cost of IAF investment. Previously, the scope of IAF and external auditor's work are separately independent. External auditor performs financial reporting verification and internal control assessment whilst the IAF involved mainly in operating and compliance audit.

Table 1 Factors influence IAF effectiveness

Factors on	Factors Influence to IAF effectiveness
Supply side	Competence of the internal audit department / Size of internal audit department/ Organizational setting / Scope limitation / Compliance with applicable standards / Management training ground / Auditee attributes / Internal audit independence / Internal audit objectivity / Conduct risk consulting / Outsourcing internal audit / Quality of audit work / Chief audit executive's leadership style
Demand side	Management support for internal audit / Interaction between internal and external audit / Cooperation with the audit committee / Information and communication / Existence of a follow-up process / Supportive control environment / Cultural dimensions

Source: Turetken et al. (2020)

Since the late of 1980s, IAF was passed to its client's external audit firm when external auditor offers "IAF service" with highly attractive incentive such as lower cost of IAF service fee or some specialized audit packages. In management's views, they are usually confused between the role of IAF and external audit. Some may think that IAF overlapped function to external auditor's role. Therefore, when external audit offered this service, the management team scarcely denied this offer. IIA surveyed the reason why management outsourced IAF. It showed cost saving as the main reason with some additional comments that may irritate the IAF professionalism like "to clean up incompetent people by looking for more competent outside" (Caplan, Janvrin, & Kurtenbach, 2007; Moeller, 2005).

Rationale of outsourced IAF decision

Widener and Selto (1999) employed Transaction Cost Economics (TCE) by Williamson (1979) to explain the criteria which the firm will use to decide whether IAF would be outsourced or developed in-house. TCE supposed that the firm would compare the cost of processing one transaction between internalized (made) or market-mediated (buy) because it would seek to minimize their operational costs. There are four attributes of criteria to regard cost of transaction whether IAF should be processed within or outside the firm: asset specificity, environmental uncertainty, behavioral uncertainty, and frequency. They found that firms with higher (lower) asset specificity, environmental uncertainty, behavioral uncertainty and frequency tend to internalize (outsource) IAF. Spek, van Elten, and Kruis (2007)'s findings in

Netherland still supported Widener and Selto (1999) including its interaction in explaining sources of IAF decision.

Some studies employed resource based management to explicate the outsourced IAF decision (Carey, Subramaniam, & Ching, 2006; Van Peursem, & Jiang, 2008). Resource based management is the management idea to support that firms should exploit their expertise and competency fully on their primary core business activities while transferring those non-core businesses to outside people to perform instead. Their findings showed that cost savings, expertise in audit procedure, and the quality of services are the main reasons for outsourced decision.

Since the article of Widener and Selto (1999), there are several studies that have been conducted to describe the determinants and consequences of outsourced IAF decision making. Table 2 illustrates some key findings of these recent papers.

Some management theories are employed to describe the phenomena of hiring outsourced entity

to perform some tasks that were regarded as non-value creating activities. Most of the theory concentrates on the usage of limited resources of the entity. Therefore, if the required activity does not generate value even though it is essential and simultaneously, there is an external unit willing to perform such work instead, and the entity tends to transfer those jobs to third parties. Except for some activities that require resources that only the entity possesses, there is an uncertainty in terms of environment or behavior, then the transfer to third parties is not possible. The firm has to perform such activity on its own.

Auditor independence and financial statement creditability

Role of IAF today is viewed as the supporting part of external audit by providing facts of client's business to external auditors. External auditors utilize the IAF's findings in shortening their audit plan and use IAF findings as evidence in deciding their types of auditor's report.

Table 2 Outsourced IAF determinants and consequences

Outsourced IAF	Attribute	Key findings	Reference
Determinant Study	Firm characteristics	Board expertise, Audit committee independence and CEO with accounting expertise are positively associated with outsourced IAF.	Baatwah and Al-Qadasi (2020)
	Audit committee characteristics	Existence of an audit committee, number of audit committee meetings held, number of audit committee meetings the CAE being invited to attend, and percentage of audit committee meetings the CAE attended are significant and positively associated with a decision to outsource some of its internal audit activities.	Scarlata, Garven, Vagner, and Bahmanziani (2019)
	Firm's financial health	These results suggest that small organizations in poor financial health may select to cut back their spending on various assurance activities, including moneys spent on internal audit outsourcing activities.	

Table 2 Outsourced IAF determinants and consequences. (Continue)

Outsourced IAF	Attribute	Key Findings	Reference
Consequence Study	Audit efficiency	Firm-specific expertise outsourced IAF providers are associated with a greater reduction in audit report lag and audit fees.	Baatwah, Omer, and Aljaaidi (2021)
	External auditor independence	The separation of staff between those who perform outsourced internal audit functions and those that perform attests functions promote the independence of the external auditor.	Enyinna (2020)
	Audit fee	An auditor who provides non-audit service to a client and thus earns additional overall revenue is willing to accept lower audit fees. Provided high audit quality can be achieved through reliance on outsourced IAFs.	Abdul Wahab, Gist, Gul, and Mat Zain (2021)

Thailand's auditing standard number 610 (Using the Work of Internal Auditors) suggests external auditors to use IAF's tasks such as working papers or some facts in IAF report to refer as the auditor's evidence which can lighten their workloads. However, external auditors have to evaluate the objectivity and independence of IAF in the organization, the qualification and experience of internal auditor team member, as well as the IAF audit plan and IAF quality control before they rely on internal auditors' findings (Accounting Profession Committee in Auditing, 2013).

Statements of Auditing Standards no 65 advises that to rely on an internal auditor's report, external auditors have to assess IAF's objectivity and oversee status and the internal auditor's competence. The willingness to the utilization of IAF's done work has a great impact on audit fee and/or reduce the amount of retesting evidence. Nevertheless, the Sarbanes Oxley Act of 2002 explicitly prohibited the external auditor from providing IAF services to their clients in order to protect the auditor's independence and objectivity.

Nowadays, companies have several options in determining the source of their internal audit activities. The source of internal audit could be either

in-house developed, one hundred percent outsourced, or even partially outsourced which is called co-source. Barr-Pulliam (2016) presented some key findings from CBOK 2015 Global Internal Audit Practitioner survey (The Global internal audit common body of knowledge). This survey was conducted around the world to explore the level of outsourcing activities to be used in IAF. By a global average, thirty-eight percent of Chief Audit Executives (CAE) used the third party in IAF while twenty-three percent of magnitude of tasks in IAF were performed by outsourced entities. Third-party services are generally used in providing special skills which are not available in the internal audit department, solving staff inadequacy, supplementing staff on an ongoing basis, covering remote business locations, and performing some special projects. Although the IAF is performed by third parties even its external auditor, external auditor independence would not have deteriorated if some factors that advocate its independence still are employed.

(1) *Staff separation*: Enyinna (2020) found the separation of staff between those who perform external audit functions and those that perform outsourced IAF for the client. The study found a

significant positive relationship between separation of staff of an audit firm and the independence of the external auditor.

(2) *Big-4 firm providing outsourced IAF service:* some studies provide the evidence to support that Big-4 audit firm is the professional accounting firm with high experiences in accounting and auditing related services. Even though the non-audit service like outsourced IAF is the supplement service for their clients, they had to maintain the quality standard of their long-standing reputation (Abdul Wahab et al., 2021; Baatwah, & Al-Qadasi, 2020).

(3) *Client's higher inherent risk:* outsourced IAF service by its external auditor would improve the financial reporting quality because knowledge and understanding of clients' businesses would be spilled over and deeper (Glover, Prawitt, & Wood, 2008; Prawitt, Sharp, & Wood, 2012).

The auditing standard encourages the external auditor to lessen their workload by utilizing the IAF report as the means to support its audit plan, including some evidence that IAF perform would be used as their audit evidence as well. However, there may be some who argue the auditor's independence and objectivity if an external auditor also provides IAF service to its customers. Some studies illustrate the factor that still promotes auditor independence although its auditor provides IAF service for the clients.

Future research opportunity

Outsourced IAF is another method of saving costs of supporting functions because the company does not want to hold the cost of permanent staff. Further studies may be conducted to compare the cost of IAF between establishing internally and hiring outside. Conversely, we can study panel design by comparing before and after outsourced to confirm whether outsourced IAF could truly save a firm's cost.

The audit committee is responsible for monitoring and directing IAF functions and audit plans directly. They take a closer look at controlling the quality of IAF because IAF is under the control of the audit committee. Therefore, the audit committee has to keep watching and revising an audit plan all the time. Conversely, IAF from the outside would be more difficult to control its quality. It, therefore, leads to the question of how the audit committee can monitor and measure outsourced IAF quality and whether the outsourced IAF will be performed as well as internally established IAF. There is still no literature paved on this way to examine the quality of outsourced IAF to ensure that outsourced and In-house have the identical standard. Also, some pieces of evidence advocate that IAF quality would enhance the financial reporting quality but there are few studies to confirm the indifference of financial report quality between in-house and outsourced.

Conclusion

In the intense world of competition, the company needs to find a way to survive. One of the most popular solutions is cutting costs and saving more money. Cost of non-value added activities is the first priority to concentrate on making a decision "to make or to buy." Nowadays, the business has choices to outsource or transfer the non-essential task to outside people. IAF is more likely to be outsourced to a more experienced entity like their external auditors because IAF internally developed unit is the permanent costs for the company. Moreover, external auditors who provided outsourced IAF have expertise in new audit methods and techniques which may be helpful in detecting fraud or error in financial statements more quickly. Specialists in auditing and accounting business have to take care of their own clients; therefore, they have experience from consulting other businesses too. However, some argued that in the case IAF is

performed outside, how audit committee can monitor the quality of IAF and how we ensure that the quality of outsourced IAF possesses equivalent standards to the internally established.

Outsourced IAF may be another interesting area of corporate governance study because IAF is one of the functions to ensure the creditability and

reliability of financial reports. Though some firms select to cut their cost by transferring some activities to the outsourced like IAF, it is still wondering how we can ensure the “adverse selection” problem that would not exist if we outsourced IAF. This would be another area that new researchers should not overlook and study further interestingly. ♦

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