THE IMPACT OF THE INTERNAL AUDIT FUNCTION ON EARNINGS MANAGEMENT BEHAVIOR IN VIETNAM

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Abstract: ***Internal audit plays a crucial role within organizations and businesses by enhancing the effectiveness and efficiency of corporate governance systems, including earnings management. However, due to the inherent divergence in objectives and benefits between managers and owners, financial information is often subject to manipulation by management to maximize company value for personal gain. This study is conducted in the context following the issuance of Government Decree No. 05/2019/ND-CP on Internal Audit (IA) on January 22, 2019. Consequently, the article employs a combination of quantitative and qualitative research methods to examine the impact of the internal audit function on earnings management behavior within enterprises, and to assess the extent to which various factors influence this relationship. The findings indicate that four key internal audit factors significantly affect earnings management behavior. Based on these results, several recommendations are proposed to improve the effectiveness of the internal audit function in influencing earnings management behavior in the current context of Vietnam.***

• Keywords: *behavior, function, internal audit, earnings management.*

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1. Introduction

According to the corporate governance model proposed by the Institute of Internal Auditors (IIA), the internal audit function stands as one of the four cornerstones of effective corporate governance, alongside the audit committee, the board of directors, and external audit (IIA, 2024). Among these, internal audit (IA) is regarded as a foundational element due to its capacity for regular monitoring, assessment, and advisory services concerning internal governance. This function is considered pivotal in ensuring highly effective control and preventing earnings management practices by company management.

Driven by legal mandates in various countries requiring listed companies on stock exchanges to establish an IA function, the topic of internal audit has garnered increased attention from researchers globally. While numerous studies have explored factors influencing earnings management (EM) behavior, research specifically focusing on the impact of internal audit on EM remains limited.

Furthermore, the Vietnamese government recently issued Decree No. 05/2019/ND-CP, which mandates the establishment of an IAF in various enterprise types, including state-owned enterprises and listed joint-stock companies. This decree introduces more comprehensive regulations than previous mandates, underscoring the growing importance of the IA function and audit standards.

This study aims to clarify the impact of the IA function on earnings management behavior in Vietnam. Based on the findings, it will propose recommendations to enhance the role of the IA function, thereby enabling organizations and businesses to achieve their objectives

2. Literature review

In Vietnam, currently, the establishment of an internal audit function (IAF) is relatively uncommon among companies, despite widespread recognition of its importance and necessity. However, due to limited resources, many companies perceive the IAF as potentially creating a cumbersome and costly management apparatus. Consequently, as the IAF is still relatively new in Vietnam, most local studies have focused on exploring organizational structures and improvements for IA.

Conversely, the majority of empirical research findings from other countries consistently indicate that the IAF influences earnings management behavior (EMB). For instance, a study by Tang.T.T.T (2019) investigated the impact of factors measuring internal audit quality on earnings management behavior through accounting policy choices and the manipulation of economic transactions in listed Vietnamese companies. This study utilized a sample of 92 companies listed on HOSE and HNX from 2014 to 2018.

Prawitt et al. (2009) examined the influence of the internal audit function on earnings management behavior. EM behavior was measured using

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discretionary accruals and the pressure to meet or exceed analyst forecasts in listed U.S. companies. The authors analyzed 528 financial statements from 218 enterprises to assess EM behavior via discretionary accruals, and 571 financial statements from 244 enterprises to analyze EM behavior through the pressure to meet or exceed analyst earnings forecasts. To measure the IA function, the authors utilized six factors guided by Statement on Auditing Standards (SAS) No. 65 for external auditors' assessment of IA. The research model consequently incorporated variables such as: professional competence (measured by average internal auditor experience, proportion of internal auditors with professional certifications, and annual training hours); independence and objectivity (measured by the reporting recipient of the Chief Audit Executive); internal audit work (measured by the total time internal audit spent on financial statement review); and the level of investment in internal audit relative to the industry.

Regarding the level of investment in internal audit, Prawitt et al. (2009) contextualized this factor by comparing the company's investment with the industry average. "The company's average data was determined by the ratio of the internal audit function's budget to the company's total assets. The industry's data was determined by the ratio of the internal audit function's budget to the industry's average total assets. This was then calculated by dividing the difference between the company's and industry's data by the ratio of internal audit's activity and the industry's average total assets" (Prawitt et al. 2009). The study's findings revealed an inverse relationship between the composite variable for internal audit quality and earnings management behavior.

Ege (2015) investigated whether a high-quality internal audit function could prevent managerial misconduct. The author utilized the IIA database to select public companies during the period from 2004 to 2009. From a sample of 1,398 financial statements from 617 companies, the author designed a model comprising factors measuring internal audit quality, including: experience, professional qualifications, annual training hours, internal audit being a training ground for future managers, professional reporting relationships with the Audit Committee, and the level of investment in internal audit.

Amuchirai (2018) conducted a study to determine the impact of internal audit function effectiveness on the management operations of non-governmental organizations (NGOs) directly in Zimbabwe. Using a mixed-methods approach combining qualitative and quantitative research, the study utilized primary and secondary data (a survey questionnaire administered to 27 respondents) selected via stratified sampling in 2018. The research results indicated that independence and objectivity, professional competence, and management support for the IAF positively influenced the effectiveness of the IAF

Thus, to date, numerous studies worldwide have explored factors measuring the IAF. The findings consistently show that professional competence, independence, and objectivity are key measures of the IAF. The majority of these studies affirm that the IAF has an inverse effect on EM behavior.

3. Research methodology and hypotheses

3.1. Research methodology

This study employs a combination of research methods, including literature review, expert interviews, and empirical testing. After data collection, it will be processed using SPSS 22 software. For the quantitative research data, the sample comprises listed companies (excluding financial institutions) on the Hanoi Stock Exchange, possessing complete financial statements and annual reports for the period 2023-2024. This resulted in an initial total of 342 companies, which was then cleaned to yield 297 observations meeting the requirements.

3.2. Official research model and research hypotheses

The hypotheses will be tested using a multiple regression model, with earnings management behavior as the dependent variable and the IAF as the independent variable.

Based on the theoretical foundations combined with the specific characteristics of the Vietnamese stock market, following factors to measure the independent variables of IAF are proposed: (1) professional competence, measured by the experience, professional certifications, and annual training of internal auditors; (2) independence and objectivity, measured by whether the head of the internal audit department reports directly to the Board of Directors/Supervisory Board; (3) IAF size, measured by the number of staff within the internal audit department; and (4) IAF quality control, measured by the establishment of an IA function evaluation and control program. The official research model is presented below:

Additionally, five control variables are: Accounting and Auditing Expertise of the Supervisory Board, Independent Board of Directors Members, CEO Concurrently Serving as Chairman of the Board, CEO Also Being a Founding Member, and Financial Leverage. Four hypotheses are formulated:

Hypothesis H1: The professional competence of the IAF has a negative impact on earnings management behavior.

Hypothesis H2: The independence and objectivity of the IAF has a negative impact on earnings management behavior.

Hypothesis H3: The size of the IAF has a negative impact on earnings management behavior.

Hypothesis H4: The quality control of the IAF has a negative impact on earnings management behavior.

To test these research hypotheses and measure the influence between the IAF and EM behavior, the following regression model will be used:

$$EM = \beta 0 + \beta 1 \times COMP + \beta 2 \times INDEPT + \beta 3 \times IAFSize + \beta 4 \times QuPRO + \beta j \times CONTROLj + \epsilon$$

Where:

EM: Earnings Management, representing earnings management behavior.

COMP: Represents the professional competence of the internal audit function.

INDEPT: Represents the independence and objectivity of the internal audit function.

IAFSize: Represents the size of the internal audit function.

QuPRO: Represents the quality control of the internal audit function.

CONTROLj: Represents the control variables, including: ACEXP (accounting and auditing expertise of the Supervisory Board), BPIND (independent Board of Directors members), CEOCHAIR (CEO concurrently serving as Chairman of the Board), CEOFOUND (CEO also being a founding member), LEV (financial leverage).

β: Coefficients of the regression model.

ϵ: Residual term, representing the error in the model.

4. Research results and discussion

4.1. Descriptive Statistics

Table 4.1: Descriptive Statistics

Variable Symbol	Number of Observations (N)	Minimum Value	Maximum Value	Mean Value	Standard Deviation
EM	297	0,000	1,000	0,132	
COMP	297	0,000	3,000	2,520	0,159
EXP	297	1,000	11,000	5,700	1,861
CERT	297	0,000	0,857	0,515	0,141
TRAINING	297	0,000	12,000	5,030	2,369
INDEPT	297	0,000	1,000	0,700	0,460
IAFSize	297	2,000	30,000	5,576	3,321
QuPRO	297	2,000	30,000	5,576	3,321
ACEXP	297	0,000	1,000	0,502	0,300
BPIND	297	0,000	1,000	0,100	0,155
CEOCHAIR	297	0,000	1,000	0,207	0,405
CEOFOUD	297	0,000	11,000	0,179	0,669
LEV	297	0,000	7,790	2,355	1,390

4.2. Pearson Correlation Analysis

This analytical step examines the correlation between the independent and dependent variables through Pearson correlation analysis. The results indicate that the independent variables, including Professional Competence (COMP), Independence and Objectivity (INDEPT), IA Function Size (IAFSize), and the control variables, namely Accounting and Auditing Expertise of the Supervisory Board (ACEXP), Independent Board of Directors Members (BPIND), CEO Concurrently Serving as Chairman of the Board (CEOCHAIR), and CEO Also Being a Founding Member (CEOFOUND), all exhibit a significance level (Sig.) of <0.05. This demonstrates that these factors are statistically significant, implying their suitability for inclusion in the research model.

However, the Financial Leverage (LEV) factor shows a significance level (Sig.) of >0.1, indicating that this factor is not statistically significant and will therefore be excluded from the regression analysis. Furthermore, the absolute correlation coefficients among all variables range from 0.061 to 0.502, which is less than or equal to 0.8. This suggests that discriminant validity has been achieved, meaning these scales effectively measure distinct research constructs.

4.3. Multivariate Linear Regression Analysis

To test the research hypotheses, multivariate regression analysis was performed. The results presented in Table 4.2 show an adjusted R-squared of 0.442, indicating that 44.2% of the variation in the dependent variable is explained by the independent variables. The Durbin-Watson (d) statistic is 1.580 (<3), which confirms that the model does not suffer from autocorrelation of residuals.

Table 4.2: Model Summary

Model	R-squared	Adjusted R-squared	Coefficient of determination R2 correction	Error of the Estimate	Durbin-Watson
EM	0,664[a]	0,442	0,431	0,1199	1,580

Note: Explanatory variables: CEOFOUD, IAFSize, QuPRO, BPIND, INDEPT, ACEXP, CEOCHAIR, COMP; Dependent variable: EM

Table 4.3 below presents an F-statistic of 40.658 with a significance level (Sig.) of 0.000. This indicates that the constructed regression model is a good fit for the collected data, and all variables included in the research model are statistically significant at a 5% significance level, meaning the independent variables in the model have a relationship with the dependent variable.

Table 4.3: ANOVA analysis of variance - Reliability of the research model

Model	Sum of Squared Deviations	Degrees of Freedom	Variance	F-Test	Significance Level
Pegression	4,090	7	0,584	40,658	0,000[b]
Residual	5,173	360	0,014		
Sum	9,263	367			

Note: Explanatory variables: CEOFOUD, IAFSize, QuPRO, BPIND, INDEPT, ACEXP, CEOCHAIR, COMP; Dependent variable: EM

The results of the multivariate regression analysis (Table 4.4, which is not provided but inferred from the text) indicate that the Professional Competence of the Internal Audit Function (measured by experience, professional certifications, and training hours), the Independence and Objectivity of the Internal Audit Function (measured by direct reporting to the Board of Directors or Supervisory Board), and the Size of the Internal Audit Function (measured by the number of internal auditors) all have a negative impact on earnings management behavior, with a significance level (Sig.) of <0.05. These findings demonstrate that professional competence, independence and objectivity, the size of the internal audit function, and internal audit quality control are four key factors measuring the quality of internal audit operations, and they contribute to mitigating earnings management behavior.

4.4. Multivariate linear regression analysis results

Table 4.4. Results of multivariate regression analysis[a]

Variable	Unstandardized coefficient		Normalization coefficient	t- Value	Significance level	Collinearity test	
	Regression weight B	Standard deviation				Acceptability of the variable	VIF
(Constant)	0,347	0,022		15,842	0,000		
COMP	-0,049	0,008	-0,257	-5,928	0,000	0,827	1,209
INDEPT	-0,119	0,015	-0,346	-7,963	0,000	0,823	1,215
IAFSIZE	-0,004	0,002	-0,086	-2,082	0,038	0,909	1,101
QuPRO	-0,112	0,014	-0,324	-7.786	0,011	0,802	1,201
ACEXP	-0,047	0,022	-0,089	-2,130	0,034	0,884	1,131
BPIND	-0,092	0,041	-0,090	-2,236	0,026	0,962	1,040
CEOCHAIR	0,087	0,017	0,221	5,144	0,000	0,842	1,188
CEOFOUD	0,015	0,010	0,064	1,502	0,134	0,866	1,154

Based on the results presented, Hypotheses H1, H2, H3, and H4 are accepted, which aligns with the theoretical framework employed in this study. The findings suggest that due to the conflict of interest between management and owners/stakeholders, managers often engage in earnings management behaviors to achieve personal benefits. A high-quality internal audit department, however, effectively mitigates these behaviors.

Furthermore, the regression analysis indicates that, with the exception of the control variable CEO Also Being a Founding Member (CEOFOUND), which is not statistically significant (p-value > 0.1), all other control variables are statistically significant (p-value < 0.05 or p-value < 0.1). Specifically, Accounting and Auditing Expertise of the Supervisory Board (ACEXP), the number of Independent Board of Directors Members (BPIND), and the CEO Concurrently Serving as Chairman of the Board (CEOCHAIR) are found to reduce earnings management behavior.

Regarding collinearity, the Variance Inflation Factor (VIF) values for all independent variables are less than 2, indicating the absence of multicollinearity. This confirms that there is no linear relationship among the variables in this study.

5. Conclusion and Recommendations

5.1. Conclusion

Findings from Section 4 reveal that even within listed companies that have established an IA function as required by regulations, EM behavior persists. This indicates that listed companies need to prioritize enhancing the quality of their internal audit to effectively support control efforts and prevent managers' EM practices. The quantitative analysis, through the proposed regression model, yielded the results presented in the previous section. These results consistently show that the factors measuring the IAF negatively influence EM behavior.

This study was conducted in a period following the effective date of Government Decree No. 05/2019/ND-CP, a period for which no prior research had been undertaken. Drawing upon the comprehensive literature review and the findings of this study, it can be affirmed that the IA function, as measured by professional competence, independence and objectivity, IA function size, and IA function quality control, has a negative impact on EM behaviors. Therefore, improving the quality of the IA function is synonymous with enhancing these specific factors. Consequently, to provide practical support for improving IA quality, the following section of this chapter will propose several recommendations from the perspectives of corporate governance, auditing, and regulatory bodies.

5.2. Recommendations

5.2.1. Independence and objectivity

For the IAF to be effective, thus minimizing earnings management behavior, internal auditors must ensure their independence and objectivity. To guarantee this attribute, IA must have direct, unrestricted access when reporting control results to senior management, the Board of Directors, or the Supervisory Board. However, in some smaller listed joint-stock companies, this department still reports directly to the General Director. To maintain and further enhance the independence and objectivity of the IA department, the following suggestions can be implemented:

- To enhance independence and objectivity, ideally, the IA department should be a separate unit from other functional departments within the company.

- A rational organizational structure is necessary to ensure the independence and objectivity of internal auditors. The IA department should be positioned as high as possible in the organizational hierarchy, preferably reporting directly to the Board of Directors rather than the Board of Management. This structure would ensure internal auditors are free from any interference, human or otherwise, that could compromise their independence and objectivity during audits.

- The appointment, dismissal, and remuneration determination for the IA department must be entirely at the discretion of the Board of Directors. If this is the case, the IA department will be able to maintain objectivity, without any "reservations" regarding managerial misconduct, and will significantly contribute to detecting and preventing earnings management behaviors aimed at personal gain.

5.2.2. Professional Competence

In this study, the professional competence of the IA function is measured by experience, professional certifications, and annual training hours, and it is found to have a negative impact on earnings management behavior.

To enhance the IAF, it is crucial to strengthen professional competence by improving the knowledge, skills, and professional experience in internal audit work. To achieve this, companies need to establish regulations regarding the qualifications and professional capabilities of staff from the recruitment phase and maintain these through continuous training.

According to the guidelines of Decree No. 05/2019, internal auditors must hold a university degree in economics, finance, accounting, or business administration; possess at least 5 years of practical experience in financial management or accounting, with at least 3 years working as an auditor within the assigned company; and have completed training in audit methodology and standards according to the unified program of the Ministry of Finance and obtained a certificate.

In the long term, companies need to develop a specialized and in-depth training program to ensure and maintain IA staffs' professional competence and skills at an optimal level, enabling them to fully complete audit tasks. For internal auditors who already meet the requirements for training and audit experience, companies should still focus on continuous training for these individuals.

In addition to developing the professional competence of the internal audit team, companies also need to establish appropriate compensation policies for internal auditors to attract and retain a highly competent IA team. Reasonable compensation policies will motivate internal auditors to perform their assigned duties effectively. Therefore, beyond salaries, bonus schemes and allowances also need to be clearly structured, commensurate with individual responsibilities, qualifications, and contributions.

5.2.3. Size of the internal audit department

Building a quality IA department not only requires ensuring that internal auditors possess strong professional knowledge and auditing skills but also requires an adequate number of staffs. Therefore, for the IA department to operate with quality, it needs an appropriate size. However, since each company has different characteristics and operational scales, the decision on what constitutes an appropriate IA size must be carefully considered. Depending on the requirements and the complexity of the operational area, this size may increase or decrease to varying degrees.

5.2.4. Internal audit function evaluation and quality control program

In terms of content, the IA function's quality evaluation and control program should be designed to include assessments of compliance with regulations, adherence to professional ethics, and identification of areas and aspects for improvement within the IA department.

In terms of scope, to ensure the quality control of IA, the evaluation program for this activity needs to be established and conducted across all aspects of the IA function, without excluding any phase or being limited to evaluating only individual audits. Therefore, the internal assessment level is considered a crucial level that needs to be carried out first to identify weaknesses within the IA function.

Internal assessment typically includes ongoing monitoring and periodic monitoring. In addition to internal assessment, independent assessment is also considered an integral part of the quality control program, aimed at enhancing the program's effectiveness. Independent assessment is required to be performed at least once every five years by an external expert or an independent competent organization (IIA, 2019)

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