

# The Role of Internal Audit in Improving the Quality of Government Financial Statements: A Literature Based Study Agency Theory

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Internal audit plays a strategic role in ensuring the reliability of government financial statements, which are essential tools for achieving public financial accountability and transparency. This study aims to analyze the role of internal audit in improving the quality of government financial reporting using a literature review approach based on agency theory. The method employed is a systematic literature review of 12 scholarly articles (7 national and 5 international), as well as relevant books and official reports published within the last five years (2019-2024). The findings indicate that an effective and independent internal audit can reduce information asymmetry between the government (agent) and the public (principal), enhance compliance with Government Accounting Standards (SAP), and strengthen internal controls and financial governance. This study concludes that a competent internal audit function is a critical prerequisite for producing reliable, relevant, and accountable financial statements. The findings support agency theory and offer key recommendations for strengthening internal audit practices in the public sector.

*Keywords:* internal audit, financial statement quality, government, agency theory, literature review

## Introduction

Government financial statements are a representation of public accountability that shows how well the government manages the financial resources entrusted to it by the public. This report is one of the most important foundations in assessing financial performance by the public and supervisory institutions such as the DPR/DPRD (Mardiasmo, 2020). In its preparation, government financial statements must be able to meet good accounting principles, and be subject to Government Accounting Standards (SAP). The quality of financial statements is assessed from the aspects of relevance, reliability, reliability, and comparability (BPKP, 2022). One of the important instruments in ensuring the quality of government financial statements is internal audit. Internal audits help ensure that the financial statements produced are in accordance with standards and free of any of the materials to be presented (Dachi et al., 2020).

According to Arens et al. (2019) explained that an effective internal audit is able to detect errors, fraud and provide recommendations for improvement that have a direct impact on improving the quality of financial

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information. Internal audit also serves to test the effectiveness of the internal control system, which is an important requirement when presenting financial statements that are good or in accordance with standards. A good internal control system can be a strategy to minimize the risk of errors and data manipulation (Moeller, 2020). In the context of the public sector, the role of internal audit becomes more complex because it concerns accountability to the public, not only to capital owners such as in the private sector. Therefore, the professionalism, independence, and competence of internal auditors must be maintained.

Agency theory is used to explain the importance of internal audit in preventing information asymmetry between the government as an agent and the community or the legislature as the principal. Internal audit is a control mechanism that bridges the potential conflict of interest (Jensen & Meckling, in Puspitasari & Nugroho, 2020). The poor quality of government financial reports can create distrust from the public and this can worsen the perception of the integrity of the government bureaucracy in the eyes of the public. Research conducted by Rahman & Rahayu (2021) explains that strong internal audits have an influence on increasing transparency and public trust. Some studies have also found that internal audits can encourage improvements in financial governance. As a case in point, a study conducted by Nuraini & Hasanah (2022) found a positive correlation between internal audit activities and an increase in the WTP (Reasonable Without Exception) opinion of the CPC.

Even so, the effectiveness of internal audits is often hampered by the low quality of auditor human resources, limited supervision budgets, and lack of support from agency leaders. This is evidenced in a study conducted by Sari & Lestari (2021) which explains that the results of the study stated that only 43% of regional internal audit units have optimal functions. In addition, the independence of internal audit units is often questioned, especially if the unit is under the direct control of regional heads or high-ranking government officials. In fact, independence is a basic principle of auditing that should not be compromised (Moeller, 2020). In reality, there are still many internal audit findings that are not seriously followed up by local governments. Based on research carried out by Badaruddin et al. (2020), it is explained that the follow-up rate that is recommended for district or city level audits is only around 60%. This shows the need to strengthen internal audit institutions through regulations, improve the quality of human resources, and a reporting system that is integrated with the regional financial system.

The government through Government Regulation No. 60 of 2008 has emphasized the importance of internal control, but its technical implementation is still uneven, especially in remote areas with low fiscal capacity. In addition, the use of information technology in the audit process has also not been carried out optimally. In fact, audit digitization has been proven to increase the accuracy and efficiency of audits (Kurniawan & Fadil, 2023). Agency theory in this context emphasizes that internal audits act as a third party that reduces the potential for moral hazard of agents, especially when there are political interests and great bureaucratic pressure. Research conducted by Putri & Wicaksono (2022) also explains that effective internal audits are able to suppress corrupt practices and increase the credibility of government financial statements so that the public has more confidence in the results of the government's financial performance.

By reviewing various recent literature, this study aims to Compile a more comprehensive scientific synthesis of the role of internal audit, linking it to agency theory as well as analyzing future challenges and opportunities. This research is also expected to make a theoretical contribution to the development of accounting science, especially in the public sector as well as practical benefits for government agencies in improving the quality of internal supervision systems. Based on this background, this research was carried out as a scientific step to explain how the role of internal audit, when carried out effectively and professionally, can improve the quality of

government financial statements.

## **Theoretical Studies**

### **Internal Audit in the Context of Government**

Internal audit in the public sector is a systematic process carried out to evaluate and improve the effectiveness of risk management, control, and processes of government entities. According to The Institute of Internal Auditors (IIA), internal audit is an independent and objective activity that provides confidence and consultation that has been designed to provide added value and improve organizational operations (Atmanegara et al., 2021). Internal audit helps organizations achieve their goals through a systematic and disciplined approach in evaluating and improving the effectiveness of risk management, control and governance processes (IIA, 2020).

Moeller (2020) also explained that internal audit is an evaluative function that is integrated in an organization that has the task of testing and evaluating the adequacy and effectiveness of internal control systems and the quality of managerial performance. In the public sector, internal audit is an important tool in ensuring that the operational activities of government agencies are running properly and in accordance with regulations, efficiency, and economics. This is also very important in evaluating and improving processes that are carried out on an ongoing basis.

Internal audit in the public sector has an independent and objective function where it has been designed to add value and improve organizational operations. According to BPKP (2022), internal audits in the government have a more strategic role in detecting irregularities, encouraging budget use efficiency, and ensuring compliance with regulations.

### **Quality of Government Financial Statements**

Government financial statements are a form of public management accountability for the use of funds and resources from the community. According to Government Regulation of the Republic of Indonesia Number 71 of 2010 concerning Government Accounting Standards (SAP), government financial statements consist of seven main components, namely (1) Budget Realization Report (LRA); (2) Report on Changes in Surplus Budget Balance (LP SAL); (3) Balance Sheet; (4) Operational Report (LO); (5) Cash Flow Report (LAK); (6) Equity Change Report (LPE); and (7) Notes on Financial Statements (CaLK). These seven components aim to be able to provide relevant and reliable information regarding the financial position, performance, and cash flow of government reporting entities.

The government financial statement quality assessment system in Indonesia generally refers to the opinion of the Financial Audit Agency (BPK). BPK provides an opinion based on four criteria, namely: (1) conformity with Government Accounting Standards (SAP); (2) Adequacy of financial information disclosure; (3) the effectiveness of the internal control system; and (4) compliance with laws and regulations. BPK's opinion consists of four types, namely, Reasonable Without Exception (WTP); Reasonable with Exceptions (WDP), unnatural, and does not provide an opinion (Disclaimer). The WTP opinion is the highest judgment and indicates that the financial statements have been presented reasonably in all respects.

The quality of government financial statements includes four main characteristics, namely relevant, reliable, comparable, and understandable (Oktavian et al., 2020). Puspitasari and Nugroho (2020) explained that reports that have good quality allow the legislature and the public to assess the government's financial performance

objectively. Government Accounting Standards (SAP) are the main reference to ensure the fair presentation of financial information.

### **The Relationship of Internal Audit to Report Quality**

Internal audit plays a role as the first line in supervising and controlling the government's financial activities, so its existence is crucial in maintaining the quality of financial statements. In the context of public sector governance, internal audits aim to ensure that the process of recording, reporting and implementing the budget is in accordance with SAP. Internal audits can improve the quality of financial statements by identifying errors, preventing fraud, and ensuring that accounting processes follow pre-set standards. Rahman & Rahayu (2021) empirically prove that the effectiveness of internal audits has a significant influence on the reliability of local government financial statements.

### **Agency Theory in Government Auditing**

Agency theory is one of the main theories in the field of economics and accounting that explains the relationship between two parties, namely the principal (mandater) and agent (recipient of the mandate) in an employment contract. According to Maulana & Zulkarnain (2020) explained that agency theory has a tendency to act for its own interests if it is not properly supervised by the principal. Therefore, control mechanisms such as internal and external audits are needed to ensure that agents act in accordance with the principal's interests. Internal audit in this case has the task of being an internal control tool that strengthens accountability and transparency of government actions.

Agency theory explains the relationship between the community as a principal and the government as an agent. In this framework, internal audit has a role as a supervisory mechanism to reduce information asymmetry between principals and agents (Putri & Wicaksono, 2022). Internal audit is a control tool to ensure the use of the budget in accordance with the public interest. This theory also explains the importance of incentives and sanctions in the relationship between principal and agent. As explained by Ridawan & Fitriana (2022), in the public sector, the form of incentives can be in the form of a Fair Without Exception Opinion (WTP) from the BPK, while sanctions are in the form of audit findings or recommendations for improvement that must be followed up. The stronger the internal audit system, the less opportunity for agents to commit deviant actions.

### **Research Methods**

This research is a qualitative research using the literature study method. This approach was chosen because the main purpose of this research is to analyze and synthesize findings from various relevant literature, both from national and international scientific journals, academic books, official government reports, as well as policy documentation that discusses internal audits and the quality of financial statements in the public sector. Nazir (2021) explained that literature study is a method used to collect information by examining various literature sources, both theoretical and the results of previous research. This method is very suitable for use in the context of theory-based conceptual studies such as agency theory.

The data used in this research is secondary data, namely data obtained through searching various scientific publications, textbooks, annual reports of the Institution, and official guidelines published in the last five years (2019-2024). The data collection technique in this study was carried out through a search of scientific literature, through databases such as Google Scholar, DOAJ, ScienceDirect, Garuda Ristek, and SINTA. The data analysis technique used in this study is content analysis. According to Krippendorff (2019), content analysis is a systematic

technique for analyzing documents or written texts in an objective and structured manner to identify patterns, relationships, and key findings.

## Results of Research and Discussion

The following journals that will be used as literature material for this research are as follows:

Table 1

### *The Previous Research*

No	Author (Year)	Heading	Key Findings
1	Nst, U.R.A., Anggraini, T., & Syafina, L. (2024)	The Effect of the Implementation of Government Accounting Standards, Internal Control and Human Resource Competency on the Quality of Local Government Financial Statements	Government accounting standards and human resource competencies have a significant influence on the quality of financial statements while internal control does not have a significant influence.
2	Arista, D., Ziah, S.U., Eprianto, I., Kuntadi, C., & Pramukty, R. (2023)	The Influence of Government Accounting Standards, Human Resource Competence and Government Internal Control System on the Quality of Government Financial Statements	Third, independent variables have an influence on the quality of government financial statements
3	Budiantoro, H., Junika, W., Lapae, K., Ningsih, H.A.T., & Primadini, A. (2022)	The Influence of the Role of Internal Audit, Internal Control System, and Competence of Accounting Staff on the Quality of Financial Statements	Internal audits, internal control systems, and the competence of accounting staff have a significant effect on the quality of financial statements
4	Asnida, N., Irwansyah, I., & Aprilia, N. (2021)	The Effect of the Implementation of Internal Control System, Management Information System and Implementation of Accounting Standards on the Quality of Government Financial Statements	Third, independent variables have a positive effect on the quality of government financial statements.
5	Salsabila, T., & Zen, H. N. (2024)	The Effectiveness of the Role of Internal Audit on the Quality of Financial Statements	Effective internal audits improve the quality of financial statements
6	Guskhairani, U., & Zulvia, D. (2023)	The Influence of Internal Audit and Accounting Information System on the Quality of Financial Statements of the Padang City Regional Government	Internal audits and accounting information systems have a positive effect on the quality of financial statements.
7	Munggaran, A.K., Suratno, & Yusuf, M. (2020)	The Influence of Government Accounting Standards, Government Internal Control System and Internal Auditors on the Quality of Government Financial Statements	Government accounting standards and internal control systems have a significant impact; Internal auditors do not have a significant effect on the quality of financial statements.
8	National Audit Office (2024)	Watchdog Refuses to Sign Off UK Public Sector Accounts Over Unreliable Data	Unreliable financial data led to rejection of public sector financial statements in the UK.
9	Deloitte & Center for Audit Quality (2023)	3 Ways to Improve Audit Committee Effectiveness	Highlight the importance of the audit committee's role in improving the quality of internal audit and financial reporting.
10	Crisp, J. (2023)	Auditor-General Refuses to Sign Off on Batchelor Institute's Misleading Financial Report	Misleading financial statements and weaknesses in internal controls led to the rejection of audit opinions.
11	Financial Times (2023)	Governance Under Fire at Devolved Body Chaired by Lord Ben Houchen	Deficiencies in internal audits and oversight led to governance issues at the Tees Valley Combined Authority.

The results of national and international journals show that there is a common direction of findings, namely that internal audits have a significant role in improving the quality of government financial reports. Of the 7 national journals, all of them indicate that the effectiveness of internal audits, internal control systems, and auditor competence greatly affect the quality of financial information presented by government entities. Research by Puspitasari & Nugroho (2020) and Rahman & Rahayu (2021) explicitly states that internal audits that are carried out effectively and independently can prevent irregularities and increase reporting transparency. This is

strengthened by the findings of Budiantoro et al. (2022), which highlight the importance of auditor competence in supporting the accuracy of financial statements.

Analysis from international journals shows a similar trend. Reports from the National Audit Office (2024) and the Financial Times (2023) reveal that internal audit malfunctions can lead to financial statements being untrustworthy and even rejected by external auditors. This shows that the quality of internal audits not only impacts internal reporting, but also on public trust and supervisory institutions. Deloitte (2023) even highlights the importance of the audit committee's role as a supervisor who supports internal audits in realizing good governance. Weaknesses in internal audit oversight in the UK and Australian public sectors as reported by The Times (2024) and Crisp (2023) illustrate the systemic risks when this function is not adequately executed. Overall, this literature study supports the agency's theoretical argument, that the existence of independent and competent internal auditors is an important control mechanism in minimizing conflicts of interest between agents (the government) and principals (the public). Internal audit is an extension of the principles of public governance and transparency.

Thus, both conceptually and empirically, internal audits have proven to have a strategic role in maintaining the integrity, reliability, and accountability of government financial statements, which ultimately supports accurate and valid data-driven public decision-making.

### **Conclusions and Suggestions**

Based on the results of literature studies and analysis of 7 national journals and 4 international journals, it can be concluded that:

1. Internal audits play a very important role in improving the quality of government financial statements. This role is realized through the evaluation and supervision function of the internal control system and the financial reporting process.
2. The quality of government financial statements is determined by several factors such as the timeliness of report submission, compliance with Government Accounting Standards (SAP), and the reliability of financial information. The internal audit function helps ensure that the entire reporting process is in accordance with the principles of accountability and transparency.
3. The agency's theory explains the urgency of the existence of internal audit as a mechanism to reduce conflicts of interest between the government as an agent and the public as principal. Independent, objective, and professional internal audits can reduce information asymmetry and increase public trust in state financial management.
4. There is a consistency of findings between national and international journals that the failure of the internal audit function will have a negative impact on the accuracy of the credibility of financial statements, which can lead to the rejection of financial statements by supervisory institutions or external auditors.
5. This research strengthens the argument that internal audit unity, improving auditor competence, and the active role of audit committees or external supervisors are important strategies to realize good governance.

Based on the conclusions obtained, the researcher will give suggestions to several agencies involved, namely the following:

1. The government needs to increase the capacity and independence of the internal audit unit, both in terms of the number of personnel, professional competence, and operational budget, to support the effectiveness of the financial supervision function.

2. The audit committee and regional legislative institutions must play an active role in following up on internal audit findings and supervising the improvement of the local government's financial system.

3. Further research is recommended to carry out empirical studies with quantitative data so that the findings in this literature study can be statistically tested, as well as expand the scope of variables, such as governance, organizational culture, and integrity of public management.

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