

The Role of Quality Internal Audit in Reducing the Manipulation of Profits of Public Companies: An Empirical Study of Oil Marketing Companies

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Abstract: There have been inconsistencies in the relationship between quality internal audit and manipulation of profits in Iraqi companies from the previous studies. Therefore, the objectives of this study are: to make clarification on the necessary practices for manipulation of profits and to increase the internal audit quality work of various departments in Iraqi public companies. Data and information were gathered from the financial statements of the company, the minutes from several board meetings held, research reports and the internal audit reports for 2012. The study found that the company's internal audit departments do not depend on research quality on the implementation of its work due to lack of critical indicators such as risk management and control, objectives and powers independence and objectivity and audit programs. Thus, the study recommends a framework that should be adopted by the international standards of internal auditing in order to promote quality internal audit in every departments for a reduction in manipulation of profits perpetrated by the company's management.

Key words: Financial statements, manipulation, international standards, framework, board meetings, internal audit

INTRODUCTION

An essential part of any management process is the internal audit function of a public company. Advisory and assurance services, governance process evaluation, enhancement of the oversight process and risk management are all provided by this function. Sufficient attention should be given to this function empowering the local and international standards for internal audit profession. The quality of the internal audit will be improved through the attention in order to detect manipulation of profits perpetrated by the management of companies in public sectors. Thus, the gap and flexibility in the accounting standards and methods are exploited in the application of the text under the legal provision of 11 and 12 to be specific. The provision is pertaining to the calculation and distribution of profits contained in the Iraqi Public Companies Law No. 22 for the year 1997 as amended. There is no consistent approach in the interpretation of the article texts and the distribution of profits generated by the administrations of those public companies.

Literature review: There are numerous studies on manipulation of profits such as the study of Al-Rifai that investigated the relationship between management

behavior and internal auditing quality for manipulation of profits in joint stock companies of Saudi Arabia. It is found that there is a negative relationship between internal audit quality and manipulation of profits in these companies. As concluded by the study, the study on manipulation of profits was conducted by the Jordanian listed companies listed on the Amman Stock Exchange (ASE) due to the previous negative and inconsistent relationship between the involved variables as mentioned above with the practices of manipulation of profits.

The aim of the study is to identify the management practices of Saudi banks registered under stock market for manipulation of profits and to evaluate the effect of factors affecting activities in auditing such as the audit manual, the size of the internal audit department, the organizational independence and the academic qualification. According to the study, the indicating variables stated above positively affect the quality of profits, management practices and other internal audit activities that make contributions to reliability and adequacy of financial statements.

Additionally, Strobel (2013) studied the correlation between the variables affecting the external members of the board of director and manipulation of profits. This study involving manipulation of profits and capital cost aimed in finding the manipulation of profits that influence

the capital cost by exploring the company's activities. The study found that a manipulation of profits depends variably on the activity outcomes. It then concludes that there are stronger incentives for companies with good activity to increase performance during the activity process.

In another study, the concept of earnings management, methods and motivations were studied by Yahya Al-Tamimi and Fleih Al-Saadi (2013). The study also added audit quality its dimensions its parameters its reflection and its characteristics on earnings management practices. Also, the study explored the law of Benford and its nature, usage and effectiveness in managing profits gained in the financial statements of the listed companies. The study conclude that earnings management practices are existing in the companies listed on the Iraqi Stock Exchange as discovered through the Law of Benford.

Wang and Huang (2014) studied profitability and manipulation of profits with the objective to calculate the regression model in order to identify the differences in manipulation of profits generally in economy and business cycle. The study found that the weak activity is blamed on the inefficient economy by the managers. Using audit standards, the aim of the study is to establish a framework for internal audit standards. Additionally, Noor *et al.* (2015) examined factors used in manipulating profits and the drivers of fraud. The study aimed to evaluate the association between manipulation of profits opportunities and fraud. It is revealed that dividends, audit quality and cash flow are the opportunities related to manipulation of profits. The study recommended that the board should be established to monitor the accounts and improve the existing practices of governance by following and adopting certain rules of rules and standards. This will improve the financial reporting quality.

Talab *et al.* (2018a-d) explored the use of M-score Model to analyze the practices of earnings management in Iraqi listed companies for securities. The sample selected represents listed banks in the Iraqi market for securities with the total number of 23 banks for the year 2004 as the base year and 2015 as the last year. During this period for most of the banks, the existence of practices has been reached in those banks listed in the Iraqi market for securities. The study found that banks that do practice the management of profits are higher than those that do not practice earnings management.

Furthermore, the aim of the study is to examine the effect of corporate governance on earnings management and to evaluate the role of audit quality as one of the measures of governance on earnings management in Iraqi listed companies for security market for the year 2015. The

study concludes that contribution to the reduction of earnings management is not done alone by the corporate governance. Also incorporation of audit quality and corporate governance contributes to the reduction of earnings management practices.

In accordance to the claim above, what distinguishes this present study from the past studies is the evaluation of internal audit departments in public companies by obtaining information, data and conducting interviews to study the actual reality in a matter that is based on the INTOSAI Auditing Standards and Iia Standards. Also, the study investigated the use of organizational related local legal guides and texts of the internal audit function. The first paper outlined the manipulation of profits by public companies while the flexibility and changes in the Public Companies law, No. 22, of 1997 as amended is exploited. Since, all previous studies focus on the manipulation of profits in private shareholding companies, this study happens to be the first to show the association between manipulation of profits and internal audit quality in the Iraqi state-owned public companies. Unlike the previous studies that do not distinguish between the negative and positive impacts of the manipulation of profits process, this study focuses on the negative impact of the manipulation of profits on the process of manipulation of profits.

MATERIALS AND METHODS

The theoretical framework

Internal audit concept: Professional organizations such as: the International Organization of Supreme Audit Institutions (INTOSAI) (IFAC), the Institute of Internal Auditors (IIA), the Accounting Standards Board of the Republic of Iraq, the Institute of Chartered Accountants in England and Wales (ICAEW), the Australian Accounting Office (AAB) have received many definitions of internal auditing but the definition issued by the institute of internal auditors is the most prominent definition. The consensus definition according to the institutes is that: "internal auditing is objective and independent activities that make provision for assurance and advisory services in order to add value to the company and improve its operations". The activities are set to achieve the company's objectives by improving the effect of the governance processes and risk control and management and through the followers of a structured method of systematic assessment. This is considered as the largest mature definition among the tariffs issued by these organizations due to the following reason:

While the definition issued by the Internal Audit Institute (IIA) do not specify the entity to link the internal

audit function with other definitions issued by other professional institutions determined that the internal audit function should be from the organization but the consensus definition is either independent and objective activity. The definition is issued by the same institute that states that function of internal audit should be linked to the highest regulatory authority that affects the company's decision and make reference to "the council" as a body and allowed the internal audit services to other institutions and companies in addition to where it works in the company.

Addition of new roles to the conventional roles that fall within the organization's definitions. Those roles that add value to the company are: assurance, consulting, risk management institutional control and oversight; the scope of internal audit will be expanded with this role.

The concept of the internal audit quality: Bedard *et al.* (2010) defined audit quality as the greater assurance that requires deep attention to audit standards. Also, Alzeban (2015) explained further that it is the compliance with international standards by the executive directors of the internal audit function establishing procedures for practice of internal auditing and appropriate modalities that facilitate internal audit. In other word, Mahzan and Hasan (2015) defined audit quality as "the compliance with ISO 9001 to report any discrepancies identified for the purpose of taking the corrective measures necessary to reach the elements of these standards".

According to the Institute of Internal Auditors (IIA), the audit standard is defined as "an official declaration given by the internal audit body that explains the criteria for performing evaluation of performances and a wide range of internal audit activities". Singer posited that it is the internal evaluation of work while it represents model for duty performance of the Internal Audit Department in compliance to the Institute of Internal Auditors (IIA).

In accordance with the legal responsibilities and professional standards, the auditor is interested in completing the audit process in an objective and systematic manner. The auditor performs the audit function as stated by Shehata, Talab *et al.* (2018a-d) with the highest possibility of quality by adoption of the institute of internal auditor's standards which is explained as the pioneer work of Moeller (2009) and highest professional institution. On 1 January, 2017, the most recent amendment to the standards came into effect. The standards are revised by the International Standards Board (IASB) after the approval and consideration by the board of supervisors framework.

Qualification standards: The qualities such as independence, objectivity, professional care and quality in the performance of audit work that should be included in the standards are provided by the internal auditor.

Standard of performance: Plan definitions, objectives and scope of internal audit, reporting and communicating audit findings and documenting the information to the parties concerned determine the effectiveness of the risk management and control, governance evaluation and internal audit activity management.

In another vein, several standards are issued by the INTOSAI with specialization in internal auditing. In the public sector, these standards focus on the objectivity and independence of internal auditing. These standards are:

Criterion 1610: In the public sector, this standard uses the internal auditor's work with the inclusion of set of measures to assess the objectivity of the internal audit function.

Criterion 9140: This standard explains the internal audit independence in the public sector which includes a set of measures to assess the independence of the internal audit function.

Manipulation of profits: As imposed by the regulatory authorities and professional organizations concerned with the development of rules and standards for the preparation of financial statements, corporate accountants operate in accordance with rules and principles. The aim is to provide information that allows decision-maker to gain access to degree of uncertainty, size and timing in the future cash flows of the company (Taher, 2006).

During the financial year, the end result of the company is represented by the profit as an important component of the financial statements because the ability of the management is determined in order to achieve cash flows and efficient resource utilization. The stakeholders evaluate the asset and profit to determine the present value of the future profit and share of the company (Rahman *et al.*, 2013). Nasser and Waleed (2011) opined that the fundamental determinant of the company's value is the profit through which the effect of the stock market price increases.

The income statement (the loss and profit account) which shows the outcome of the activity presents the profit which is the major source of information for the study of the company's performance through which the calculation of the financial indicators and ratios can be generally done. This is to know the association between

the result and effort of the company in order to give a clearer picture (Marginean *et al.*, 2015). Ameer and Nuri (2015) mentioned that after the primary objective, the company can seek to optimize their profits.

Manipulation of earnings is done by many companies for different reasons and these manipulations by the managers lead to false financial statements in accordance to the stakeholder's interests. Therefore, wrong decisions are made due to the statements that are adopted in accordance to the manipulation method which is in contrary to the objectivity and quality of accounting information based on the international accounting standards. A caution is called for for the manipulation of profits by corporate managers (Bader and Saleh, 2017, Talab *et al.*, 2018a-d). The umbrella under which all management practices intervene is the earnings management in order to change the profit amount by numerous methods such as the manipulation of accounting policies and time control of certain transactions. Other methods are the fraud forgery, the classification of elements of the income statement in a certain way and fraudulent operations intended to create an idea from what the financial statements presented on users (Talab *et al.*, 2018a-d).

Paolone and Magazzino (2014) in this context stated that the public domain of accounting manipulation can be differentiated according to the separate groups. Creative accounting is the first step to keep the accounting practices within the earnings management of legality limits. Accounting fraud is the second one which implies going against the principles and rules of manipulation of profits and profit manipulation. These 2 concepts belong to the same domain as many studies found that the same model and method are applied in the 2 groups.

Furthermore, manipulation of profits is a deliberate misappropriation of profits in a way that leads to certain accounted amounts which are totally different from what they could be in the absence of manipulation as a result of non-strategic decisions by managers to change simple the profits (Hamza, 2012). Also, due to the profits to achieve certain goals and objectives, manipulations by the company's management of the accounting results exist (Mariani *et al.*, 2015). It is agreed upon that the administration wants to achieve a goal consistent with the vision, despite the differences in the definitions of manipulation of profits. The objective is to reflect on the amount of profit and have impact on the activity of the financial statements that serve the interest and affect the decision of different users of accounting information. Manipulation of profits can be defined on this basis as a set of motives that guide management through the use of conjectured methods that affect the profits shown in the

financial reports in order to achieve and influence the objectives and decision of the stakeholders. According to many accounting studies, the motive of management is to adopt profit-manipulation practices with the aim to change the amount of profits realized. The management reduces the profits achieved to a certain level and the motives that raise them from these profits at other times due to many motives for these practices. In order to reduce the volatility and fluctuations in annual profits, there is a motive that makes the administration prepare income (Al-Mashhadani and Naji, 2012).

RESULTS AND DISCUSSION

In the economy of Iraq, the research sample in the oil marketing company using a public company was of importance. To study the financial statements and the internal audit departments of the company, the year 2012 was chosen as a time limit as that was after the year the earnings management was discovered and the complexity of the operations. The company took into account the provisions of the Public Companies Law No. 22 of 1997 on June 25, 1998. The aim of the company was to examine the commercial activity for the marketing of petroleum products, gas and crude oil inside and outside Iraq. For continuity in the activity in the number of contracted tasks such as: the implementation of barter contracts and agreements for payment of crude oil and its products; importation of petroleum products; exportation of crude oil; management of the Iraqi company's share; engagement of the company in the exploration contracts and production of oil and gas and other functions. Therefore, supporting the national economy is important through:

Increase in revenue of the export of crude oil and petroleum products through existing outlets which is the main contribution to the Federal budget of the state. The contribution of the company to meet up with the needs of petroleum products of the country in a manner according to the size and need of the financial allocations available for that purpose.

The reality of internal audit departments of the selected company: In order to ensure facilitation and improvement of the quality of the internal audit work and procedures, the board of directors determines the responsibilities, power and objectives of the Internal Audit Department. The department is related to the general manager of the company based on the organizational structure of the company but the idea is not in consonance with the recommendations of the internal audit standards. After the highest regulatory authority contributes to the

support of the objectivity and independence of the internal auditor, linking the Board of Directors of the company to the division is recommended. No adoption of control instruction and programs that will contribute to obtaining information in a manner that leads to self-development of internal audit staff or their professional level. Also, no control or audit body examined the work of the Internal Audit Department in indicating its compliance with the local standards. The essential part of the company's organizational activity is the governance process. However, no activity was undertaken by the internal audit departments in order to assess the course of governance where one of the major parties or the internal audit staff rely on the accumulated guidance and experience from the management of the divisions, especially if the department does not depend on a written or clear work programs to perform the audit work.

Manipulation of profits in the oil marketing company:

Amounts of JD (15357) million. was allocated by the company. This amount of money was collected from advertising expenses, the confiscation of bank guarantees and the contractual fines at the detriment of the commercial activity revenues (423/2012) and JD 5412 million. The account of the revenues of previous years H/491 and the amount of 9488 million dinars were taken from the bank commission expenses (modifying, strengthening and opening of documentary credits for the importation of oil as a product) at the expense of banking services H/3366. These amounts are to import contracts for oil derivatives during the year 2012 even though these amounts do not belong to the marketing company. This is a result of commercial activity for the company in the distribution of the petroleum products in the ministry of electricity and oil extraction.

However, it was not diagnosed by the internal audit department of the company. The financial control authority of the Federal Financial Control Bureau operating in the company discovered the manipulation. According to the books of the Federal Audit Bureau No. 11/28/7/17 713 and 11/28/7/20840 on 23/9/2014 and 13/11/2014, respectively, the financial statements for the year 2012 have been amended. The change in the activities is affected by the manipulation which resulted to increase in the expenses (9488) increase the cost of the current activity increase in the total revenues of the company (20769) and change in the result of the activity. These increases are subject to changes in the activity of the company (Surplus Phase 2). The current operations of the company before and after the process of adjusting the financial statements of the company and the difference in the result are shown in Table 1.

Table 1 clearly shows that the activity's result as reached by the company as a result of manipulation amounted to an increase of 11280 million dinars and 44563 million dinars. The amount reached (33283) million dinars after the amendment of the financial statements of the company.

The sum of the amounts included in the current expenditure accounts and in the consolidated accounting system is the cost of the current activity. These accounts include: contracting and services, benefits of the city and land lease, commodity inputs, services inputs, purchases of goods and land for sale and salaries and wages. Thus, an increase in the cost of the current activity is due to any increase in the expense accounts above. Due to the reversal of expenses to the current accounts above and the recognition of the wrong amount by (9488) million dinars, the cost of the current activity has increased in amount. Table 2 shows the difference before and after the amendment:

Table 1: Disclosure of the current operations for the financial year in December 31, 2012

Details	Amounts before adjustment (Million dinars)	Amounts after adjustment (Million dinars)	The difference (Million dinars)
Current revenue	61490	46133	15357
Revenue from current activity	70116	70116	-
Current expenses	493	493	-
Salaries and wages	14276	4788	9488
Commodity inputs	560	560	-
Service requirements depreciation	22341	12853	9488
Surplus of current operations (Phase 1)	39150	33281	5869
+Conversion and other income			
Transforming revenues	1	1	-
Other revenues	5899	487	5412
Transfers and other expenses	5900	488	5412
Transfer expenses	340	340	-
Other expenses	146	146	-
Surplus (Phase 2)	44563	33283	11280

Table 2: Increase in the cost of the activity before and after the amendment

Cost of current activity before adjustment (million dinars)	Cost of current activity after adjustment (Million dinars)	The difference (Million dinars)
22341	12853	9488

Table 3: The distributable profit before and after adjustment and their calculated difference

Profit before distribution (million dinars)	Profit after distribution (Million dinars)	The difference (Million dinars)
6702	3856	2846

In accordance to the article (11-tier) of the Public Companies Law No. 22 of 1997 as amended, the basis for the calculation of the distributable profit which represents 30% of that cost is the cost of the current activity. This is the distributed to a group of beneficiaries such as the employees and the company's management. Therefore, by reversing the amounts of banking commission fees referred to above, the company's management increased the cost of the current activity in order to increase distributable large amounts of profit as shown in Table 3.

CONCLUSION

There are no formal, written objectives, responsibilities and powers in the internal audit departments, weak independence affects these departments. Administratively, they are connected to the general manager rather than the board of directors. The parts of the employees who are affected by profit and loss are the internal audit staff. To prevent the contradiction with the impartiality of the internal auditor in excess and the process of manipulation of profits, the lack of the number of professional certificates and academic senior in the area of auditing and accounting of staff working should be avoided in the internal audit departments. The management and the accountants should also be in seeking to achieve the most. Going through the process of manipulation of profits, the benefit can be obtained. As provided to the management, this benefit is received in cash in the form of incentives just like the other employees of the company who take advantage of the wrongful application of the Article 11 provision of the public companies law and the correct classification and non-recognition of expenditure that affects the gain.

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