

CHAPTER I

INTRODUCTION

1.1 Research Background

Business has developed greatly nowadays, the need to compete is also higher than before. Today's fast-paced competitive business environment is defined by change and innovation. Companies or organizations need to understand and respond to the customer demands that keeps increasing in order to develop agile supply chains and to mitigate risk. Decision-making becomes more difficult, with little time to gather evidence and to consult with colleagues. The desire to reach a decision in the shortest time possible is arguably important in today's business. In order to make such decision, every organization or companies, no matter what industry they are in, is forced to work as efficient and effective as possible. In addition, they also have to be more competitive and perform better than others. As a result, they need to be more productive, to increase the size of the company, to increase the service, to invent more innovations, to be creative, to be unique, and so on.

As a result of business development, management becomes more complex. The function in a company becomes more complex as time goes on, there are various new functions that are important to the company such as learning, spreading risk, customer value, and economics of scale. Today's challenge for companies is complexity, as it cannot be made simple and it is not going away in

the near future. It is difficult to control the entire operation process and the management also cannot delegate all of its responsibility. That is why the management needs control specialist or internal auditor to assist in supervising the company operation and to ensure the company's effectiveness and efficiency.

In Indonesia, the existence of internal audit function is a mandatory for Badan Usaha Milik Negara (BUMN), government institution, bank, and public company. For public company, there has to be an audit committee and in order to perform the task efficiently, there has to be internal audit function within the audit committee. The internal audit function itself should be able to act independently and objectively when they work.

According to Institute of Internal Audit (IIA), internal audit is defined as an independent, objective assurance and consulting agency designed to add value and improve the organization's operation. Internal audit is one of the most important activities because it involves evaluating and examining the entire activities within the company and in result, giving correction and reporting to the management if there are fraud or error in the company's activities. Internal audit is done by internal auditors who are independent people in the company who are willing to stand up and be counted. Internal auditors need to have a remarkably varied mix of skills and knowledge because they need to provide an independent, objective, and constructive view of all the activities within the company.

Internal Audit has to be effective because it serves as a front-line set of eyes and ears for the senior management, also supports administration and Board of Directors, manages the company effectively by using their knowledge and

professional judgement. Internal audit provides an independent appraisal of financial, operational, and control activities. Internal audit also provides analyses, recommendations, consultation, and information concerning the activities that are being reviewed. In order to do all that, the internal audit itself has to be effective to carry on such tasks in the limited amount of time. There is a scope limitation placed in internal audit activity that makes it more difficult to accomplish the company's objective and plans and to minimize the scope limitation. Internal audit division needs to be effective to carry their tasks within the company.

Internal audit charter states that their mission is to provide assurance and give consultation to the management that are systematic, consultative, and constructive by evaluating and increasing the system's effectivity. In order to add company value and helping the company to reach their goals. On the other hand, the internal auditor provides an independent appraisal which examines and evaluates the activity of a company. Internal auditor should be able to possess a set of skills that ultimately adds more value to the company.

Internal auditors in BUMN differs from internal auditors for private company. The internal auditors for BUMN, need to establish a Satuan Pengawasan Internal (SPI) and the rules are called SPI BUMN. For government institution, they have to follow the rules made by the government, called Standar Audit Aparat Pengawasan Pemerintah. However, for internal auditors in private companies, there are no specific set of rules that they have to follow. In this case, the principles and rules that they have to follow come from internal audit organization that have been recognized for its credibility in many countries, which

is the Institute of Internal Auditors (IIA). IIA has published set of rules called Professional Practices Framework (PPF) which covers the definition of internal audit, code of ethics, auditing standard, and the other rules. In this case, the company uses Standar Professional Audit Internal (SPAI) as a substitute for IIA. The contents of SPAI refers to IIA, and a lot of the guidelines were taken directly from IIA, so it can be said that the SPAI is the same as IIA.

The objectives behind creating an internal audit division in the company are to assess the management of risk and to assist the management in improving internal controls. Internal audit is fundamentally concerned with evaluating company's risk management. The key to a company's success is to manage the risks such as financial risks, IT risks, health and safety risks, and others more efficiently and more effectively than its competitors; and as stakeholders demand. Internal auditors assess the quality of risk management process, systems of internal control, and corporate governance expressed across all parts of organisation; moreover report all the results to senior level management as objective as possible. Their knowledge of management risks allows them to act as consultant and catalyst in improving the organisation practices, furthermore they can help to ensure that risks are clearly identified and controls are put to manage them.

As an internal auditor in a company, there is a need to understand the implementation of effective internal controls. There has to be a system of internal controls to become the basis for effective operational and accounting business process. Internal auditing activity involves evaluating and assessing multiple level of controls. In order to understand how to evaluate and assess those controls, an

internal auditor needs to develop an understanding of the internal controls framework. To be able to do that, there has to be a set of guidance for the internal auditor to understand the framework and The Committee of Sponsoring Organizations of the Tread way Commission's (COSO) *Internal Control — Integrated Framework* provides detailed information about that. COSO has been recognized by executives, board members, regulators, standard setters and professional organizations as a comprehensive framework of internal control.

COSO provides internal auditors with multidimensional concepts of internal controls and defines internal control as a process, affected by an entity's board of directors, management, and other personnel, designed to provide reasonable assurance regarding the achievement of the following core objectives for which all businesses strive:

- Effectiveness and efficiency of operations.
- Reliability of financial and management reporting.
- Compliance with laws and regulations.
- Safeguarding of Assets

Based on that definition, one of the assurances is reliability of financial and operational information which is important for any company. For financial internal control reporting, the company should have information and communication links established with the management and the control should be monitored.

The reliability of financial and operational information is necessary, especially the management reporting. As an internal auditor, the responsibilities are to evaluate whether the management control is present and performing effectively and free of risk, and sometimes make an adjustment or recommendations to the management. Errors and frauds are likely to occur in an enterprise, to minimize or remove that risk, an internal auditor needs a safeguards at their planning to ensure that fiduciary responsibilities can be accomplished. Therefore, implementing effective internal control over management reporting is needed. Effective controls reduce the risk of asset loss, and help ensure that plan information is complete and accurate, financial statements are reliable, and laws and regulations are complied with. If the internal control is effective, it can be a strong assurance to achieve its management reporting objectives.

Prior internal audit studies have examined the effectiveness of internal audit function (Damping, 2011), some of the studies were held in public sector area Getie, 2007 and Christopher, 2009), but neither of them were actually held in private company and not all of them talks about the internal auditor function rather than the internal audit unit.

PT. A specializes in Indonesia crude palm oil and palm kernel. Its major operation includes planting palms, producing fresh fruit bunches, and processing crude palm oil and palm kernel in Indonesia. The main operation is located in South Sumatra, where crude palm oil and palm kernel from fresh fruit bunches are directly harvested and further processed at the processing plant located at the company's plantation in South Sumatra. PT. A was originally a private company.

Later in 2007, the company changed the name, then in January, the company's status was changed to foreign investment. PT. A is operating in Jakarta and this company has a subsidiary company in Surabaya called PT. X. PT. X is chosen for this research because this is the first time for PT. X to conduct the audit activity also, it is a good opportunity for the researcher to understand more about internal audit function and to evaluate whether the first audit activity is done properly or not. Furthermore their internal audit division's office is also located in Surabaya.

1.2 Research Problem

According to the research background, the problem can be formulated as "how does internal auditors in PT. X conduct the internal audit function in the company?"

1.3 Research Objectives

The purposes of this research are:

1. To know about internal audit practice, especially in reliability of management reporting in PT.X.
2. To evaluate whether the internal auditor has performed its job.

Internal audit is expected to evaluate the effectiveness and efficiency of management operation.

3. To evaluate whether the internal auditor has complied with the regulations. Internal auditor is expected to evaluate the management's performance and compliance with regulations.

1.4 Research Contribution

This study contributes to internal auditors by evaluating their job and comparing it to the standard. The advantages are:

1. To provide a reflection of internal audit conducted by the internal auditors and serve as a benchmark to improve the internal auditor's performance.
2. To increase the researcher's knowledge about internal audit and internal control activities.
3. To give the readers an understanding of internal audit function and its importance within the company.
4. The result is expected to be useful to the readers and as a comparative substance for the next researcher with similar interest.

1.5 Research Framework

The discussion in this thesis uses an organized systematic structure as follows:

CHAPTER 1 : Introduction

In this chapter, the research problem, background, and reasoning for choosing the company is explained. Furthermore, the objectives, research contribution, and research framework is also explained.

CHAPTER 2 : Literature Review

In this chapter, theories and concepts regarding internal audit, internal control, internal control framework and rules is explained.

CHAPTER 3 : Research Methodologies

This chapter contains research approach, research model, research limitation, source of data, the procedure of collecting data, and techniques for collecting data.

CHAPTER 4 : Results and Discussion

This chapter outlines the company profile, description of research results, and the discussion about the role of internal auditor in PT. X.

CHAPTER 5 : Conclusion

The last part of this research concludes the research problem and its results, also giving recommendations that can be used as a reference in the future research.