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Internal Audit, Internal Control Effectiveness, Corporate Governance Structure and Financial Reporting Quality: Investigating the Internal Line of Defense of Manufacturing Firms in China

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Abstract

The study aims to investigate the effectiveness of internal audit, internal control, and corporate governance towards the financial reporting quality among listed manufacturing firms in China Due to the waves of financial scandal outbreaks that disrupted the social and economic order in recent years, public scrutiny of the quality and credibility of financial reporting has escalated. In response to the upending circumstances, China has followed suit the US Sarbanes–Oxley Act (SOX) and introduced a quasi-SOX (C-SOX) practice to reinforce and substantiate the monitoring mechanism such as internal audit and corporate governance. The C-SOX specify that firms are to disclose the management and audit reports on internal control to encourage for high quality financial reporting. Although the effectiveness of SOX has been well supported by prior research, it is not applicable to be generalised to emerging markets such as China. The sample includes 200 manufacturing companies listed on the Shanghai Stock Exchange A-share from 2018 to 2020, making a total sample size of 600 firm-year observations. The findings indicates that the effectiveness of internal audit, internal control, and corporate governance influence the financial reporting quality positively. This research suggests that future studies can add control variables and refer to more research to investigate factors affecting the quality of financial reports, so as to avoid the impact of

insufficient control variables on research results. This study contributes to the financial reporting quality literature by providing empirical evidence on the effectiveness of internal audit, internal control, and corporate governance towards an unqualified audit opinion that indicates a higher quality of financial reporting among Chinese listed manufacturing firms.
Keywords: Internal Audit, Internal Control Effectiveness, Corporate Governance Structure, Financial Reporting Quality, Manufacturing Firms, China

Introduction

Extant literature has shown that managerial opportunism activities would often deteriorates the financial reporting quality (Ghazali et al., 2018; Ghazali et al., 2015). Managerial opportunism modus operandi such earnings management is a rampant but often discreet and usually happened within the governance and accounting loopholes (Ghazali et al., 2018). For example, managers could inflate reported earnings via favourable accounting choices and reverse the earnings in later years or intervene by adjusting reported accounting numbers through operational decisions, including manipulating sales revenue and cutting valuable investments such as R&D (Ghazali & Shafie, 2019; Roychowdhury 2006; Jones, 1991). Earnings management would prevent stakeholders from understanding the firm's actual circumstance and performance, resulting in unreliable financial reporting, unstable financial system, and unsustainable future profits. Therefore, having a strong and effective line of defence, namely, internal audit, internal control, and corporate governance structure is vital to financial reporting quality.

Apart from the internal line of defence as mentioned earlier, the external auditor also plays a critical role in in ensuring and attesting the quality of financial reporting. From this point of view, the audit opinion of the external auditor act as the watchdog of managerial opportunism, particularly when the probability of earnings management is high. Gajevszky (2014), found that firms of which audit opinions are qualified manage the discretionary accruals more negative and more significant than those with unqualified audit opinions. A study in Vietnam by Doan et al. (2021), also found that the auditor’s probability of issuing modified opinion is positively associated with earnings management. While there are several studies on audit opinions, majority focuses on issues related to auditor’s legal obligations, audit pressure, audit fees and others. The nexus between audit opinion as a proxy for financial reporting quality and the internal monitoring mechanisms such as internal audit, internal control, and corporate governance structure are scarce particularly for China’s financial market landscape.

High profile financial scandals such as ENRON and WorldCom have revolutionised the corporate governance globally. Major reformations are being developed to restore the public and investors' confidence on the quality of financial reporting of listed firms. In line with the upheaval of the US capital market at the time, the US government established the Sarbanes–Oxley Act (SOX) in 2002. SOX mandates that both management and auditors to respectively provide an opinion on the firm’s internal control. Several studies have shown that reporting quality (Iliev, 2010; Kalelkar & Nwaeze, 2011; Nagy, 2010) and operation efficiency (D'Mello et al., 2017; Feng et al., 2015) have improved significantly post-SOX. Hence, it is expected that an effective internal monitoring mechanism would serves as the internal line of defence for a firm in ensuring a production of quality financial reporting.

Following the establishment of SOX in 2002, China has followed suit and introduced a quasi-SOX (C-SOX) in 2008. The C-SOX was adopted to enhance risk management and prevent business disasters and requires detailed disclosure of internal control for public and private Chinese firms. Internal control comprises all the process, procedures and activities designed to provide reasonable assurance in relation to reporting, operations, and compliance (COSO, 2013). Theoretically, compliance with internal control regulation requirements helps firms to maintain and strengthen firms' oversight mechanism. Being the first line of defence, an effective internal control effectively improves the company's operating efficiency, optimize the allocation of resources, and ensure the integrity of financial and accounting information, thus ensuring the orderly realization of management objectives (Xiao, 2020; Franchi, 2019; H. Zhang, 2019; PwC, 2013).

Corporate governance being the second line of defence is deemed to support the management in ensuring that risks and controls are effectively managed. The C-SOX is intended to provide immediate upgrade the corporate governance structure and alignment with the equivalent global standards. In making sure that internal control is effective, internal audit function serves as the internal watchdog and helper as well as protector of the corporate governance structure. The essence of internal audit is to evaluate the effectiveness of risk management, control and governance, so as to enable enterprises to constantly adjust and ultimately achieve the value and goals of enterprises (International Professional Practice Framework (IPPF),2017, n.d.). An effective internal audit would ensure a properly designed internal control are in place and efficient to minimises risks and threats to the organisation (Swanson, 2019).

Effective internal audit and corporate governance are vital to each other. As the third line of defence for a business, internal audit equips the board with a holistic view of governance structures and how well they are working within the company. Although China have made substantial progress in recent years to improve corporate governance, some problems still exist. The manufacturing sector is a crucial support for the real economy in China and therefore has been committed to the high-quality development of this sector. There are 3,628 A-share listed companies in China, among which 2,276 are manufacturing listed companies, accounting for 62.73%. However, manufacturing enterprises still face a sharp increase in the risk of operation, many companies are issued non-standard audit opinion.

Therefore, the objective of this paper is to explore the relationship between internal audit, internal control effectiveness, corporate governance, and financial reporting quality by using the financial data and related materials of listed manufacturing companies in Shanghai Stock Exchange from 2018 to 2020 in China. With regard to the implementation of SOX-like reform in emerging economy such as China, the current study would extend the existing literature on internal control and corporate governance reforms and reporting quality. This study is motivated by the growing global focus on the effectiveness of corporate governance, internal audit, and internal control systems, especially in expanding economies like China. Recent financial scandals and company failures have intensified the necessity for strong internal mechanisms to protect the integrity of financial reporting. Given the significant role of China's manufacturing sector in its economic growth, it is essential to comprehend the impact of internal audit, control effectiveness, and governance structures on the quality of financial reporting for both academic and practical applications.

This study significantly strengthens the literature by offering empirical information from a fast emerging economy, where corporate governance policies are adapting to global norms like the Sarbanes–Oxley Act. The results will address current research deficiencies and provide actionable insights for policymakers, regulators, and company leaders to improve financial reporting quality via robust internal controls and governance.

The rest of the paper is organised as follows. The next section discusses on the literature review, relevant theories, and hypotheses development. The later section describes the research methodology, which is followed by a section on findings and discussion. Lastly, conclusion, limitations, implications, and potential future research are discussed.

Literature Review and Hypotheses Development

The design of an efficient and effective internal monitoring mechanism persists to be significant concern for modern corporation. Existing theories and current best practice are still unable to provide a generalisable framework for an optimum corporate governance mechanisms. Against this background, the 'Three Lines of Defense' model as shown in figure 1 was introduced and advocated by the Institute of Internal Auditors (IIA) and the Institute of Directors in 2013 followed by an update in 2020.

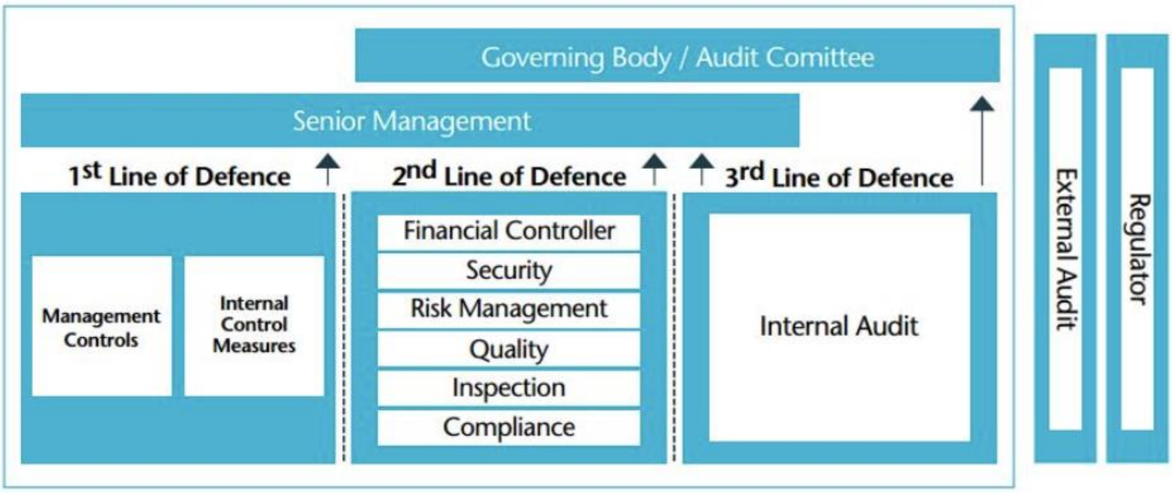

Figure 1: Three Lines of Defense model
Source: IIA, 2013

The model differentiates governance functions into a first, second and third line of defense, which are intended to mitigate corporate risk systematically and from different perspectives (Bantleon et al. 2020). The model also explains the relationship between the function of internal control, corporate governance structure and internal audit as well as a guidance to how each responsibility should be divided.

As China's stature in the global economic arena rises, the government recognizes the need to strengthen China's financial reporting and align with global standards. Hence a quasi-SOX (C-SOX) was introduced in 2002 to facilitate this movement. The benefits and ramifications of disclosure concerning the internal governance as part of the financial reporting has always been a protracted and contentious debate among all the stakeholders. Hence, C-SOX highlights on the requirements for management assessment of internal controls, and an opinion on the effectiveness of the internal controls. Internal controls regulate the generation of accounting information and effective internal controls can improve the quality of financial reporting by rectifying governance issues (Dashtbayaz et al., 2019; Lu, 2019). A primary objective of an effective internal control system is the reliability of financial records and reporting, which is essential for the timely provision of accurate financial statements to the authorities and stakeholders.

COSO (2013), defined internal control as “a process, effected by an entity’s board of directors, management, and other personnel, designed to provide reasonable assurance regarding the achievement of objectives relating to operations, reporting, and compliance.” Internal control comprises the plan of organization and all the coordinate and methods measures adopted within a business to safeguard its assets, check the accuracy and reliability of its accounting data, promote operational efficiency, and encourage adherence to prescribed managerial policies (Sawyer, 2003). Hence, regulating the internal environment of a company and ensuring that it operates effectively will ensure the reliability of financial reporting (Z. Liu & Wang ,2018). A notion that internal control regulation could improve financial reporting reliability has been empirically substantiated by prior studies (Elbannan, 2009; Krishnan et al., 2020).

Empirically, an ineffective internal control can harm reporting reliability (Ashbaugh-Skaife et al., 2008). A study by Hogan and Wilkins (2008), found that firms with weak internal control systems generally have lower quality audits. It has also been demonstrated that less accurate information generated by low-quality controls can result in suboptimal acquisition decisions (Darrough et al., 2018) and low operational efficiency (Cheng et al., 2018). Correspondingly, Zhang et al (2018), asserted that a dynamic disclosure of internal control deficiencies by the management would increases reliance on the company's internal control environment. This would allow the auditor to give a standard audit opinion with a greater likelihood of being given a non-standard audit opinion when the company's internal control is materially deficient (Zhang et al., 2018). However, due to lack of monitoring and weak regulatory enforcement in China, it remains unclear whether C-SOX has been able to improve reporting quality.

As a relatively independent party in the company, internal audit reflects and supervises the work of various departments so that the financial statements can more objectively and truly reflect the operating results of the enterprise, and its impact on the quality of financial reporting cannot be ignored. According to undertake a study on how corporate governance attributes and the quality of internal audit affect the quality of financial reporting by means of a questionnaire among CFOs, senior accountants and internal audit managers in 45 financial institutions in Uganda, Kaawaase et al (2021), discovered a positive link between the quality of internal audit and the quality of financial reporting. Furthermore, applying the German setting, the empirical results shown that high-quality internal audit can contribute to financial reporting quality and audit efficiency in a two-tier system, internal audit plays an important role in financial reporting as the most fundamental element of corporate governance (Gros et al., 2017). Given these arguments, it can be suggested that internal audit ensures the integrity, reliability and objectivity of corporate financial reporting and is instrumental in preventing and correcting fraudulent financial reporting to improve the quality of financial reporting.

In particular, the quality of financial reporting can be improved by optimizing the internal audit system, the internal audit affiliation model and the size of the internal audit. The size and level of internal audit is directly related to the independence of internal audit, indicating that there is an increased supervisory role with a larger size (Gong, 2018). By selecting a sample of A-share listed companies on the Shanghai Stock Exchange, Feng & Lan (2019) revealed that companies whose internal audit departments are affiliated with institutions above the board of directors have lower levels of surplus management than those affiliated with institutions below the board. However, some scholars have put forward different arguments. Previous studies still do not comprehensively consider the setup of the internal audit department, the size of the department, the development of systems and the performance of the internal audit activity, Liu & Huang (2017), indicated that the size, system setup and affiliation of internal audit do not improve the quality of financial reporting.

As the continuous outbreaks of financial fraud disrupt the socio-economic order and indicate weaknesses in the quality of financial reporting, investors' demand for clarity on the quality of financial reporting is on the rise. Based on this background, companies are aware of the need to strengthen internal audit, the effectiveness of internal control and corporate governance, and how to improve the quality of financial reporting is one of the pressing concerns of corporate managers. The objective of this research paper is to explore the relationship between internal audit, internal control effectiveness, corporate governance and financial reporting quality.

Agency Theory

Audit is a monitoring mechanism that helps to reduce information risks in financial statements (Watts & Zimmerman, 1986). Agency theory provides a rich foundation for academics and also provides a useful theoretical framework for the study of the internal audit function (Adams, 1994). Agency theory suggests that there are drawbacks to the owner-operator approach and therefore advocates the separation of ownership from management and the use of a proxy manager to govern the company (Jiang & Wang, 2018b; Ma, 2016). A principal-agent relationship is characterized by the delegation of authority to other individuals and organizations to perform services for oneself through a contract or deed, and the payment of remuneration for the results of those services. According to the increasing development of the enterprise, the interests of the principal are well protected, but the trustee is more interested in gaining its own interests while maximizing its leisure time, which generates the contradiction of the principal- agent in the development process (Lu, 2019; Zhang, 2019).

For the purpose of perfecting the principal-agent system, the auditor joins this contractual relationship as an independent third entity. Compared to the external auditor, the internal auditor has a deeper understanding of the economic operations of the company and the organizational synergy of the various departments, which to some extent ensures the fulfilment of the principal-agent relationship. A well-constructed internal control system in an enterprise can play an effective role in supervising and restraining agents, while in external audits CPAs help their principals to monitor the behaviour of agents from another aspect by strictly and objectively auditing the financial reports of the enterprise and giving them a more reliable understanding of the actual operation of the enterprise (Xiao, 2020).

To sum up, the creation of a principal-agent can cause certain costs while promoting the development of the enterprise. This cost is significantly higher when there is information asymmetry and conflict of interest between the principal and the agent. When the principal does not meet the customized economic objectives of the trustee by pursuing the maximization of its own interests, moral hazard of the trustee will arise; when the agent only pursues its own interests, it will harm the interests of shareholders, which are the two main reasons to aggravate the cost of principal-agent. Therefore, satisfying the objective of maximizing the interests of corporate owners while reducing principal-agent costs is a central issue in contemporary corporate governance.

The Importance of Financial Reporting Quality

A high-quality financial report should provide information for investors, creditors and intended users of financial statements to make relevant decisions (Gong, 2018; Y. Sun, 2019). The quality of financial reporting depends on the quality of the financial statements themselves but is also closely related to the quality of off-balance sheet disclosures and other financial reporting (Gong, 2018). The quality of financial reports, namely, the ability to provide investors with information for rational decision-making, is characterized by comprehensibility, relevance, reliability and comparability (International Accounting Standards Committee (IASC), 1989). Financial accounting

reports should meet the eight characteristics of reliability, relevance, comprehension, comparability, substance over form, importance, caution, and timeliness (China Accounting Standards Committee (CASC), 2014). In recent years, there are abundant researches on the quality of financial report.

Audit Opinion Type

The audit opinion of financial reports issued by accounting firms can provide a more independent and accurate overall assessment of the financial quality of a company than the financial reporting quality evaluation system purchased by the researcher himself, and can be regarded as a better proxy variable for the quality of financial reporting (Guo, 2020). Audit opinion is the final result of auditor's work and the main way of communication between auditor and audit report users (Liu et al., 2021).The interpretation of the audit opinion indicates that certified public accountants (CPAs) have issued opinions on the company's financial statements to certify the financial position and results of operations, verifying the fair release of financial reports (Jinyu Tian & Meijin Xin, 2017).

According to the types of audit opinions, audit reports are classified into standard unqualified opinion audit reports and non-standard unqualified opinion audit reports.
Generally speaking, the issuance of standard audit opinions usually indicates the high quality of financial reports, and investors can rely on financial reports to make investment decisions. In contrast, when a non-standard audit opinion is issued, it usually indicates that the financial report cannot be fully trusted (Lu, 2019). Providing empirical evidence on the 12 indicators that prioritize the quality of financial reporting and examining the causal relationships between them, Himanshu et al (2020), indicated that the auditor's opinion is the most significant indicator of financial reporting quality.

However, some scholars refute this idea. By selecting a sample of companies listed on the Tehran Stock Exchange for the period 2015-2019, Golmohammadi Shuraki et al (2020), uncovered a negative relationship between the quality of financial reporting

and audit opinions. Simultaneously, previous studies have argued that external auditing can only provide reasonable assurance for financial reporting due to its own limitations, Tang (2020), believes that management can influence auditors' decisions in certain ways, such as financial bribery. In this view, it is not accurate to measure the quality of financial reports with audit opinions, because this kind of situation rarely happens and is not representative due to the independence of audit and the constraints of relevant professional ethics.

Internal Audit and Financial Reporting Quality
As a relatively independent party in the company, internal audit reflects and supervises the work of various departments so that the financial statements can more objectively and truly reflect the operating results of the enterprise, and its impact on the quality of financial reporting cannot be ignored. According to undertook a study on how corporate governance attributes and the quality of internal audit affect the quality of financial reporting by means of a questionnaire among CFOs, senior accountants and internal audit managers in 45 financial institutions in Uganda, Kaawaase et al (2021), discovered a positive link between the quality of internal audit and the quality of financial reporting. Furthermore, applying the German setting, the empirical results shown that high-quality internal audit can contribute to financial reporting quality and audit efficiency in a two-tier system, internal audit plays an important role in financial reporting as the most fundamental element of corporate governance (Gros et al., 2017). Given these arguments, it can be suggested that internal audit ensures the integrity, reliability and objectivity of corporate financial reporting and is instrumental in preventing and correcting fraudulent financial reporting to improve the quality of financial reporting.

In particular, the quality of financial reporting can be improved by optimizing the internal audit system, the internal audit affiliation model and the size of the internal audit. The size and level of internal audit is directly related to the independence of

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of the department, the development of systems and the performance of the internal audit activity, Liu & Huang (2017), indicated that the size, system setup and affiliation of internal audit do not improve the quality of financial reporting. Empirically, research has highlighted scientific and effective internal auditing can largely improve the quality of financial reporting and reduce financial information fraud. Therefore, this paper proposes the first hypothesis:
$\boldsymbol{H_1}$**:** Internal Audit is positively related to Financial Reporting Quality.

Internal Control Effectiveness and Financial Reporting Quality

Internal controls, as internal influences, regulate the generation of accounting information and effective internal controls can improve the quality of financial reporting by rectifying governance issues (Lari Dashtbayaz et al., 2019; Lu, 2019). A primary objective of an effective internal control system is the reliability of financial records and reporting, which is essential for the timely provision of accurate financial statements to the authorities and shareholders (Dezan Shira & Associates, 2017). Regulating the internal environment of a company and ensuring that it operates effectively will ensure the reliability of financial reporting (Liu & Wang ,2018). When there is a deficiency in a company's internal control, the remediation of the internal control deficiency will not improve the quality of financial reporting and may lead to a further deterioration (Jiang & Wang , 2018). Angle of view from the type of audit opinionZhang et al (2018), pointed out that active disclosure of internal control

deficiencies by management increases reliance on the company's internal control environment, enabling the auditor to give a standard audit opinion with a greater likelihood of being given a non-standard audit opinion when the company's internal control is materially deficient. Therefore, the second hypothesis is proposed in this paper：

$H2$**:** Internal Control Effectiveness is positively related to Financial Reporting Quality.

Corporate Governance Mechanism and Financial Reporting Quality

The level of corporate governance, on the one hand, is affected by the quality of corporate governance structure, on the other hand, more affected by the quality of

corporate financial reports (Sun, 2019). Corporate governance mechanism plays an effective role in improving the quality of financial reporting (Saime Önce & Gülşen Çavuş, 2019).In the corporate governance mechanism, financial reporting is an important tool to improve the manager's responsibility in the whole process of managing the business, eliminating the cost of agency problems between shareholders and managers (Arieftiara & Utama, 2018).There is evidence that board independence and ownership concentration are the key factors of corporate governance mechanism, and this paper focus on the two factors to explore their impact on the quality of financial reports. Through an empirical study conducted on a sample of 300 non-financial listed companies listed in Malaysia, Rahman et al (2018), observed a positive relationship between independent directors and the quality of financial information reporting. Similarly, board independence, audit committee independence and shareholding structure significantly and positively influence the quality of financial reporting (Alsaadi et al., 2021). Nevertheless, some scholars do not support this view. According to Kaawaase et al (2021), board independence was not a significant predictor of financial reporting quality through implement questionnaire survey in Uganda with CFOs, Senior

Accountants and Internal Audit Managers of financial institutions. Similarly, according to Al-Haddad & Whittington (2019), ownership concentration has a negative impact on the independence of the board, reducing its monitoring capacity and the quality of financial information. Furthermore, Hasan et al (2022), investigate the impact of corporate governance on the quality of financial reporting in the context of Pakistan and the UK between the year of 2009 and 2018, their analysis suggests that board gender diversity and ownership concentration have a negative effect on the quality of financial reporting in UK companies. Therefore, this paper proposes the third hypothesis:

$H3$: Corporate Governance is positively related to Financial Reporting Quality.

Methodology

Data and Sample Selection

In this study, the sample includes 200 manufacturing firms listed on the Shanghai Stock Exchange A- share between 2018 and 2020, making a total sample size of 600. This period was chosen for the survey due to the availability and stability of the data. The data is sourced from the CSMAR database and the WIND database. The CSMAR database is a comprehensive database of Chinese business research covering Chinese stock market data. The resources for the internal control index reports were obtained from the CSMAR database and the information for the annual reports and internal audit reports was obtained from the Wind database. After collecting the data, Excel software was used to sort out the data. Then SPSS Program26.0 was used for descriptive analysis, correlation analysis and binary logistic regression analysis of the original data, and finally the results were extracted according to the statistical reports.

Variable Definition

The dependent variable of this article is the Financial Reporting Quality, which is measured by the type of audit opinions issued by external auditors of Certified Public Accountants (Golmohammadi Shuraki et al., 2020; Guo, 2020; Himanshu et al., 2020; B. Lu, 2020), and this is a dummy variable. For this study, the standard audit opinion is defined as 1, otherwise it is 0. The independent variables are Internal Audit (IA), Internal Control Effectiveness (IC) and Corporate Governance (CG). In this paper, the subordination mode of internal audit department, disclosure of internal audit system and size of internal audit are selected as proxies to measure Internal Audit. A higher value of IA indicates that the Internal Audit of the relevant firm is better (Feng & Lan, 2019; Gong, 2018; Z. Lu, 2019).The Internal Control Effectiveness(IC) is measured by the Internal Control Index (Jiang & Wang, 2018a; Xiao, 2020; Zhang et al., 2018). Corporate Governance (CG) is measured by ownership concentration, which refers to the proportion of shares held by the top five shareholders and board independence, which refers to the proportion of independent directors to the number of directors on the board (Alsaadi et al., 2021; Guo, 2020; Hasan et al., 2022; Rahman et al., 2018).

Next, this paper includes the following control variables: asset-liability ratio, return on assets, operating income growth rate and company size. Asset-liability ratio is the percentage of total liabilities divided by total assets at the end of the period (Lari Dashtbayaz et al., 2019; Z. Lu, 2019). Return on assets is calculated as the ratio of net profit to total assets at the end of the period (Lari Dashtbayaz et al., 2019; Y. Sun, 2019; Zhong & Deng, 2018). The operating income growth rate is the ratio of the increase in operating income of the enterprise in the current year to the total operating income of the previous year (Z. Lu, 2019; Y. Sun, 2019; Zhong & Deng, 2018). Finally, company size is measured by the natural logarithm of total assets at the end of the year (Z. Lu, 2019; Rahman et al., 2018; Rakhman & Wijayana, 2019). Refer to the appendix for a description of the variables.

Empirical Model

According to the above selection and definition of variables, in order to verify the impact of internal audit, effectiveness of internal control and corporate governance on the quality of financial reporting of Listed manufacturing companies in China, this paper puts forward three research hypotheses. Due to the dependent variable is essentially a dichotomous variable, therefore the established logistic regression model is as follows:

$$\ln(p/1-p) = \beta_0 + \beta_1 IA + \beta_2 IC + \beta_3 CG + \beta_4 LEV + \beta_5 ROA + \beta_6 GROWTH + \beta_7 SIZE + \varepsilon$$

The dependent variable of this Model is Financial Reporting Quality (Audit Type). For this model, *p* represents the probability that Audit Opinion Type is 1, and 1-*p* represents the probability that Audit Opinion Type is 0. The independent variable is Internal Audit (IA), Internal Control Effectiveness (IC) and Corporate Governance (CG). In this model, asset-liability ratio (Lev), return on total assets (ROA), growth of operating income (GROWTH) and size of company (SIZE) are control variables， β_0 represents the intercept term， β represents the coefficient of each variable， ε is the residual term.

Results and Discussion

Descriptive Analysis

Table 1
Descriptive Statistics

Variables	N	Minimum	Maximum	Mean	Std. Deviation
Audit Opinion Type	600	0.00	1.00	0.79	0.41
IA-Regulation	600	0.00	1.00	0.92	0.28
IA-Model	600	0.00	5.00	2.54	0.99
IA-Size	600	1.00	5.00	3.67	1.29
IA	600	2.00	11.00	7.13	1.92
IC	600	0.00	1.00	0.84	0.37
Top5	600	14.59	92.79	52.94	15.26
Ind	600	22.22	66.67	37.36	6.21
CG	600	47.92	136.09	90.30	16.33
Lev	600	0.84	135.70	47.18	20.86
ROA	600	-112.50	29.79	1.81	11.40
Growth	600	-97.02	2220.50	10.95	118.77
Size	600	17.65	27.55	22.71	1.45

This table presents the descriptive statistics of the variables. The descriptive statistics consist mainly of maximum values, minimum values, mean values and standard deviations. The variation in the relevant data can be seen through Table 1. The analysis shows that the mean value for the type of audit opinion in the sample is 0.79, indicating that 79% of the listed manufacturing companies in China were able to be issued a standard audit opinion and 21% had problems, which indicates a better quality of financial reporting by listed manufacturing companies in China. For internal audit, the mean value of IA- Regulation is 0.92, reflecting a good disclosure of internal audit systems and revealing that most listed companies in the manufacturing sector have standardized and regulated internal audit systems.

The mean value of the Internal Audit Affiliation Model was 2.54, close to 3, pointing that the general affiliation model used by the listed companies in the selected sample was the supervisory board. The mean value of the Size of the Internal Audit Department is 3.67, pointing out that the overall number of internal auditors in the sample is stable at 3-5, meeting the minimum standard set by the regulator for the number of internal auditors in listed companies, which should not be less than 3. The above three indicators constitute the overall level of Internal Audit, and the mean value of internal audit is 7.13, demonstrating a medium to high level of internal audit in listed companies in the manufacturing sector.

Meanwhile, the mean value of IC is 0.84, representing that the company's overall internal control is in good condition. The mean value of Corporate Governance is 90.3%, which is the overall level composed of TOP5 and IND. The mean value of LEV is 47.18%, which is lower than 50%, illustrating that listed manufacturing companies are more solvent, and the appropriate level of LEV is generally considered to be 40-60%. The average value of ROA is only 1.81%. Finally, the average values of GROWTH and SIZE are 10.95% and 22.71% respectively.

Pearson Correlation Analysis

Table 2
Correlation Matrix

	Audit Opinion Type	IA-Regulation	IA-Size	IA	IC	Top5	Ind	CG	Lev	Roa	Growth	Size
Audit Opinion Type	1											
IA-Regulation	0.270**	1										
IA-Model	0.187**	0.157**										
IA-Size	0.146**	0.274**	1									
IA	0.235**	0.411**	0.846**	1								
IC	0.487**	0.266*	0.12	0.18	1							

		*	8**	7**								
Top5	0.196**	0.123**	0.241**	0.234**	0.211**	1						
Ind	-0.071	-0.034	0.017	-0.289**	0.059	-0.026	1					
CG	0.157**	0.102*	0.231**	0.109**	0.220**	0.925**	0.356**	1				
Lev	-0.128**	-0.210**	0.141**	0.105**	-0.066	-0.026	0.012	-0.019	1			
ROA	0.203**	0.481**	0.222**	0.253**	0.181**	0.184**	0.028	0.182**	-0.265**	1		
Growth	-0.099*	-0.118**	-0.111**	-0.139**	-0.105*	0.034	0.06	0.055	0.065	0.038	1	
Size	0.174**	0.274**	0.703**	0.668**	0.213**	0.414**	-0.029	0.376**	0.245**	0.205**	-0.120**	1

** Correlation is significant at the 0.01 level (2-tailed).
* Correlation is significant at the 0.05 level (2-tailed).

shows the results of the Pearson correlation coefficient test between the variables, which indicates whether and to what extent the variables are correlated. It is generally believed that multicollinearity between variables will affect the accuracy of empirical results. The criterion for judging multicollinearity is whether the correlation coefficient between variables exceeds 0.8. As can be seen from Table 2, the correlation coefficients between variables are all below 0.8, indicating that there is no problem with the empirical data in this paper and the choice of variables is reasonable.

Firstly, the table shows that there is a correlation between Internal Audit (IA) and Financial Reporting Quality (Audit Opinion Type) (p=0.235), which is positive at 1% confidence level. Meanwhile, all three indicators, IA-Regulation, IA-Model and IA-Size, are positively correlated with Financial Reporting Quality. The preliminary validation of H1: There is a positive relationship between Internal Audit and Financial Reporting Quality. Secondly, there is a correlation between Internal Control Effectiveness (IC) and Financial Reporting Quality (Audit Opinion Type) (p= 0.487), which is positive and significant at 1% confidence level, tentatively confirming H2: There is a positive relationship between Internal Control Effectiveness and Financial Reporting Quality. Finally, table 2 reveals that there is a correlation between Corporate Governance (CG) and Financial Reporting Quality (Audit Opinion Type) (p=0.157), which is positive at 1% confidence level, tentatively confirming this paper's H3: There is a positive relationship between Corporate Governance and Financial Reporting Quality. Where the measure of CG, TOP5, is positively correlated with Financial Reporting Quality, however there is no correlation between IND and Financial Reporting Quality.

Turning to the control variables, it is clear that there is a significant relationship between Financial Reporting Quality (Audit Opinion Type) and LEV, ROA, GROWTH and SIZE respectively. In particular, LEV is negatively correlated with Financial Reporting Quality at 1% confidence level, indicating that the greater the financial leverage, the greater the pressure to repay debts, forcing operators to falsify their financial statements and affecting the quality of financial reporting. In addition, this paper reveals that there is a positive and significant relationship between ROA and Financial Reporting Quality, demonstrating that the better the profitability of a company, the higher the quality of financial reporting. The quality of financial reporting is improved by a better internal governance structure, better internal audit and internal controls. Through the correlation analysis, the conclusion is initially consistent with the research hypothesis proposed in this paper, but it still needs to be verified by binary logistic regression analysis.

Binary Logistic Regression Analysis
As the dependent variable Financial Reporting Quality (Audit Opinion Type) isa dichotomous variable and its value code is 0 and 1, this paper uses binary logistic regression to analyse the research hypothesis. Hosmer-Lemeshow fit test is used to analyse the goodness of fit of the model.

Table 3
Hosmer and Lemeshow Test

Chi-square	df	Prob.
15.268	8	0.054

It can be seen from Table 3 that: The fit value of the model is consistent with the observed value; *p* value>0.05(Chi=15.268, *p*=0.054>0.05), Therefore, it indicates that the original hypothesis is accepted, which means that the model has passed the HL (Hosmer and Lemeshow) test, and the model has a good goodness of fit.

Table 4
Results of Binary Logistic Regression analysis

Variable	B	S.E.	Z value	Wald χ^2	Prob.	Exp(B)	95% CI for Exp(B)
IA	0.384	0.125	3.078	9.474	0.002	1.468	1.150 ~ 1.874
IC	5.162	0.545	9.462	89.539	0.000	174.426	59.883 ~ 508.061
CG	0.026	0.012	2.125	4.517	0.034	1.027	1.002 ~ 1.052
Lev	-0.019	0.008	-2.271	5.155	0.023	0.981	0.965 ~ 0.997
ROA	0.013	0.011	1.136	1.29	0.256	1.013	0.991 ~ 1.036
Growth	-0.005	0.003	-1.549	2.399	0.121	0.995	0.988 ~ 1.001
Size	-0.143	0.182	-0.784	0.615	0.433	0.867	0.606 ~ 1.239
Constant	-3.248	3.17	-1.025	1.05	0.306	0.039	0.000 ~ 19.396

Dependent variable: Audit Opinion Type
McFadden R-squared: 0.496
Cox & Snell R-squared：0.352
Nagelkerke R-squared：0.604

Table 4 provides the analysis results of binary logistic regression on the model. As expected, IA has a significant positive impact on Financial Reporting Quality (Audit Opinion Type). The B value of IA is 0.384 and shows a significance at 0.01 level (*z*=3.078, *p*=0.002<0.01). Exp(B) value is 1.468, indicating that when IA increases by one unit, the Audit Opinion Type changes by 1.468 times. The result supports the first hypothesis (H1). This finding is consistent with Ehiedu & Toria, (2022); Feng & Lan, (2019); Gong, (2018). Furthermore, the B value of IC is 5.162, showing a significance level of 0.01(*z*=9.462, *p*=0.000<0.01). There is a significant positive relationship between IC and Financial Reporting Quality (Audit Opinion Type). And Exp(B) value is 174.426, meaning that when IC increases by one unit, the Audit Opinion Type increases by 174.426 times. The second hypothesis (H2) is verified. The result supports Lari Dashtbayaz et al., (2019) ; Z. Lu, (2019) that the effective internal control can improve the quality of financial reporting and correct governance problems.
Moreover, CG has a significant positive impact on Financial Reporting Quality (Audit

Opinion Type). The results support the third hypothesis (H3). The B value of CG was 0.026 and showed significance at the level of 0.05 (*z*=2.125, *p*=0.034<0.05). Exp(B) value is 1.027, demonstrating that the Audit Opinion Type increases 1.027 times when CG increases by one unit. This finding therefore supports previous research Guo, (2020); Rahman et al., (2018); Saime Önce & Gülşen Çavuş, (2019); Sun (2019), that confirms the positive relationship between corporate governance mechanism and the quality of financial reports. Nevertheless, this finding is in contrast with the findings of Al-Haddad & Whittington, (2019); Hasan et al., (2022), that they found a significant negative relationship in this context. Finally, for the control variables, the B value of LEV is -0.019 and presents significance at the level of 0.05 (z=-2.271, p=0.023<0.05). It implies that LEV has a significant negative influence on Financial Reporting Quality (Audit Opinion Type). Exp(B) value is 0.981, indicating that when LEV increases by one unit, the Audit Opinion Type decreases by 0.981 times. The B value of ROA is 0.013, but it does not show any significance (z=1.13, p=0.256>0.05). Showing that ROA does not affect the Financial Reporting Quality. In addition, the B value of Growth is -0.005, however it does not show any significance (z=-1.549, p=0.121>0.05), which means that Growth will not affect the Financial Reporting Quality. This is inconsistent with the original expected results, and the regression results may deviate due to the influence of the company's development cycle. At last, the B value of Size is -0.143, and it does not show significance (z=-0.784, p =0.433>0.05), which means size does not have an effect on Financial Reporting Quality.

In general, this study empirically demonstrates that Internal Audit, Internal Control Effectiveness and Corporate Governance have a significant positive effect on Financial Reporting Quality (Audit Opinion Type), and LEV has a significant negative effect on Financial Reporting Quality. However, for another three control variables, ROA, Growth and Size did not have an effect on Financial Reporting Quality respectively in the manufacturing listed companies of China.

Conclusion

Based on Agency theory and Information Asymmetry theory, this paper aims to investigate the effectiveness of internal audit, internal control, and corporate governance towards the financial reporting quality among listed manufacturing firms in China. By using the data of financial statements, audit opinions of financial reports and internal control index, 200 listed companies in Shanghai Stock Exchange from 2018 to 2020 are selected, with A total of 600 samples. This paper also verifies the three research hypotheses proposed above. This empirical study shows that Internal Audit, Internal Control Effectiveness and Corporate Governance positively affect the Quality of Financial Reporting. Specifically, the disclosure system of internal audit, the subordination mode of internal audit, the size of internal audit department, effective internal control, and the improvement of corporate governance are related to the level of higher financial report quality.

The research of this article has certain theoretical and practical significance. From the theoretical point of view, financial report is a means to demonstrate the company's operating results, and the owner realizes the purpose of supervising the operator's operating activities through financial report. At the same time, the quality of financial reports is closely related to the economic interests of external investors, the existence of internal audit effectively solves the problems caused by information asymmetry. However, there are few literatures on the relationship between internal audit, effectiveness of internal control, corporate governance and the quality of financial reporting in China. Most studies focus on a single analysis, and few combine them together. The research findings of this paper fill up the gap to some extent. From the perspective of practical significance, this study could help external financial report users to provide reference to make a correct judgment, and help owners to strengthen the construction of internal control system. To strengthen corporate governance, effectively play the role of internal control and supervision, safeguard the safety of enterprise property and resources, and suppress financial fraud, so as to provide high-quality financial reports and a healthy and stable environment for enterprises.

In addition, there are some limitations in this study. First of all, the data used in this paper are manually collated from CSMAR Database, WIND Database and the information disclosed by Shanghai Stock Exchange, which is difficult to obtain. Therefore, only the data of a total of three years from 2018 to 2020 are selected for the study. Secondly, subordination mode of internal audit, disclosure of internal audit system and size of internal audit department are subjectively quantified. Other factors affecting internal audit are not considered, and personal subjective judgment and analysis are involved, which affects the objectivity of data to a certain extent. Thirdly, the selection of control variables is insufficient. There are many factors that affect the quality of financial reports. In this paper, LEV, ROA, GROWTH and SIZE are only selected as control variables, and some other control variables that have a significant impact on the quality of financial reports may be ignored.

Therefore, based on these limitations, this paper puts forward the following suggestions for future research. First of all, in view of the problem of insufficient sample size, the sample size should be expanded, the time span should be increased, and the influence of the relationship between independent variables and dependent variables in a longer period of time should be studied to increase the credibility of the study. Secondly, there is no unified standard for substitute indicators of internal audit. It generally includes the independence of internal audit, the professional ability of internal audit personnel, the disclosure of internal audit system, the scope of internal audit work, and the education background of internal audit department personnel as substitute indicators. Future research can use factor analysis method to determine the most representative alternative indicators to measure internal audit according to the weight. At the same time, for the quality of financial reports, this paper takes audit opinion as a substitute indicator, and other variables can be selected as a substitute indicator for analysis. Furthermore, this research suggests that future studies can add control variables and refer to more research to investigate factors affecting the quality of financial reports, so as to avoid the impact of insufficient control variables on research results.

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