

A PRELIMINARY STUDY ON THE IMPORTANCE OF INTERNAL CONTROL INFORMATION IN CORPORATE REPORTING

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Abstract—This study aims to analyze financial statement users' perception of internal control information in annual reports of Indonesian corporations. This subject needs to be investigated because presently, there are no standards or rules for the presentation of internal control disclosure in annual reports. As the extent of information disclosure may influence financing and/or investment decisions of stakeholders, we believe that it is necessary to consider the possibility of creating a guide for presenting internal control information in company annual reports. Based on our analysis, we find that internal control system presentation/disclosure has to be improved; more detailed to meet the needs of users. Findings in this preliminary investigation will be further explored in our future studies.

Keywords—Internal control, format, content, information, disclosure.

I. INTRODUCTION

Internal control system is a process of developing and implementing policies which affects everyone within the company. The main purpose of internal control implementation is to ensure the protection of company assets and to provide certainty about (1) the effectiveness and efficiency of company operations, (2) reliability of financial reporting, and (3) compliance with applicable laws and regulations. An effective internal control enables the generation of reliable financial reports, thereby reducing the risk of material misstatements and fraud. However, the state and condition of internal control is in fact, confidential. Stakeholders would find it difficult to assess the quality of a company's internal if not properly disclosed in its annual report.

Presently, internal control disclosure of Indonesian public companies can be found in their annual reports, specifically the sections of Management's Responsibility for Financial Reporting and Management Assessment of Internal Controls. Generally, internal control information is not disclosed

in a detailed and transparent manner. The fact is that investors rely heavily on this information, particularly the design and the implementation practices of a company's internal control (Deumes & Knechel, 2008). Deumes and Knechel (2008) argue for the need of internal control disclosure; stating its importance for public companies. This is in the best interests of investors and capital market regulators because such disclosure will assure stakeholders of the reliability of a company's financial information.

Based on our given introduction, the purpose of this study is to analyze financial statement users' perceptions of internal control reporting format and content in company annual reports. As conditions of internal control influence the quality of corporate financial reporting (O'Reilly-Allen & McMullen, 2002; Doyle, Ge, & Mcvay, 2007; Hoitash, Hoitash, & Bedard, 2009; Rice & Weber, 2012), we will assess the ideal format of internal control disclosure and the type of information that suit the needs of financial statement users, particularly those that relate to investing and financing decisions.

II. LITERATURE REVIEW

Previous studies indicate contrasting findings about the importance of internal control disclosure in management reporting, which are associated with costs incurred by companies. The fall of Enron, however, has emphasized the need for companies to include internal control disclosure in their reporting. Prior to the Enron incident, there had been studies on the importance of internal control disclosure. For example, Hermanson (2000) analyzed specific reporting requirements of companies' internal controls from perspectives of various report users. His research shows that financial statement users agree on the importance of internal control and that voluntary management reporting enhances control activities and provides additional information for decision-making. It also offers a better indicator for a company's going-concern. Nevertheless, there can also be differences in perceptions between executives, shareholders, and internal auditors when it comes internal control

disclosure, although O'Reilly-Allen and McMullen (2002) found that there are no differences between user groups about the usefulness and reliability of the report.

Other studies (Costello & Wittenberg Moerman, 2010; Kim, Song, & Zhang, 2011; Schneider & Church, 2008) reveal that internal control disclosure influences the decision-making of creditors. They tend not to finance companies with weak internal control. More studies also show the disclosure's effect on investment decisions (De Franco, Guan, & Lu, 2005; Hammersley, Myers, & Shakespeare, 2008; Lopez, Vandervelde, & Wu, 2009; Rose, Norman, & Rose, 2010; Shelton & Whittington, 2008). Effective internal control leads to a higher quality of financial statements, which attracts investors. On the other hand, Schneider (2009) found that internal control disclosure does not significantly influence investment decisions.

Our study was motivated by previous research findings (Hermanson, 2000; O'Reilly-Allen & McMullen, 2002). What distinguishes this study from preceding ones is that the information we assess are extracted from annual reports. Additionally, our respondents are made up of financial statement users, comprising investment analysts.

For some time, there have been arguments about the costs of benefits of internal control disclosure in financial reporting. If we consider this issue from the perspective of agency relationship and information asymmetry theory, then internal control information needs to be disclosed. Many factors determine the ways and content of the disclosure in annual reports. Our study is also stimulated by the differences between the views of the company which generates the report and the stakeholders which use it. This relates to the readability and reliability of the reporting on the conditions of a company's internal control (Foster, Gist, McClain, & Shastri, 2005; Gist, McClain, & Shastri, 2004). Therefore, one could make a case for a reporting standard for the internal control disclosure, so that users would be able to read and utilize the information accordingly (Gist et al., 2004).

III. METHODS

Our exploratory research gathers evidence about the format, usefulness, and reliability of internal control disclosure in annual reports of Indonesian public companies. The research is conducted in two stages. In the first stage, we collect data from investment analysts and credit analysts, representing external users of financial statements. Meanwhile in the second stage, data would be collected from internal auditors and accountants, representing the public companies. This preliminary study comprises the first stage and findings from this investigation will be explored further in the second stage (upcoming studies).

Our data are intended to describe the perception of users regarding the presentation of internal control information in company reporting: what needs to be included and in what manner? We direct the following questions to our respondents: (1) Do you read and review internal control information in the annual report? (2) What is the purpose of the internal control information? (3) Does the provided information meet your needs? (4) What details have not yet been informed regarding the company's internal control? (5) In what cases do you feel that your needs are met/fulfilled (6) How many pages in annual reports should be dedicated to internal control disclosure? and (7) What specific information about a company's internal control that you require for your decision-making purposes? The responses, which are gathered via email, are analyzed descriptively to give an overview of the users' preference on internal control disclosure by companies.

IV. RESULTS AND DISCUSSION

Data collection was conducted throughout the month of April 2019. We gathered responses from thirty-six financial analysts; fifteen of them women. The majority of them were highly-educated: sixty-one percent possessed bachelor's degree, twenty-seven percent had master's degree, and two percent held doctorate degree. Meanwhile forty-seven percent of them had fewer than five years of work experience.

A. The Presentation of Internal Control Information in Annual Reports

The average number of pages for the presentation of internal control information in annual reports, as suggested by the respondents, is as many as three pages. Sixty-nine percent (or twenty-five out of thirty-six respondents) were found not to utilize internal control information in their work.

B. The Purpose of Internal Control Information

Respondents have a varied use for the available internal control information: (1) As a factor which influences lending decisions, (2) To understand the company's oversight practices; whether they increase the reliability of financial reporting and mitigate risks of fraud. (3) As a part of standard procedure for credit or investment decisions. (4) To be aware of (and avoid) the possible investment and financing risks.

C. The Usefulness of Internal Control Information

Presentations of internal control information by companies were considered by the majority of respondents (fifty-six percent) to be satisfactory or meeting their needs. Meanwhile twenty-two percent of the respondents claimed that the information did not meet their needs, and eleven percent found that the information was merely sufficient.

The following needs to be considered/included by companies in disclosing internal control information, based on the preference of users:

1. The company has yet to provide information on internal control in a concrete and standardized format.
2. Companies need to score their internal control implementation. This review is needed to assess whether the company consistently improves their control procedures.
3. Effectiveness of the internal control has to be presented.
4. How the internal control prevents risks arising from new line of businesses.
5. Good corporate governance practices.
6. The clear authority and responsibilities of heads of divisions.
7. Standard Operating Procedure.
8. The current political and economic climate.
9. Scope of control.
10. Frauds that occur.
11. The number of procedures that have been conducted.
12. The internal control for the management information systems.
13. Internal control findings and plans of action to reduce the risks of ineffectiveness and inefficiencies of internal control procedures.
14. Methodology for testing internal controls.
15. Implementation of the latest COSO guide on ERM (Committee of Sponsoring Organizations of the Treadway Commission Enterprise Risk Management).
3. The structure and elements of the internal control, as well as the control environment, control procedures, and changes in policies.
4. How to identify and monitor arising problems.
5. Self-assessment (scoring) for the internal control implementation.
6. Financial and operational controls; whether cash control is adequate for companies with considerable cash flows.
7. Effective and consistent reporting for every audit finding and fraud.
8. Well-defined standards and criteria for assessing the control regulations that a company must possess.
9. Standard Operating Procedure.
10. Management activities and future plans and strategies.
11. Company's operating performance.
12. Evaluation of the internal control's effectiveness and shortages.
13. Segregation of duties within management and divisions.
14. Restricted access to highly-confidential data.
15. Clear organizational structure; authority and division of tasks.
16. Profile of board members.
17. The financial reporting's conformity with generally accepted standards (PSAK/Indonesian Financial Accounting Standards, or COSO).
18. Impacts of implementing an internal control system.
19. The need for a periodic preventive maintenance.
20. The job description and scope of work for internal auditors.
21. Methodology for testing internal controls.
22. Actual and potential control deficiencies, control risks, and an estimation of financial impact from internal control weaknesses.

Even though the current presentation has not satisfied all users, the following internal control information had been provided by companies:

1. The board members' understanding of the importance of internal control.
2. The organization of periodical audits.
3. General description of internal control.
4. Risk assessment and identification.
5. Compliance with laws and regulations.
6. Internal control objectives, conformity, and evaluations, along with management responsibilities.
7. Whistleblowing system.
8. Profile of board members (directors and commissioners) and audit committee, as well as the frequency of board meetings.
9. General procedures for internal control systems and policies.
10. The assigned team of internal auditors and their practices, which are in accordance with regulations.

Furthermore, the following is the list of information which users need about companies' internal controls:

1. Corporate internal control policies and procedures.
2. Complete description of internal control implementation throughout the company.

Based on the summarized responses, we can conclude that financial statement users generally utilize internal control information system for various decision-making, including investing and financing decisions. The extensiveness of the information determines the reliability and effectiveness of corporate financial reporting; whether we can put our trust in it. However, there are some information that have yet to be disclosed in the annual reports. For instance, findings of control weaknesses and fraud occurrences are of interest to stakeholders; therefore, it should be included to mitigate certain financial and investment risks.

Our findings correspond to previous empirical studies on the influence of internal control disclosure on the decision-making of creditors and investors (Costello & Wittenberg Moerman, 2010; De Franco et al., 2005; Hammersley et al., 2008; Kim et al., 2011; Lopez et al., 2009; Rose et al., 2010; Schneider &

Church, 2008; Shelton & Whittington, 2008). The stakeholders, specifically the external users of company annual reports, require internal control disclosure by the investees. Only good internal control system can generate reliable financial reports.

V. CONCLUSION

In summary, we find that the current presentation of companies' internal control information in annual reports has been adequate. However, a portion of the respondents feel that there is room for improvement; there are a number of information which have yet to be included by the investees are needed by financial statement users for investment and financing decision-making process.

On the presentation format, the respondents agree that internal control disclosure should be three pages long, containing full and detailed description of the internal control system, its objectives, and implementation. Other information include: (1) How the company implements standard procedures for identifying, anticipating, and solving internal control issues, (2) How the company evaluates and corrects internal control weaknesses, (3) Profile of board members: top executives, commissioners, and audit committee, (4) The effectiveness and self-assessment of the internal control implementation, and (5) The company's compliance with accounting standards, e.g. PSAK and COSO.

There are also a small number of respondents who do not utilize internal control information because their work relies more on quantitative analysis. They measure investment or financing feasibility from financial performance and information on corporate governance practices, which also reflects a company's internal control.

This has been a preliminary study and our findings will be further explored. We will follow up by confirming the results of the study with two parties: (i) Accountants, which represent financial statement preparer, and (ii) Internal and external auditors, which represent financial statement examiners. Finally, more studies also need to be conducted through focus group discussions to obtain a deeper and more comprehensive understanding of the usefulness of internal control information and how to present them to best aid the decision-making of stakeholders.

ACKNOWLEDGEMENT

We would like to express our utmost gratitude to the Directorate General of Research and Development of the Ministry of Research, Technology, and Higher Education for funding this research through the "Penelitian Dasar Unggulan Perguruan Tinggi" 2019 scheme. (Direktorat Jenderal Penguatan Riset dan Pengembangan, Kementerian Riset, Teknologi, dan Pendidikan Tinggi).

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