Literature Study Of Determinants Of Internal Control Disclosure

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ABSTRACT

Effective internal control is essential in ensuring the quality of financial reporting, preventing business risks, and also achieving sustainable development. The purpose of this research is to examine the determinants of Internal Control Disclosure (ICD) used in research and its effect on firm value. The factors tested in this study are the number of commissioners, the proportion of independent commissioners, board of commissioners meetings, size of the audit committee, and audit committee meetings. This research was conducted using content analysis from the annual reports of manufacturing companies in Indonesia from 2012-2016. The results of the study found that the size of the board of commissioners, the proportion of independent commissioners, the board of commissioners' meetings, and the size of the audit committee have a positive effect on the extent of ICS disclosure. Furthermore, ICS disclosure has been shown to increase firm value. Another finding is that audit committee meetings have a negative effect on the extent of ICS disclosure. Disclosure of ICS is proven to be used as a monitoring mechanism used by stakeholders in making decisions regarding the company.

Keywords: net interest margin, loan to deposit ratio, transaction cost

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INTRODUCTION

TCorporate governance refers to the way a company is managed and can be described as a system by which a company is directed and controlled. The main issue in governance relates to how the company complies with the rules and principles of governance itself, one of which is transparency. A company should be managed in the best interests of its stakeholders, especially shareholders. According to Agyeman (2013), companies with good governance practices will offer important information to shareholders and other stakeholders, thereby reducing the information asymmetry that occurs due to the principal-agent relationship.

They argue that a company's ability to attract potential investors depends on how effective its corporate governance practices are. Investors need to be given assurance that they are investing in a credible company that will protect their interests and ultimately provide investors with the returns they expect (Agyei-Mensah, 2016). Corporate governance (GC) can be understood as the structures and processes by which a company can be directed and controlled (IFC, 2018) in accordance with the interests of its shareholders and stakeholders. Therefore, the company's ability to attract potential investors is determined by the extent to which the company can implement CG effectively, or in other words, can provide assurance to the investor audience that their investment will be safe and profitable (Agyei-Mensah, 2016).

Important issues of CG include how companies comply with the rules and follow the principles of good governance, including the principle of transparency. Companies that implement CG and provide the same information to both shareholders and other stakeholders mean that the company is trying to minimize asymmetry and in turn will reduce moral hazard and adverse selection behavior.

From an agency theory perspective, transparency through internal control disclosure and board monitoring can reduce agency cost problems and information asymmetry in the market. This means that efforts to attract direct investment are highly dependent on the transparency of corporate IC information disclosure. Elliot & Elliot (2017) argue that good governance is characterised by transparent disclosure to shareholders and regulators about the nature, extent and management of risks.

One of the sub-systems of governance is internal control, which are several control elements designed to ensure the achievement of organisational objectives. As part of the internal managerial mechanism, IC activities cannot be accessed directly by investors. That is why the disclosure of information about IC then becomes important, namely to help shareholders or investors assess the ability of management and at the same time protect existing resources from losses.

The topic of IC attracted more attention when the Enron case emerged, which was then responded to by the issuance of the Sarbanes Oxley Act (SOX) by the US Parliament in 2002 (Ashfaq & Rui, 2019). With the enactment of the Act, the disclosure of internal control information in the United States changed from voluntary to mandatory (Xiaowen, 2012).

The law at least stipulates that, first, auditors must be able to access IC through the company's financial statements, and second, the company must

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publish an internal control reporting statement to determine whether the IC system is effective. These two requirements are the characteristics of the rule-based approach to internal control, which can be contrasted with another approach that is more "loose", namely the principle-based approach to internal control. In the first approach, internal control is seen from a broader perspective, covering strategic, operational and compliance risks in addition to financial statement risks. In contrast, in the second approach, the issue of internal control disclosure is only seen from the perspective of financial statements (narrow perspective).

The important position and role of ICS has received a lot of attention from several studies, including by linking it to management decisions in terms of quality and earnings management (Chalmers, Hay, & Khlif, 2019; Khlif, Samaha, & Amara, 2020). Transparency through disclosure of internal control information and oversight of the board of directors also plays an important role in reducing agency costs and information asymmetry problems that occur in the market.

Furthermore, Ashbaugh-Skaif, et al. (2009) found that the market reacts negatively to information that shows internal control weaknesses. Disclosure of information on internal control is an important channel for investors to obtain accounting information from the company. The quality of the company's internal control disclosure also determines whether or not it is appropriate to invest in the company and affects the efficiency of resource allocation and information asymmetry in the capital market (Ying, 2016).

Ying (2016) further reveals that both theoretically and in practice, the implementation of ICS is proven to prevent errors and irregularities that occur quickly. Thus ICS will improve the reliability and quality of accounting information reporting and reduce the weakness of the company's control procedures. Then ICS will also provide a positive signal that quality corporate financial statements can reduce financial costs. That is, information asymmetry between management and shareholders that can lead to moral hazard and adverse selection behaviour can be reduced.

Shareholders and prospective shareholders will use the company's annual report to evaluate the investment potential of the company's shares, creditors and lenders use it to assess creditworthiness and liquidity, while the government uses it to regulate corporate law. Meanwhile, according to Deumes (2004), internal control reporting will improve the quality of financial reporting and reduce governance issues (Agyei-Mensah, 2016). Effective internal control is essential in ensuring the quality of financial reporting, preventing business risks, and also achieving sustainable progress. Meanwhile, Elliot & Elliot (2017) state that one of the important aspects of providing complete and reliable information that is taken seriously by the financial community is the availability of a rigid set of internal controls.

In recent years, a series of accounting scandals that have occurred at home and abroad have attracted the attention of national regulators to how to establish effective internal control. The collapse of Enron was entirely due to malpractices in the company's internal control system by the authorities and the formalisation of internal control information disclosure. Therefore, when a company experiences bankruptcy, it must be suspected that the cause is an ineffective

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internal control system (Agyei-Mensah, 2016). When from a theoretical perspective and empirical evidence generally agree on how important the position and role of ICD is, but the discussion of the determinants of why companies are willing to disclose IC, it seems that there is still no unanimous agreement among researchers and even tends to be inconsistent.

That ICD is a decision output agreed by the main actors of a governance system (board of directors, shareholders & management), there seems to be no significant difference of opinion among researchers. However, when the governance environment is reduced or translated into operational indicators, disagreements and research results begin to emerge. Therefore, research on the validity and reliability of ICD indicators is still important and relevant to do.

This research aims to describe and map some of the ICD determinants most often used by research along with the logical and empirical arguments that support the

m. The results of this study are expected to be used as an alternative reference for studies aimed at developing factors that determine ICD.

THEORETICAL STUDIES

Agency theory underlies the conceptual framework for the relationship between governance and internal control disclosure. According to agency theory, firms with high agency costs will seek to reduce these costs by increasing the breadth of corporate disclosure and by using more intensive monitoring tools. Jensen & Meckling (1976) argue that the separation of ownership and control will create agency problems, where management, as rational human beings, have a tendency to put personal interests before the interests of shareholders. This agency problem leads to information asymmetry caused by the excess information possessed by management as an "insider" of the company. Jensen & Meckeling (1976) and Hossan, et al (1995) also argue that agency theory may be an explanation of why companies disclose internal controls. Disclosure and transparency are functions of the corporate governance structure, and managers' attitudes towards disclosure behaviour may change depending on the trade-off between costs and benefits. Mitton (2002) found that stock performance is associated with firms that have high quality disclosures that are part of good governance.

Based on signalling theory, corporate reporting can be said to be the desire of management to disclose its good performance, with the aim of improving management's reputation and the company's position in the market. Good reporting, including disclosure of internal controls, is considered as one of the good performances of management (Agyei-Mensah, 2016). Signalling is a reaction to information asymmetry in the market, due to ownership of company information (private information) that is not owned by investors. Management of companies that have good performance tries to distinguish their companies from companies that have low performance by providing more information to outsiders.

Internal control disclosure is a measure in understanding the effectiveness of the management organisation and its implementation regarding the achievement of company objectives. In 1978, the Cohen Commission (Commission on Auditors' Responsibilities) required that management should

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assess the internal control system. In 1992, COSO (The Committee of Sponsoring Organizations of the National Commission of Fraudulent Financial Reporting) issued the Integrated Internal Control Framework, which provides a more comprehensive internal control framework.

Internal control disclosure changed from voluntary to mandatory, after the Sarbanes-Oxley Act was passed and implemented in July 2002. In 2006, the Shanghai Stock Exchange (SSE) and Shenzhen Stock Exchange (SZSE) issued the Control Guidelines for Listed Companies on the Shanghai Stock Exchange and the Internal Control Guidelines for Listed Companies on the Shenzhen Stock Exchange, which are legal norms that Chinese listed companies must disclose internal controls from voluntary to mandatory (Leng & Ding, 2011).

In Indonesia, OJK, which was originally BAPEPAM, is the institution that regulates corporate disclosure. Based on Bapepam Chairman Decree Kep-431/BL/2012, the Internal Control System is one of the instruments that must be disclosed by the company. Likewise, in the Circular Letter of the Financial Services Authority Number 30/SEOJK.04/2016 in section III Report Content point g.8 requires that issuers must report a description of internal control. However, this reporting obligation is not accompanied by complete instruments that must be included in it. So that Setiawan, et al (2016) said, that the disclosure of internal control is mandatory, but the details of the contents of the SPI are not specifically regulated so that the depth and breadth of disclosure are voluntary.

RESEARCH METHODS

This research uses a descriptive method that reveals and describes the determinants of internal control disclosure (ICD) based on several research results. The author selected 10 articles related to the topic of internal control disclosure (ICD) accidentally, namely the results of Xiaowen's research, 2012; Ashfaq & Rui, 2019; Dewayanto et al., 2018; Khlif et al., 2019; Pangaribuan et al., 2019; Setiawan et al., 2017; Leng & Li, 2011; Jati & Anggoro, 2018; Agyei-Mensah, 2016; and Bagaskara & Dewayanto, 2018. The data were analysed using content analysis techniques, which reveal themes and patterns that appear in narrative data (Schreire, 2012; Vaismoradi et al., 2013) regarding the determinants of internal control disclosure (ICD) that are often used in research.

After summarising, the data or determinants of internal control disclosure (ICD) will be interpreted in a straight description, or only describe and interpret the meaning at the surface level. This means that the author does not penetrate too far into the data by conducting in-depth interpretation (Sandelowski, 2010), including conducting statistical testing.

Due to the small sample size and lower level of inference interpretation, this research tends to be exploratory and not intended for generalisation. The implication is that the findings in this study tend to be more indicative, and their validity needs to be tested by future studies.

RESULTS AND DISCUSSION

Description of ICD Determinants

There are 57 items used as determinants of ICD in the ten research articles. Tend to vary, but approximately 87.8% narrowed or can be grouped into three major factors, namely those related to the board, audit committee (AC) and

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financial & market performance. The position of the board, which is mostly used as a determinant of ICD, can be understood considering that the control system is indeed the main responsibility and is designed by the board of directors (Ashfaq & Rui, 2019), so that the determinant is a manifestation of the decisions made by the board. The Board of Directors (BOD) is one of the core organs of corporate governance in addition to shareholders (general meeting shareholders-GMS) and management (management-MGT).

In contrast to civil law countries such as Indonesia, the Board of Directors is the Board of Directors. Thus, the Board of Directors in Indonesia is management in the terminology used in the language of corporate governance. As shown in the following table, the most widely used BOD indicators in consecutive studies are board independence, board size, and CEO duality. The second most common determinant of ICD is audit committee (AC), which is also understandable considering that AC is the main supporting organ of governance related to control aspects, or by Lin, et al (2006) interpreted as a crucial attribute that is responsible for the effectiveness of control.

Tabel 1. Distribution of ICD determinants referenced in the study

Determinan	Item	%
Berhubungan dengan *Board* :	20	35.10%
Board independence	7	
Board size	6	
CEO duality	3	
Board ownership concentration	1	
Female on board	1	
Non-executive director as chairman	1	
No. of Meetings of the Board	1	
Berhubungan dengan *Audit Committee* :	16	28.10%
Audit committee independence	5	
Audit committee size	4	
Audit Committee Expertise	3	
Audit committee meetings	2	
Audit committee shareholdings	1	
Women on audit committee	1	
Berhubungan dengan *financial & market performance* :	14	24.60%
Profitability	4	
Leverage	4	
Liquidity	2	
Earning quality	2	
Market capitalisation	1	
Earnings Per Share	1	

Source: Data processed (2022)

The role of the AC is to monitor the implementation of internal controls and provide authentic information to shareholders and ensure that the internal audit function continuously assesses business risks (Hsu, 2007). Thus, the output of AC roles and activities can be seen from its decision in designing and deciding the ICD. The most widely used AC indicators in consecutive studies are AC independence, AC size, and AC expertise (competence).

Although it may occur due to differences in the methods and statistical tests used, the following table can be used as an initial guide to recognise what ICD indicators are classified as valid and reliable. The first rank is shown by the audit

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committee expertise indicator (100% significant effect) and followed by the audit committee expertise indicator (80% significant effect).

Table 2. Distribution of statistical test results of internal control determinants

	Frekuensi (%)	
	s	ns
Board:		
board size	50	50
board independence	50	50
CEO duality	30	70
Audit Committee:		
AC independence	80	20
AC size	50	50
AC Expertise	100	0
Financial & market performance:		
Profitability	20	80
Leverage	20	80
Liquidity	50	50

Source: Data processed (2022)

Why audit committee characteristics are decisive in ICD decisions is explained in another section. Although not as tight as the audit committee, the role of board size and board independence in determining ICDs should not be overlooked.

Board Size and ICD

One of the important roles of the Board of Directors (BoD in Indonesia) is to supervise and monitor management (Fama & Jensen, 1983; Jensen, 1993; Weisbach, 1988). One of the issues often associated with the effectiveness of the BoD is its size and composition. For example, Pearce & Zahra (1991) state that a large BoD will strengthen the link between the firm and its environment, provide guidance on strategic choices to be made, and play an important role in establishing the firm's identity. Conversely, studies by Eisenberg et al (1991) and Beiner et al (2004) concluded that too large a BOD makes coordination, communication and decision-making more difficult.

As a key function of corporate governance, the board of directors is responsible for the development and implementation of the internal control system, and must ensure the accuracy and reliability of the information disclosed. This is in line with the agency theory point of view where information asymmetry arises due to differences in information held by principals (shareholders) and agents (management).

Board Size can to some extent reflect the ability of the board of directors or supervisors to be involved in decision-making and supervision of management, because the larger the size of the board of directors, the more professional members with competence and experience in various fields that can improve the quality of disclosure. The size of the board, both executive and non-executive, will also avoid the role of domination.

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Some studies show that board size can improve the quality of corporate disclosure (Ashfaq & Rui, 2019; Bagaskara & Dewayanto, 2018; Barako, Hancock, & Izan, 2006; Leng & Ding, 2011; Zaheer, 2013; Zulfikar, May, Suhardjanto, & Agustiningsih, 2017) which means that if the board's supervisory function runs optimally, the disclosure of company information including disclosure of internal control can be better.

However, some studies show that the motivation for strategic decision making is negatively affected by the size of board members (Agyei-Mensah, 2016; Chalmers et al., 2019; Goodstein et al., 1994). This is because the larger the size of the board of directors leads to a less effective decision-making process. Discussion of several experts and from various perspectives will cause difficulties in making a decision. Of the studies that argue for a positive or negative relationship between board size and internal control disclosure, some of them show insignificant results. This is because it may not be the size of the board itself, but the effectiveness and performance of the board that needs to be considered in the process of assessing the board.

Board Independence and ICD

One of the commonly used variables in disclosure studies is the independent board ratio (Agyei-Mensah, 2016; Andriani & Tanjung, 2015; Ashfaq & Rui, 2019; Bagaskara & Dewayanto, 2018; Jati, 2017; Khlif et al., 2020; Leng & Ding, 2011). Generally, research believes that board independence from the management structure is the most effective tool in the monitoring and control function in the governance structure. Board independence usually represents the interests of minority shareholders or stakeholders other than shareholders who are not directly involved in the company's activities.

From an agency theory perspective, it can be said that an independent board is seen as a balancing mechanism to ensure that the company acts in the best interests of shareholders, and other stakeholders. Independent boards can encourage companies to disclose more information to outsiders in order to increase investor and stakeholder confidence. However, there are some studies that find a negative relationship between board independence and corporate disclosure.

Some studies show a positive influence between the Independent Board and internal control disclosure (Agyei-Mensah, 2016; Bagaskara & Dewayanto, 2018; Jati, 2017). However, other studies show an insignificant relationship (Ashfaq & Rui, 2019; Chalmers et al., 2019; Leng & Ding, 2011). The Independent Board has no effect on internal control disclosure allegedly because the independent board, which is usually appointed by the majority shareholder, in the case of collusion, the supervisory role of the board of directors or management is limited (Demb & Neubauer, 1992). Under these conditions, the presence of an independent board with a high proportion can actually cause a negative effect on disclosure (Chalmers et al., 2019).

Audit Committee Size and ICD

The audit committee, a sub-committee of the board of commissioners, and its structure and membership also affect the board's ability to conduct oversight. Because it has a greater understanding of financial reporting processes and

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audits, the audit committee increases the capacity of the board of commissioners to oversee management (Michelon, Bozzolan, & Beretta, 2015). The effectiveness of the audit committee affects SPI disclosure well, according to Setiawan (2016). The size of the board of commissioners is one of the characteristics that can be used as a proxy for the effectiveness of the audit committee.

Empirically, the size of the audit committee is a characteristic of the audit committee that determines the effectiveness of the audit committee in carrying out its duties, according to research by Ratnasari (2011) and Setian, et al. (2018). This is so that the design of the board of commissioners on the size of the audit committee ensures the effectiveness of its supervision. According to BRC (1999), the size of the audit committee affects the audit committee's capacity to identify financial statement errors that affect the accuracy of company reporting. According to various studies, audit committee size has a favourable impact on internal control disclosure (Ashfaq & Rui, 2019; Jati, 2017). Conversely, other studies show that audit committee size has no effect on financial statement disclosure (Pangaribuan, Donni, Muse, & Popoola, 2019).

Audit Committee Independence and ICD

Audit committees have an important role in achieving corporate governance objectives. Audit committees encourage high effectiveness in overseeing the internal control and financial reporting of the company (Barua, Rama, & Sharma, 2010), because audit committee members tend to want to maintain their reputation, it is less likely to be influenced by management interests. An independent audit committee will avoid risks related to misrepresentation of information that will harm its reputation by carrying out a more objective supervisory function and improving the quality of internal control disclosures to the public (Madi, Ishak, & Manaf, 2014; Pangaribuan et al., 2019).

Different results were revealed by Allegrini & Greco (2013) who stated that the proportion of the audit committee has no relationship with corporate disclosure. Similar to the independent board, an independent audit committee appointed directly by the majority shareholder, under certain conditions, is expected to experience limitations in carrying out its supervisory function.

***Audit Committee Expertise* and ICD**

The audit committee plays an important role in ensuring the integrity of financial statements through its oversight of the company's financial reporting process, internal control systems and audit function. To properly perform this role, the Board (including the Audit Committee) must ensure that it has individuals with appropriate qualifications to provide independent, objective and effective oversight. The audit committee should use its ability to protect the company from adverse activities by conducting early supervision and detection of irregularities in its activities.

In addition, an important point that the audit committee should pay attention to is the level of activity to increase the transparency of the company so that the quality of its internal control is considered adequate (Khlif & Samaha,

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2016). This shows that an audit committee that is an expert in its field is needed and needed by the company. In other words, companies that have internal control weaknesses symbolise audit committee members who are less skilled and have less knowledge of financial accounting and non-financial accounting (Zhang, Zhou, & Zhou, 2007).

Audit committee expertise plays an important role in reducing asset misappropriation that will improve the accuracy of corporate information disclosure. Furthermore, the expertise of the Audit Committee reflects the effectiveness of the implementation of internal controls so that financial reports are more reliable (Dewayanto, 2017; Schmidt & Wilkins, 2012). Dewayanto (2017), Ashfaq, et al (2019), Pangaribuan (2019) state that audit committees that have accounting or financial expertise have a positive and significant effect on internal control disclosure.

CONCLUSIONS

As an initial clue, audit committee characteristics, especially audit committee expertise and audit committee size, are valid and reliable indicators to reveal the ICD variable. This means that the more competent and the larger the audit committee size, the greater the chance of the company to disclose its internal control. Meanwhile, board characteristics that can be considered to measure ICD variables are the number and independence of the board. Meanwhile, financial performance, let alone market performance, does not seem valid and reliable.

The limitations of the study are that the number of samples used is very small, the business sectors studied are heterogeneous, and the methods and statistical tests used by each researcher are not uniform. Therefore, for future research, sample size, method and homogeneity of the object of research should be taken into consideration.

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