Internal Control Disclosure and Financial Reporting Quality : Evidence from Banking Sector in Indonesia

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ABSTRACT

The purpose of this study is to examine the influence of Internal Control Disclosure Index (ICDI) and discretionary accruals (as a proxy for financial reporting quality). This study uses a data collection of Indonesian Stock Exchange listed banking sector companies' financial statement and annual reports in 2016-2019. Sample was chosen using purposive sampling method. The analysis method used in this study is using STATA. The results of this study indicate that internal control disclosure there is significantly related to financial reporting quality. This research contributes empirically to the development of the literature as well as practically becomes a consideration for relevant management in making corporate decisions regarding the disclosure of their internal controls.

Keywords: Internal Control Disclosure; Financial Reporting Quality; Banking.

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Pengungkapan Pengendalian Intern dan Kualitas Pelaporan Keuangan: Bukti dari Sektor Perbankan di Indonesia

ABSTRAK

Penelitian ini bertujuan untuk menguji secara empiris pengaruh dari Internal Control Disclosure Index terhadap kualitas laporan keuangan (diproksikan dengan discretionary accrual). Sampel dalam penelitian ini adalah perusahaan sektor perbankan yang terdaftar di Bursa Efek Indonesia pada tahun 2016-2019. Sampel yang dipilih menggunakan metode purposive sampling. Data yang digunakan dalam penelitian ini dianalisis dengan bantuan software STATA. Hasil menunjukkan ada hubungan antara Internal Control Disclosure dengan kualitas laporan keuangan. Penelitian ini berkontribusi secara empiris dalam pengembangan literatur sekaligus secara praktis menjadi pertimbangan bagi managemen terkait dalam pembuatan keputusan perusahaan dalam hal pengungkapan internal control mereka.

Kata kunci*:* *Internal Control Disclosure Index, Kualitas Laporan Keuangan; Perbankan.*

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INTRODUCTION

The clear impact of globalization today is undeniably the existence of a free market, as evidenced by the large number of foreign companies operating in one country. This situation requires companies to improve operational efficiency in order to remain competitive in the existing market (Doyle et al., 2007). Now, the company need to disclose the information in the financial report. Financial reports play an important role in this circumstance. According to Iatridis (2010) reliable financial reports will reduce miscommunication between stakeholders and reduce user suspicion of manager decisions, such as agency costs and will also reduce the expected cash flow of the company. Poor quality financial statements change the relationship between a company and its investors and ultimately lead to information risk, so they must offer investors a higher risk premium.

In Indonesia, Bapepam and LK (2012) issued Regulation No. XK6 of 2012 regarding the Obligation to Submit Annual Reports for Issuers or Public Companies in accordance with the provisions of the issuer or public company in the system established by the company. The annual report is a summary report of the company's activities over a period of time and aims to inform shareholders and other stakeholders about the company's activities and financial performance (Arifuzzaman, 2011).

Companies are required to provide financial statements that contain the actual financial position and the information in it is used to make decisions. If there is fraud in presenting the report, then the decision taken can be wrong. Therefore, the quality of financial reports has become a broad topic and has received much attention from regulators, investors, academics and researchers, especially since Enron's accounting manipulation practices in the 2000s. The Enron case was a fraudulent corporate financial reporting scandal that rocked the global financial system (Agrawal et al., 2015; Brown, 2012). The incident caused the United States government to enact the Sarbanes-Oxley Act (SOX) in terms of regulating corporate governance, auditor freedom, evaluation of internal control and disclosure of financial statements.

Leng, Jianfei & Li (2011) states that financial statements cannot be used as a means by which management is accountable to the owners of the company because the information is available in the best interest of management. This explanation based on Agency theory, which is the principals and agents seek to maximize their own well-being, so management doesn't always act, and make the problems, namely incongruence of interests. The owner (principal) usually does not know information about company activities and information. Inappropriate behavior of agents in the form of earnings management or correction of financial statements, such as in the form of earnings restations which results in poor quality of financial reports (Doyle et al., 2007) and (Lafond & You, 2010). For example, the information in the financial statements does not reflect the actual situation, so the information is immaterial (Doyle et al., 2007) and (Feng et al., 2015). This incident will place the management (agent) in a position where there is the possibility of committing fraud for their own benefit. The behavior is called information asymmetry and the owner cannot fully monitor the activities of the company (Dashtbayaz, 2019).

In this case, the reasons for fraud is the failure of internal control and the lack of disclosure of related information. The form of failure in a company that benefits one party is earnings management using financial statement manipulation. Manipulation of accounting income that can be evaluated based on total costs and states an inverse relationship with profit (Schipper & Vincent, 2003). Sloan & Sloan, (1996) stated that an increase in accrued costs may indicate income distortion. Therefore, as it should be in Moeller (2015), that internal control that is implemented densely and monitored continuously is essential for the prevention and detection of fraud. Based on COSO's Internal Control – integrated framework, internal control is a process that the company can rely on to achieve its goals and internal control is the basis for evaluating the effectiveness of the company's activities, finances and business processes (Moeller, 2015). Management is one of the efforts to achieve business goals. Internal control ensures that operations are carried out properly and helps the company to achieve its objectives (Moeller, 2015). This requires business stakeholders (stakeholders), including investors. Records information about internal controls to ensure that the company manages them. We are agreed that the establishing internal controls helps to achieve business objectives of credibility, financial relationships and compliance with applicable laws and builds investor confidence (Klai, 2011).

Arifuzzaman (2011) suggests that investors and external stakeholders (who are outside the company) have limited interests in exercising the company's internal control. Internal control disclosure used to increase the credibility of financial statements and achieve the objectives of effective corporate governance. Disclosure of the company's internal control shows that the company has the right controls to carry out its operating and financial activities. This method makes investors and external stakeholders have full trust given by the company.

Basically, internal audit strengthens internal control, determines whether an organization follows procedures or policies set by management, and effective, efficient, and cost-effective internal controls are designed to ensure that they exist. Programmed systematic approach to efficiency, profitability, adequacy of control management is a goal. We use content analysis and design evaluation criteria to calculate the internal control disclosure index (referring to ICDI) to measure disclosure quality based on previous research.

Effective internal control can verify the truth and reliability of financial information. Disclosure of information can contribute to the improvement of internal controls that provide information to be obtained quickly. Establishing and implementing effective and sustainable internal control can ensure business continuity and healthy growth of the company (Feng et al., 2015). Basically, it is internal control and determines whether an organization needs to check the procedures or politics set by its managers. Ensuring that internal controls are defined as effective, efficient and economical helping organizations to achieve their goals through a systematic approach and evaluation plan (Lafond & You, 2010). Based on Thanh & Cheung, (2010) which supports the selection of the Internal Control Disclosure Index (ICDI) as a measurement of the company's internal control.

This study aims to determine the relationship of the Internal Control Disclosure Index (ICDI) to the quality of financial reports in the banking sector in Indonesia. Previously, research on the Internal Control Disclosure Index (ICDI) and the quality of financial reports was not widely studied. Therefore, this study wanted to examine the relationship between the two. This research was conducted on companies in Indonesia that are included in the category of developing markets so that they can be analyzed and obtain evaluation criteria for the disclosure of banking internal control.

RESEARCH METHOD

The method used in this research is quantitative and testing uses OLS regression and is processed using STATA software. The sample selection using *purposive sampling.* The determination of this method is considered to follow several criteria, namely, (1) Banking sector companies listed on the Indonesia Stock Exchange in 2016 – 2019 (2) The company has complete data needed *(non-missing data).* For more details, the following is Table 1. the selection criteria process in this study.

Table 1. Sample selection and firm distribution by industry and period

Panel A: Sample selection process	
Selection criteria	Observations
Initial observations: Banking Sector 2016 – 2019	172
Excluded: firms with missing data	(71)
Final observations	101
This table reports the sample selection for the period and industry breakdown of the sample firms.	

Source: Processed Data, 2021

In this study, the quality of financial statements is calculated using discretionary accrual models of Beaver and Engel (Beaver & Engel, 1996). Rahmawati, (2007) considers this model the most appropriate for testing the practice of reporting quality of banking sector companies. The calculation steps are as follows.

Calculate total Accrual

$$TA_{it} = NDA_{it} + DA_{it} \quad (1)$$

Calculate *Non-Discretional Accrual* (NDA)

$$NDA_{it} = \beta_0 + \beta_1 CO_{it} + \beta_2 LOAN_{it} + \beta_3 NPA_{it} + \beta_4 \Delta NPA_{it+1} + \varepsilon_{it} \quad (2)$$

Calculate *Discretionary Accruals* (DA)

$$DA_{it} = TA_{it} - NDA_{it} \quad (3)$$

Explanation:

DAit = discretionary accruals of firm i within period t
NDAit = nondiscretionary accruals of firm i within period t
TAit = Firm total accrual i within period t
COit = loans charge offs of firm i within period t
LOANit = loans outstanding of firm i within period t
NPAit = non-performing assets of firm i within period t
ΔNPAit+1 = The difference of non-performing assets of firm on period t+1Next

Leng, Jianfei & Li (2011) states that the control environment, risk assessment, control activities, communication information, internal control, internal control weaknesses and evaluations of external and internal parties are eight items of internal control information that need to be disclosed. To be detailed, this study using the measurement of Internal Control Disclosure Index (ICDU) is determined from the total score of 18 disclosure items made by companies in their annual

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reports. The criteria that are met will get a score of 1 and 0 otherwise, the criteria for submitting information in the annual report as following.

Audit Committee	Internal Audit Unit
1. Committee Name	1. Internal Audit Name
2. Position history, work experience and basis of appointment	2. Position history, work experience and recruitment basis
3. Educational History	3. Qualification and certification as a profession of Internal audit
4. Term of Position	4. Structure and Position
5. Disclosure of Independence	5. The duties and responsibilities of internal audit are as stated in the charter.
6.Disclosure of company policies and their implementation related to the frequency of meetings and the extent to which they participate	6. A brief description of the implementation of tasks in the financial year.
7. A brief description of the activities during the fiscal year specified in the article	
Internal Control System	Risk Management System
Compliance with financial and operational controls and other laws and regulations.	An overview of the company's risk management system.
Evaluation or review of the effectiveness of the internal control system.	Types of risks and how to manage them.
	Review the effectiveness of the company's risk management system.

Source: Processed Data, 2021

The 18 point criteria above represent all the information that stakeholders expect to describe. So then, the ICDI measurements are obtained as follows.

$$ICDI = \frac{\Sigma xij}{nj} \quad (4)$$

Explanation:
xij = the number of items disclosed by the company
nj = maximum number of items disclosed

Then, circular letter based on Bank Indonesia Number 6/10/PBI dated April 12, 2004 concerning the Rating System for Commercial Bank Soundness (State Gazette of the Republic of Indonesia Year 2004 Number 3, State Supplement Number 4382) several indicators are used to measure the analysis as a ratio analysis technique using CAMEL (Capital, Asset Quality, Management, Earnings, Liquidity). For the regression model, we included some variable.

For the first, ROA is one of the important indicators to assess the health of a company and influence investor decision making. Assih & Gudono, (2000) suggest that companies with higher ROA tend to manage more earnings than companies with low ROA. This is because management understands the possibility of future benefits as a result makes it easier to delay or increase the speed of profits.

$$ROA = \frac{Net\ Profit}{Total\ Assets} \times 100\% \qquad (5)$$

Second, *Capital Adequacy Ratio* (CAR) is the relationship between bank performance and risky supporting activities. *Capital Adequacy Ratio* (CAR) is one indicator of a bank's capital adequacy that is used to measure whether a bank has a bank's capital adequacy and provides sufficient capital for the bank to support risky assets or have the potential to ownthem. Based on the study of Lilis & Ainun, (2000), banks implement earnings management to meet the minimum capital adequacy ratio set by Bank Indonesia.

$$CAR = \frac{Capital}{ATMR} \times 100\% \qquad (6)$$

Third, *leverage* shows the relationship between theuse of debt and financing an investment (Sartono, 2004),. Investors demand higher returns because the more debt a company has, the greater the risk. As a result, companies tend to adopt results-based management. Here is the calculation formula for leverage:

$$Leverage = \frac{Total\ Liability}{Total\ Assets} \qquad (7)$$

And for the last, the size of a company can determined the quality of financial statements. Nasution & Setiawan, (2007) suggest that company size is a measure that can be used to classify companies in terms of total assets. Tests conducted by (Siregar & Utama, (2005) show that the variable that has a significant effect on revenue management is company size. Indeed, large companies pay attention to their financial statements and people. The size of the company in this study uses total assets recorded at the end of the year.

Size = LN (Total Assets)……(8)

RESULT AND DISCUSSION

The sample used in this study is banking sector companies in Indonesia which are listed on the Indonesia Stock Exchange between 2016 - 2019. The number of samples in this study amounted to 101 companies. Table 2 shows the statistical descriptive of the entire sample. Enhancement *discretionary accruals* (DA) means the greater the possibility of corporate earnings management, which means the quality of financial statements is low.

Based on the table, the average value or mean *absolute discretionary accruals* (DA) of all companies in the banking sector as the sample is 775,872. As previously mentioned, low quality financial statements are presented on a high accrual basis. So then it can be interpreted that the DA financial statements of the banking sector are of high quality or have good quality financial reports.

ICDI worth 1 means the company has disclosed all the identified internal control disclosure criteria and the lowest value is 0.389. Average result or mean of variable *Internal Control Disclosure Index* (ICDI) which is used as a sample is 0.898. Judging from the results of the analysis, it can be concluded that most companies in the banking sector disclose internal control (*Internal Control Disclosure*) tall one.

Table 2. Statistical Description

	Mean	Median	Minimum	Maximum
DA	775.872	110.553	60.001	10885.662
ICDI	0.898	0.944	0.389	1.000
ROA	2.305	1.700	-3.720	16.000
CAR	22.918	21.260	2.240	55.030
LEVERAGE	0.816	0.831	0.091	1.353
FIRMSIZE	29.773	29.798	16.200	33.356

Source: Processed Data, 2021

Pearson Correlation examines the correlation between one variable and another. In this Pearson correlation test, as shown in Table 3, it can be found that ICDI is correlated with DA, the direction is positive with a coefficient of 0.204 at the 5% significance level.

Table 3. Pearson Correlation

	DA	ICDI	ROA	CAR	LEVERAGE	FIRMSIZE
DA	1.000					
ICDI	0.204**	1.000				
	(0.041)					
ROA	-0.049	0.134	1.000			
	(0.625)	(0.181)				
CAR	-0.179*	-0.272***	0.067	1.000		
	(0.074)	(0.006)	(0.508)			
LEVERAGE	0.077	0.070	0.052	-0.289***	1.000	
	(0.441)	(0.484)	(0.606)	(0.003)		
FIRMSIZE	0.111	0.024	-0.035	-0.137	0.067	1.000
	(0.271)	(0.812)	(0.729)	(0.172)	(0.507)	

Source: Processed Data, 2021

This study has a regression analysis model to determine the relationship between *Internal Control Disclosure Index* (ICDI) on the quality of financial reports. Measurement of the quality of financial statements expressed by *discretionary accruals* (DA), the independent variable is

Internal Control Disclosure Index (ICDI), as well as the control variable, namely *Return on Assets* (ROA), *Capital Adequacy Ratio* (CAR), *LEVERAGE*, and company size (*FIRMSIZE*). Therefore, to test the hypothesis in this study, we specified a regression model linking dependent variable, independent variable, and batteries of control variables as follows:

$$DA = \beta_1 + \beta_2 ICDI_{it} + \beta_3 ROA_{it} + \beta_4 CAR_{it} + \beta_5 LEVERAGE_{it} + \beta_6 FIRMSIZE_{it} + \varepsilon \quad \text{.......(9)}$$

Table 4 shows the results of the regression equation model between ICDI and DA showed a significant positive relationship at the 10% level. This means that the hypothesis in this study is accepted. The other variables also show that there is no relationship between the control variables as indicated by ROA, CAR, LEVERAGE and FIRMSIZE. With DA itself. There is also a number of determination displayed in (R^2) in the linear regression of this model is 0.071 or 7.1%. Variables ICDI, ROA, CAR, LEVERAGE and FIRMSIZE provide results to predict an increase in DA of 7.1% while the remaining 92.9% is explained by other variables not used in this study. However, this can then be ignored because the sample characteristics in the regression model have their own characteristics.

Table 4. Regression Result

	(1)
	DA
ICDI	1.944.254*
	(1.73)
ROA	-30.603
	(-0.65)
CAR	-17.656
	(-0.96)
LEVERAGE	300.270
	(0.31)
FIRMSIZE	51.467
	(0.88)
_cons	-2,3e+03
	(-0,97)
r2	0,071
N	101

Source: Processed Data, 2021

From table 4 above, it can be concluded that *Internal Control Disclosure Index* (ICDI) has a significant relationship with the quality of financial statements as proxied by *discretionary accruals* (DA). This can be interpreted that the presence of agents or management has a more open attitude in presenting better financial statements and can be submitted to parties related to the company. Internal controls applied in banking sector companies are more open to the principal because of the presence of agents in reporting. As in Jensen & Meckling, (1976) states that if both parties (agent and principal) maximize utility, the agent does not always act based on the interests of the principal. As mentioned in agency theory which states that management is too self- centered, it turns out that according to the results of this study, ICDI has a high value, so management is not too concerned with itself.

CONCLUSION

This research was conducted on 101 banking companies listed on the Indonesia Stock Exchange in 2016 – 2019. This study obtained the results that the Internal Control Disclosure Index is positively related to the quality of financial reports. This can explain that banking companies in Indonesia that disclose their internal control well are evidence as well as indicating that they have better quality financial reports. This research contributes both empirically and practically. This study develops literature about internal control disclosure's effect on financial reporting quality in the banking sector. This study also can be a consideration for relevant management in making corporate decisions in disclosing company internal control information on the related financial reporting quality indicated.

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