Internal Audit, Audit Committee and Independent Auditor and Its Effect on Internal Control Disclosure

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Abstract

Annual reports are the most comprehensive documents available for public and become one of primary source for researchers. Currently, there is no international standard for annual report content and presentation. Every country has their own regulations on annual reports. One of the components must be disclosed in the annual report according to Bapepam (Indonesian Capital Market Oversight Board) is an internal control section. This study aims to examine whether there are differences in the disclosure of internal control in companies included and excluded in the superior category. In addition, this study aims to identify the influence of the internal audit function, the audit committee and the independent auditor on the disclosure of internal control. Internal audit is a function of the control structure of entities, while in corporate governance, the audit committee is responsible for assisting the board of directors to ensure that the financial statements and internal control structure are presented adequately. This research was conducted using content analysis of the company’s annual report. In this research, samples were grouped into two categories: included and excluded in the superior category. In the superior category, there were 30 public companies whose shares were included in IDX30 (IDX30 is a new index in Indonesian Stock Exchange for investors who trade large-cap shares with high liquidity and consists of 30 stocks from blue-chip companies). Then, with matched sampling method, 30 companies were taken as an equivalent comparison. Moreover, the results of the content analysis were processed furthermore through path analysis. The result reveals that there were differences in the two categories. The IDX30 group disclosed more satisfied internal control disclosure than the non-IDX30 group. The results of path analysis found that the internal audit function and the audit committee positively affect the disclosure of internal control.

Keywords: Internal Audit, Audit Committee, Independent Auditor, Internal Control Disclosure

1. INTRODUCTION

Corporate disclosure are all forms of corporate communications to all stakeholders of the company (Healy & Palepu, 2000). There are various factors to be considered in the communication to the public, including the rules and regulation, corporate transparency, and the company's image (Cai, Liu and Qian, 2011; Healy and Palepu, 2000; Parsa, Chong, & Isimoya, 2007). Balancing the demand for regulatory, corporate image and implementing good governance is a decision that must be made by a company related to the corporate reporting. Annual reports are the most comprehensive documents provided by the company to the public and are one of primary source for researchers and investors (The Association of Chartered Certified Accountants, 2013; Melis & Carta, 2010). Currently, there is no international standard for the presentation of the annual report. Every country has
their own regulations on annual reports. In Indonesia, on August 2012, Bapepam (Indonesian Capital Market Oversight Board) issued a regulation about the content and presentation of the annual report.

According to the Bapepam, one of the components that must be disclosed in the annual report is the disclosure of the internal control (IC). IC is a process designed to provide reasonable assurance with regard to the achievement of objectives about operations, reporting, and compliance (Committee of Sponsoring Organizations of the Treadway Commission, 2013). However, IC cannot be observed directly by the stakeholders because such activities are carried out within the company. The impact is the increasing risk of information that can lead to a loss of public trust to the company. That is why companies disclose information to minimize information asymmetry. Information asymmetry can be mitigated with voluntary disclosure about risk management and IC (Deumes & Knechel, 2008). There is a tendency that companies having good performance tend to disclose more to show their integrity to their stakeholders (Healy & Palepu, 2000). To demonstrate the tendency, this research took two groups of companies, first, companies that are considered as superior and second, companies that are not considered as superior. In this research, superior companies are represented by companies whose shares are included as IDX30 group. Shares included in ID30 are superior in terms of: (1) value of transactions, (2) frequency of transactions, (3) market capitalization, (4) financial condition, (5) growth prospects, (6) other factors that affect business continuity of the company, and (7) considered as stock that can survive in the market (Soekirno, 2012; Taqiyyah, Kusumaningtyas, P & H, 2012; Prayogi, 2012; Putra, 2013; Prativi, 2013).

Objectives of this research were (1) to determine whether there are differences in the company's internal control disclosure of IDX30 and non-IDX30 groups, (2) to determine the effect of internal audit on the disclosure of internal control, (3) to determine the effect of audit committee on the disclosure of internal control, and (4) to determine the effect of the independent auditor on the disclosure of internal control. The remainder of the paper was structured as follows. The next sections review the theoretical background and followed by the development of the research hypotheses. The research method is described in section 4, followed by result discussion in section 5. Conclusion, limitations, and suggestion for future research are presented in the last section.

2. PRIOR LITERATURE

One of corporate governance components is the internal control. The public could assess the internal control of a company by internal control disclosure in a corporate annual report. The internal auditor, audit committee, and independent auditor are important components of corporate governance. This section describes the relationship of each component (internal auditor, audit committee, and independent auditor) with corporate governance and furthermore with internal control disclosure.

2.1 Internal Auditor in Corporate Governance

Internal audit is a function of the control structure of an entity. Internal audit and management structure of the IC should be separated because they are different (Daniela & Attila, 2013). In accordance with the regulation of Bapepam (Indonesian Capital Market Oversight Board, 2012), corporate governance must contain a brief description of the internal audit function. The disclosure about internal audit function emphasizes on personnel in internal audit function and presented as an individual section in the annual report, separated from disclosure about IC.

2.2 Audit Committee in Corporate Governance

In corporate governance, the audit committee is responsible for assisting the board of directors to ensure that financial statements are presented with reasonable and adequate IC structure, audit and follow up of audit (The National Committee on Governance, 2006). The audit committee should be structured formally and transparently to apply the principles of IC and controlling financial statements. This committee is generally responsible for overseeing financial reporting, operational auditing and applying IC in the company. In line with this, the United States implements the Sarbanes-Oxley Act 2002 (SOX) emphasizing the importance of the audit committee of a company (Tarantino, 2008).

In accordance with the regulation of Bapepam (Indonesian Capital Market Oversight Board, 2012), corporate governance must contain a brief description of the audit committee that includes the identity of audit committee members, independence of the members and implementation of corporate policies related to the frequency and the presence of members of the audit committee.
2.3 Independent Auditor in Corporate Governance

The auditor is considered as a means to reduce agency problems (Haat, Rahman, and Mahenthiran, 2008; Deumers & Knechel, 2008; Michelon, Beretta, and Bozzolan, 2009). Professional independent auditors are competent to issue a reliable opinion on the company's financial statements (Soedibyo, 2010).

2.4 Internal Control Disclosure

IC disclosure is important because the public can only access IC of a company through its IC disclosure (Spira & Page, 2010). Adequate IC will affect the management of an organization, and corporate governance itself is influenced by the support of IC. Lately, after many fraud incidents happened to big companies around the world, IC became one of the focus in the organization. Disclosure of IC becomes important for company's image.

Without going into depth and breadth of disclosure, investors expect to get the information issued by management of a company, including information about management controls have been implemented (Cavelius, 2011). Align with agency theory, public companies tend to make voluntary disclosures because the management usually wants to prove their performance to their stakeholders (Ismail & El - Shaib, 2012).

3. BACKGROUND AND HYPOTHESES DEVELOPMENT

3.1 Superiority of Company and Internal Control Disclosure

One way to determine whether a company is considered as good or bad is through evaluation by the authority. Having their shares rated as best shares by the authority is essential for companies to get the image as superior companies. In this research, companies whose shares rated in IDX30 were considered as superior companies. As a comparison, companies whose shares not rated in IDX30 (non-IDX30 group) were matched to IDX30 companies, as done by previous studies (Abbott, Park, & Parker, 2000; Haat, Rahman, and Mahenthiran, 2008). Companies considered as superior disclosed more reliable about their internal control compared with companies excluded from superior companies. To verify this difference, the first hypothesis is formulated as follows: H1: Companies in IDX30 group disclose IC better than the non-IDX30 group.

3.2 Internal Audit and Internal Control Disclosure

Performance evaluation of internal audit function is generally made based on standards issued by the association of internal auditors in each country. There are various standards used in assessing the performance of the internal audit function, such as independence, professional competence, scope, audit performance and audit department management. In this study, the effectiveness of the internal audit function is assessed through (1) the quality of the internal audit, (2) management support, and (3) organizational setting (Dittenhofer, 2001; Mihret & Yismaw, 2007; Saha & Arifuzzman, 2011; Yasin&Nelson, 2012).

The quality of the internal audit is assessed through independence, level of education, experience, certifications related to audit function, and the audit program (Mihret & Yismaw, 2007; Reinstein, Lander & Gavin, 1994; Kalbers & Fogarty, 1995; Kalbers & Fogarty, 2005). Management support can be assessed through review of the audit committee, financial statements audit assignment and IC review assignment (DeZoort, Houston, and Reisch, 2000; Mihret & Yismaw, 2007; Reinstein, Lander & Gavin, 1994). Organizational settings can be assessed through the separation of functions, independence of functions, the number of staff, vision, mission and existence of internal audit charters (Staikouras, 2008; Reinstein, Lander & Gavin, 1994; Koufopoulos, Lagoudis, Theotokas & Syriopoulos, 2009). One of the responsibilities of internal audit function regulated by Indonesian regulation body is to ensure that internal controls are performing well. This responsibility leads to the second hypothesis formulated as follows: H2: Internal audit function has a positive effect on IC disclosure.

3.3 Audit Committee and Internal Control Disclosure

Audit committee effectiveness have a positive effect on IC disclosure (Said, Zainuddin, and Haron, 2009). The effectiveness of audit committees can be assessed through audit committee effectiveness index, including: (1) composition, (2) authority, (3) resources, and (4) diligence (Ika & Ghazali, 2012; DeZoort, Hermanson, Archambeault & Reed, 2002).
Audit committee composition can be assessed through expertise, independence, integrity, and objectivity (Ika & Ghazali, 2012; DeZoort, Hermanson, Archambeault & Reed, 2002). Expertise of the audit committee can be assessed through accounting expertise (Michelon, Beretta, and Bozzolan, 2009; Iyer, Bamber, and Griffin, 2013). On the other hand, the authority includes responsibility and influence (DeZoort, Hermanson, Archambeault, & Reed, 2002), which can be assessed through audit committee charter and responsibilities of the audit committee (Ika & Ghazali, 2012). The resources of the audit committee include an adequate number of audit committee, access to management, independent auditor and internal auditor (Ika & Ghazali, 2012; DeZoort, Hermanson, Archambeault & Reed, 2002). One of the responsibilities of the audit committee regulated by Indonesian regulation body is to review audit result from internal audit function, including internal controls of the company. This responsibility lead to third hypothesis formulated as follows:

\[ H_3: \] Audit committee effectiveness has positive effect IC disclosure.

3.4 Independent Auditor and Internal Control Disclosure

There are two factors that affect the quality of the independent auditor; size of accounting firm and expertise in particular industry (Bafqi, Addin, & Rad, 2013; Stephens, 2011). Many researchers in Indonesia classify accounting firm into three classes: large accounting firm with more than 400 professional staffs, medium accounting firm with 100-400 professional staffs and small accounting firm with the less than 100 professional staffs (Soedibyo, 2010). Meanwhile, Institute of Indonesian Chartered Accountants classifies accounting firm into three classes as well, but with different classification: large accounting firm with more than ten partners, medium accounting firm with four to ten partners and small accounting firm with less than four partners (Mustafa, 2009).

Accounting firm that often audit firms in specific industries is considered as expert in the industry because they have adequate expertise and experience (Bafqi, Addin, & Rad, 2013; Murcia & Santos, 2012; Haat, Rahman, and Mahenthiran, 2008; Deumnes & Knechel, 2008; Jensen & Payne, 2003; Owusu-Ansah & Ganguli, 2010; Stephens, 2011). The fourth hypothesis is formulated as follows:

\[ H_4: \] Independent auditor has positive effect on the disclosure of IC.

4. SAMPLE SELECTION AND RESEARCH DESIGN

4.1 Research Framework

This study was conducted to test whether internal control disclosure affects the quality of the company. This research further examined the influence of internal audit, the audit committee and independent auditors on internal control disclosure that will ultimately affect corporate quality as measured by the position of the company’s stock on the index IDX30. The background of this research is presented in figure 1. Meanwhile, the research framework is presented in figure 2.

4.2 Sample Selection and Data Collection Techniques

This research has two groups of sample, the first group is the IDX30 group and the second group is non-IDX30 group. Non-IDX30 group are companies that never included as IDX30 group, included in the same domain in Indonesian Stock Exchange and have similar total assets amount. The data was taken from 60 companies’
annual reports (30 companies of IDX30 group and 30 companies of non-IDX30 group) from 2012 to 2014. The data was collected through secondary data, processed data, and content analysis data.

4.3 Variable Measurement and Hypothesis Testing Method

Internal control disclosure is measured by (1) internal control component, (2) implementation of internal control, (3) internal control objectives, (4) roles in internal control, (5) internal control framework and (6) separate section in annual report disclosing about internal control systems. Internal audit function is measured by: (1) independence and experience of internal audit chairman, (2) certification in internal audit function, (3) audit program, (4) audit committee review, (5) authorization of financial report and internal control, (6) separation of function, (7) independence of internal audit function, (8) number of staff and (9) objectives of internal audit function. Audit committee is measured by (1) number of meetings, (2) audit committee report, (3) changes in audit committee members, (4) independence of audit committee, (5) education background of audit committee, (6) education level of audit committee, (7) audit committee charter, (8) authorization of financial report, internal control, internal and external audit activities, (9) number of audit committee and (10) audit committee access to management, internal audit function and independent auditor. Data analysis and hypothesis testing were conducted through two sample t-test and Structural Equation Modelling (SEM) analysis. Two sample t-test is used to test the differences in the unit of measurement, IDX30 group and non-IDX30 group. SEM is used to analyze the relationship between the latent variables in the research model. SEM analysis in this study is Partial Least Square (PLS) using WarpPLS 3.0. (Sholihin & Ratmono, 2013).

5. RESULT AND DISCUSSION

5.1 Company’s Superiority and Internal Control Disclosure

The average IC disclosure score for IDX30 group is 17.66, higher than non-IDX30 group whose average score is 14.30 with p-value less than 0.000001. This shows that companies in IDX30 group disclose more adequate internal control systems that consisted of contents of the section at the IC section, implementation of IC, role of IC, IC objectives, IC framework, and had separate section about internal control systems. Consistent with the expectation, H1 is accepted. T-test for equality of means is presented in Table 1.

<table>
<thead>
<tr>
<th>Group</th>
<th>N</th>
<th>Mean</th>
<th>Std. Deviation</th>
<th>Std. Error Mean</th>
</tr>
</thead>
<tbody>
<tr>
<td>IDX30</td>
<td>90</td>
<td>17.66</td>
<td>5.567</td>
<td>0.587</td>
</tr>
<tr>
<td>Non-IDX30</td>
<td>90</td>
<td>14.30</td>
<td>6.005</td>
<td>0.633</td>
</tr>
</tbody>
</table>

5.2 Influence of Internal Auditor on Internal Control Disclosure

Internal audit variable had qualified convergent validity because its loading factor is above 0.50, with a significance value below 0.05 for all indicators. Thus, it can be concluded that the measurement indicators used reflect this variable. The validity of the measurement results through the loading factor value and p-value are shown in Table 2. Standardized path coefficients of internal audit function to IC disclosure is 0.459 and with p value is less than 0.001. In general, companies with internal audit function focus more about IC disclosure and internal control systems is more effective if supported by internal audit function. As expected, H2 is accepted. In general, companies with internal audit function will have to focus more in related disclosures of internal control and internal control will perform better as well. Internal audit functions can be analyzed through functions in the company, if there is any, and the background of the individual who heads the internal audit function. Based on the weight indicator and conversion with real data, the optimal range for the number of internal audit staff was between five to ten people. Although the number of internal audit staff was influenced by the complexity and size of the company, in this study, of the 60 companies, the optimal size for the internal audit division was between five to ten people. Meanwhile, related to the certification of auditors in the internal audit division, the number of the optimal certification is up to 50% of the certified staff. Certification above 50%, will no longer provide significant added value to the company, and the internal audit division assignments will increase and require a significant increase in staff number. This significant increase in staff will increase the effectiveness of the completion of assignments, one of which will improve the disclosure of SPI. However, to a certain extent, this addition will not add more value to the company, primarily related to the company or by SPI in its disclosure. This is similar with certifications possessed by the internal audit function. If 50% or below of staff were certified, and it will provide added value in the disclosure of SPI. However, if more than 50% of staff are certified, the addition will not provide significant value added.
5.3 Influence of Audit Committee on Internal Control Disclosure

Based on validity assessment, out of 15 indicators measured, 10 indicators show that the value of loading factor and p-value meet the requirements of validity, value loading factor is above 0.50 as presented in Table 2. Standardized path coefficient of the audit committee effectiveness to IC disclosure is 0.148 and with p-value of 0.03. As expected, H3 is accepted. Audit committee effectiveness has positive effect on IC disclosure. Composition, authority, and resources of the audit committee should be optimum to achieve the effectiveness of the audit committee. These three components must be proven by the perseverance of the audit committee in order to realize the effectiveness of the audit committee. Assessment process by audit committee can be done through a number of audit committee meetings and voluntary disclosure made by the audit committee.

5.4 Influence of Independent Auditor on Internal Control Disclosure

Independent auditor variable has qualified convergent validity because it has a loading factor above 0.50 with a significance value below 0.05 for all indicators. Thus, it can be concluded that the measurement indicators used have reflect this variable. The validity of the measurement results through the loading factor value and p-value are shown in the Table 2. Standardized path coefficient of an independent auditor to IC disclosure is 0.105 with the p-value of 0.060. In consistent with expectation, H4 is rejected. Companies audited by major accounting firm were expected to have better disclosure for advice or request the auditors. However, the independent auditor cannot enforce their client on how to present their annual report. Independent auditor can recommend about IC disclosure through internal audit function.

<table>
<thead>
<tr>
<th>Path Coefficient and p-value of Internal Auditor</th>
<th>Path Coefficient and p-value of Audit Committee</th>
</tr>
</thead>
<tbody>
<tr>
<td>Path IA (Internal Audit)</td>
<td>Path AC (Audit Committee)</td>
</tr>
<tr>
<td>IA_independence</td>
<td>0.62</td>
</tr>
<tr>
<td>IA_expertise</td>
<td>0.534</td>
</tr>
<tr>
<td>IA_sertification</td>
<td>0.803</td>
</tr>
<tr>
<td>IA_audit program</td>
<td>0.841</td>
</tr>
<tr>
<td>IA_audit committee</td>
<td>0.679</td>
</tr>
<tr>
<td>IA_financial report</td>
<td>0.73</td>
</tr>
<tr>
<td>IA_internal control</td>
<td>0.816</td>
</tr>
<tr>
<td>IA_financial</td>
<td>0.825</td>
</tr>
<tr>
<td>IA_organization</td>
<td>0.762</td>
</tr>
<tr>
<td>IA_staff</td>
<td>0.576</td>
</tr>
<tr>
<td>IA_charter</td>
<td>0.731</td>
</tr>
<tr>
<td>Path EA (External Auditor)</td>
<td>Path AC (Audit Committee)</td>
</tr>
<tr>
<td>EA_size</td>
<td>0.829</td>
</tr>
<tr>
<td>EA_expertise</td>
<td>0.829</td>
</tr>
</tbody>
</table>

5.5 Path Analysis of Internal Control Disclosure

After analyzing the construct validity and reliability, the data was processed to generate path coefficient analysis to determine the value and significance of the path coefficients between variables. Based on the results of the processing, a research model was generated and presented in Figure 3.
6. CONCLUSIONS

The average IC disclosure score for IDX30 group is higher than non-IDX30 group which indicates that companies in IDX30 group disclosed more satisfying internal control systems than non-IDX30 group. Internal control disclosure examined in this research are contents of the section at the IC section, implementation of IC, role of IC, IC objectives, IC framework, and having a separate section about internal control systems. Internal audit function and audit committee are factors that affect internal controls disclosure, meanwhile, an independent (external) auditor is not directly affecting internal controls disclosure. Independent auditor influences the disclosure of internal control through internal audit function. Indicators used to assess IC disclosure are contents of the section at the IC section, implementation of IC, role of IC, IC objectives, IC framework, and having separate section on internal control systems. While indicators to measure effectiveness of the internal audit function are independence of the auditor, experience of auditors, certification of auditors, audit program, review by the audit committee, audit of financial statements assignment, review of IC assignment, separate functions, independence of the function, number of staff, and vision, mission and responsibility. Measurement of effectiveness of the audit committee are audit committee report, independence of the audit committee, audit committee charter, authority of financial statements, authority over IC, authority over internal and external audit activities, authority about the appointment of the external auditor candidates, access to management, internal audit, and external auditor.

6.1 Limitations of the Study

There are some limitations for this research. Firstly, the assessment only measures annual report disclosed by the company. Secondly, the limitation due to the fulfillment of mandatory disclosure. In accordance with signaling theory, companies that perform well tried to give signal on its performance. However, companies with poor performance also adapted this signal. As a result, public could not assess the performance of company through the annual report. Thirdly, the ignorance of internal control regulations as compared to other countries like USA, Canada, Germany, and other countries in Asia such as China and Malaysia, IC disclosure regulations in Indonesia is not adequate. This led companies to only disclose in accordance with the regulations.

6.2 Suggestion for Future Research

This research was conducted on a group of companies whose shares were included and excluded from IDX30 group during 2012-2014. Future research can extend the period of study to increase the sample size and use more alternative statistical tools. Since this study aimed to examine the adequacy of the disclosures, the data collected was limited to the disclosures made by the company. Future research is suggested to use primary data for further investigation.
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