Disclosure of Weaknesses and Effectiveness of Internal Control in Indonesia

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Abstract. Internal control plays an important role in managing the company's resources to achieve its goals, guarantees that the financial reports presented can be trusted and ensures that there are no violations of the provisions committed by the company. However, parties outside the company cannot know directly the implementation of internal control that has been carried out. Adequate disclosure can help stakeholders to assess the quality of the company's internal control system. Section 302 and Section 404 of SOX state that management is responsible for establishing and maintaining the company's control system as well as disclosing weaknesses and providing management's assessment of the company's internal controls. This study aims to conduct a review of the provisions for disclosing internal control in Indonesia through a literature review and analysis of item descriptions of disclosures for companies that are members of the 2020 IDX80. The results of the study indicate that disclosure of internal control in Indonesia has been regulated by the Financial Services Authority but has not detailed for disclosure of weaknesses and effectiveness of internal control. The implication is that not all companies disclose the effectiveness of internal control. The results of the analysis show that there are still 28.21% of companies that have not declared the effectiveness of their internal controls. Meanwhile, for internal control weaknesses, no company has yet disclosed them in the annual report. In order for a company to disclose the effectiveness and weaknesses of its internal control, it is necessary to have provisions that clearly explain the content of the disclosure.

Keywords : Disclosure, Internal Control, Weaknesses, Effectiveness

1. Introduction

The internal control system is an important aspect of providing complete and reliable information. The internal control system is a series of processes and actions designed by the company to provide reasonable assurance of achieving company goals [1]. Internal control plays role in managing the company's resources to achieve its goals, guarantees that the financial reports presented can be trusted, and ensures that there are no violations of the provisions committed by the company. However, parties outside the company cannot know directly the implementation of internal control. Companies must present reports containing actual conditions and information for decision-making [2]. Adequate disclosure can help stakeholders to assess the quality of the company's internal control system. In addition, the company's focus on its internal control system will increase when management is required to disclose the internal controls implemented by the company [3].

The existence and implementation of an effective internal control system can provide confidence that the company is practicing and developing properly [4]. The quality of internal control disclosure by the company reflects the internal control system built by them. The information is important for regulators and investors. Furthermore, transparency through the disclosures of internal control information plays an important role in reducing the impact of agency costs and information asymmetry in the market [5].

Sarbanes Oxley-Act (SOX) 2002 has regulated the company's obligations in terms of internal control, including disclosure in financial reporting. SOX Section 302 states that management is responsible for establishing and maintaining a company's control system. In addition, the company is also obliged to evaluate the effectiveness of internal control and present in the financial statements the conclusions of the evaluation. Furthermore, to the auditors, the audit committee, and the board of commissioners, companies are required to disclose weaknesses in internal control that have been identified by management.

Management's assessment of the company's internal control is also regulated in SOX Section 404. It states that the annual financial report must include an internal control report stating that management is responsible for an adequate internal control structure and management's assessment of the effectiveness of the control structure. The weaknesses that occur must also be reported. Management responsibilities are written in the form of a statement and also contain an assessment of the effectiveness of internal control in that year.

In Indonesia, the form and content of annual reports are regulated by the Financial Services Authority. Provisions for disclosure of internal control are stated in a circular letter regarding the form and content of the annual report of a public company. These provisions began with the Decree of the Chairman of the Capital Market and Financial Institution Supervisory Agency (Bapepam-LK) Number KEP-431/BL/2012 which was later revised through a circular letter from the Financial Services Authority Number 30/SEOJK.04/2016. In 2021, the Financial Services Authority will revoke the validity of the Financial Services Authority Circular Letter Number 30/SEOJK.04/2016. This study aims to examine the policy of disclosing weaknesses and the effectiveness of internal control in Indonesia. The study was conducted by comparing Financial Services Authority regulations and SOX regulations regarding the disclosure of company internal controls. In addition, this study also analyzes the implications of these regulations on the implementation of disclosure of weaknesses and the effectiveness of internal control by public companies. A descriptive analysis was carried out on the disclosure of internal controls that had been made by 80 companies that are members of the IDX80 in 2020. The weaknesses and effectiveness of internal controls disclosed by companies can be relevant information for stakeholders.

2. Method

This research was conducted through a qualitative approach with literature review and descriptive methods. This method is carried out through review and synthesis of previous research by selecting relevant literature, analysis, mapping and interpretation of previous literature. The stages in the literature review method are determining the literature to be reviewed for later analysis and finally mapping the results of the review [6]. Literature review was conducted to analyze the policy of disclosing weaknesses and disclosing the effectiveness of internal controls in Indonesia and comparing them with SOX rules. In addition, this study also uses descriptive analysis to see the disclosure of weaknesses and the effectiveness of internal controls that have been carried out by public companies that are members of the 2020 IDX80. Internal control disclosures are analyzed through disclosure items carried out by companies [7]. As an additional comparison, a descriptive analysis was also carried out on disclosing weaknesses and the effectiveness of internal controls carried out by the company after the issuance of the latest regulation.

3. Results & Discussion

Regulations regarding the information contained in the annual reports of public companies were regulated by the Capital Market and Financial Institution Supervisory Agency (Bapepam LK) in 1996. Through the Decree of the Chairman of the Capital Market Supervisory Agency Number KEP-38/PM/1996, Bapepam LK regulates the obligations submission of annual reports for the public company including the form and content of the annual report. However, the decision does not contain rules regarding the disclosure of the company's internal control.

Capital Market and Financial Institution Supervisory Agency (Bapepam LK) issued another regulation through Circular Letter Number SE-02/PM/2002 concerning Guidelines for the Presentation and Disclosure of Financial Statements of Issuers or Public Companies in 2002. In this regulation, Bapepam has regulated the disclosure of the internal control system implemented by companies. The regulation was then updated through the Decree of the Chairman of the Capital and Financial Institution Supervisory Agency Number KEP-431/BL/2012.

In 2016, the Financial Services Authority (OJK) issued Financial Services Authority Circular Number 30/SEOJK.04/2016 concerning the Form and Content of Annual Reports of Issuers or Public Companies. In accordance with these regulations, the issuer's annual report must contain information on the internal control system implemented by the company, at least regarding:

a. Financial and operational control, as well as compliance with other laws and regulations; And
b. Review of the effectiveness of the internal control system.

Based on these Financial Services Authority (OJK) regulations, disclosure of internal control in Indonesia has not been regulated down to the disclosure content. Disclosure of existing internal controls includes the level of information regarding the company's internal control system itself and an overview of the effectiveness of the company's internal control system. Regulations on disclosure of internal control in Indonesia do not oblige companies to disclose internal control weaknesses.

The results of a descriptive analysis of disclosures in 2020 use the internal control disclosure index. The level of control disclosure has varying values with a minimum value of 0.78 to a maximum of 0.98. The average level of disclosure of the company's internal control is 0.92. The average disclosure of internal control in Indonesia is higher than that of previous studies in China, which was 0.677 [4]. The standard deviation of 0.03643 indicates that companies included in the IDX80 list make control disclosures at almost the same level.

The maximum value of the internal control disclosure level is 0.98 indicating that not all disclosure items are disclosed by public companies. Mandatory items were displayed in almost all sample companies such as the duties and responsibilities of the directors, the duties and responsibilities of the board of commissioners and the holding of directors' meetings. Meanwhile, voluntary disclosure items are not entirely displayed by companies in their annual reports. Statement items on the effectiveness of the company's internal control and discussion of internal control in the reports of the board of commissioners and directors to stakeholders and employees were disclosed in less than 71.79% of the sample companies. At least there are still 21.28% of companies that have not stated the effectiveness of their internal controls in the annual report.

On the points of internal control weaknesses, company disclosures are still very limited or almost non-existent in the form of statements. Disclosures are more widely disclosed in the number of audits conducted by internal auditors. The company has not presented an explanation of weaknesses and a mechanism for repairs to possible deficiencies in its internal controls. Companies tend not to show existing weaknesses in internal control to protect the value and existence of the company [8]. Apart from not being required in Indonesia, showing weaknesses in the annual report can have consequences that must be accepted by the company.

In 2021, Financial Services Authority (OJK) will issue a new circular letter to replace the previous annual report form and content provisions through SE Number 16/SEOJK.04/2021. The issuance is carried out in the context of implementing sustainable finance. There has been a change in the internal control disclosure requirements. There are additional points that must be disclosed by the company in the annual report, namely the statement of the Board of Directors and/or the Board of Commissioners regarding the adequacy of the internal control system. This obligation comes into force for the preparation of the 2021 Annual Report. Meanwhile, the Financial Services Authority (OJK) has not yet required companies to disclose internal control weaknesses.

Compared to SOX which is a mandatory item, the disclosure of the internal control system in Indonesia tends to be a voluntary disclosure. Until 2020, companies can choose which internal control system information will be presented as long as two minimum pieces of information have been met so that the company's disclosure levels can vary. This makes the level of disclosure as an object of research to see the factors that influence it. There is a need to understand managers' incentives to voluntarily disclose information about internal control [9]. Knowing the determinants of internal control disclosure will help investors, management and policy makers understand differences in reporting between companies because disclosures that truly reflect company conditions will greatly assist in the decision-making process [10].

Several empirical studies have succeeded in identifying factors that differentiate the level of disclosure between companies. In countries where disclosure of international controls is more voluntary, the level of disclosure is associated with good corporate governance. An independent board of commissioners, separation of duties and authorities and good audit quality increase the level of internal control disclosure [11]. It was further found that an effective audit committee, the number of commissioners and the proportion of independent directors ensure that internal control information is disclosed in the annual report [12]. This means that adequate disclosure of internal control shows good governance of the company.

Information on internal control weaknesses is important to stakeholders but can have a negative impact on the company. Disclosure of internal control weaknesses tends to be avoided by companies because such disclosure will give a bad signal to stakeholders [13]. Showing the weaknesses that exist in the company has a negative impact on company value [14]. In addition, disclosing internal control weaknesses also has a negative impact on customer perceptions of their commitment resulting in a decrease in sales [15]. In government financial reporting, disclosure of internal control weaknesses can be used to predict the quality of these financial reports [16]. On the other hand, it is important to know and disclose internal control weaknesses because it will emphasize continuous improvement for the company [17]. Disclosure of internal control weaknesses accompanied by improvement plans may indicate that the company is well managed because it is able to find weaknesses and resolve these findings. However, when market conditions and the environment do not accept negative information, the company needs to review the benefits and costs of whether this information will be disclosed or not.

Prior to the regulatory changes in 2021, not all companies disclosed the effectiveness of their internal controls. The new company declares the effectiveness of its internal control after being required by the Financial Services Authority (OJK). In fact, when a company can provide a statement regarding the effectiveness of the internal control system, the company believes that the function of the company's internal control system will function. With these disclosures, management gives a signal that the company is on the right track in achieving company goals. In addition, companies that report ineffective internal controls tend to have a higher risk of investor perception than companies that report effective internal controls [18]. This means that before being required to state the adequacy of its internal control system, companies tend to provide a gray line to display this information.

The discussion above suggests that when disclosure is voluntary, the primary incentive for disclosure of internal control effectiveness lies in the tradeoff between the benefits and costs of disclosing information. However, when it becomes an obligation, the company will inevitably display this information in its annual report. There needs to be a mechanism to ensure that information on internal control weaknesses and effectiveness disclosed by the company is a true reflection of what is happening in the company.

4. Conclusion

Information on the effectiveness and weaknesses of the company's internal controls is important for stakeholders to know. The development of regulations in Indonesia regarding disclosing the effectiveness of internal controls has led to the obligation to state the adequacy of the internal control system by 2021. Meanwhile, the Financial Services Authority (OJK) has not yet regulated in detail the disclosure of internal control weaknesses. The implication is that before the issuance of the latest provisions, not all companies disclose the effectiveness of internal controls. These results indicate that in order for companies to disclose the effectiveness and weaknesses of their internal controls, regulations are needed that explain in detail the disclosure content obligations.

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