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Research paper

Determinants of Internal Control Disclosure and Its Impact on Company Value

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Abstract

The aims of this study were to examine the factors that affect the disclosure of the Internal Control Structure (ICS) and its impact on Corporate Value. Factors tested in this study were the size of the board of commissioners, the proportion of independent board of commissioners, board of commissioner's meetings, the size of the audit committee and the audit committee meetings. This study was conducted using content analysis from the annual report of manufacturing companies in Indonesia from 2012-2016. The study found that the size of the board of commissioners, the proportion of independent board of commissioners, board of commissioners meetings, audit committee size had positive effect on the extent of ICS disclosure. Furthermore, the disclosure of ICS had been shown to increase the value of the company. Another finding was that audit committee meetings negatively affect the extent of ICS disclosure. Based on the above findings, it could be concluded that the board of commissioners and audit committees encourage companies to conduct ICS disclosure as a means of reducing agency problems. ICS disclosure proved to be used as a monitoring mechanism used by stakeholders in decision-making related to the company.

***Keywords**: internal control disclosure; corporate governance; corporate value.*

1. Introduction

Annual reporting is one communication form of public companies to its shareholders. The purpose of annual reporting is to convey information of the company's performance. However, the effectiveness and conformity of the meaning of information conveyed are influenced by several factors. Information can drives people to act according to the message or signals they received based on their perceptions. To make sure that public perceptions in line with the information sender purposes, several factors must be considered by the company in communicating to the public, such as regulations and legislation, corporate transparency and corporate image (Healy and Palepu 2000). Relevant and reliable information needed to allocate resources optimally. The reliability and relevancy of information are not only influenced by the behavior of decision makers but also the quality of their decisions.

Information quality obtained by the users of financial statements generally depends on the extent to the completeness of the information submitted by the company in its financial statements (Andriyanto and Metalia 2011). Healy and Palepu (2000) stated that corporate information disclosure is any form of corporate communication to its stakeholders. Accordingly, there are several factors that must be considered by the company in communicating to the public, such as regulation and legislation, corporate transparency and corporate image.

In general, companies use annual reports as a medium to communicate with their stockholders. However, there are no international standards governing corporate disclosure in its annual report. Therefore, each country has its own rules regarding annual reports (Setiawan, Hamfri and Majidah 2016). To deliver high quality information, there is need to balancing the reporting demands to regulation and legislation, corporate image and good corporate governance is one of such important decision in preparing its financial reporting (Setiawan, Hamfri and Majidah 2016). Lower information quality increasing the risk of making a poor investment decision.

The Indonesian Financial Services Authority (OJK), formerly the Capital Market Supervisory Agency (Bapepam) regulates the disclosure in the annual reports of the Indonesian public companies. Based on the Decree of the Chairman of Bapepam Number 431 / BL / 2012, one of the items that should be disclosed in the annual report is the disclosure of the existence of company Internal Control System (ICS). It means that the ICS disclosure is mandatory, but the details of ICS disclosure are not specified. The depth and extent of disclosure are voluntary (Setiawan, Hamfri and Majidah 2016).

An effective ICS can ensure the objectivity and reliability of financial information (Leng and Ding 2011), affect how an organization is managed (W. Setiawan 2012) and generally ICS regarded as management's tool that provides a means to achieve the company's performance and profitability target (Hunziker 2013). However, the existence of ICS cannot be observed directly by external stakeholders such as shareholders and debtors, and whether the internal control activities are implemented effectively within the company (Hunziker, 2013; Mei-Ying, 2014; Michelon, Saverio, & Beretta, 2015; Setiawan, Hamfri, & Majidah, 2016). As a result the external stakeholders are not aware of the nature, extent and quality of company ICS. The lack of such information about company's ICS resulting the information asymmetry between companies and its external stakeholders. Whereas ICS can provide protection of stakeholders interest in the company because the company's operations will be run effectively and efficiently, a more reliable reporting system and company compliance with applicable regulations (Haron, et al. 2010).

Previous studies suggest that disclosure of ICS provides several benefits to companies, investors and creditors (external stakeholders). There are three reasons for the importance of ICS disclosure for companies as well as external stakeholders. According to Ying (2016), first, it is proven that the implementation of ICS within an organization can guarantee that error and irregularities can be detected or prevented to occur timely as theoretically and practically. The ICS increased the reliability and reporting quality of accounting information and reducing the weaknesses of the control procedures in the company. Second, the presence of information asymmetry between management and shareholders may lead to moral hazard and adverse selection. Therefore, the disclosure of the company's ICS is a positive signal of the high quality of corporate financial reporting in reducing financing costs. Third, the ICS disclosure may state the objectivity of the enterprise ICS and disclose an assessment of the effectiveness of ICS (Ying, 2016; and Haron, et. al., 2010). In addition, companies are motivated to disclose ICS to explicitly point out management responsibilities to it or to indicate management support for IC implementation (Hunziker 2013). Thus, it can be concluded that the disclosure of ICS can improve the quality of financial reporting through increased reliability of information content and reduce agency problems (Deumes and Knechel 2008).

The disclosure of ICS is important because the community as a stakeholder can only know the existence of ICS from a company through disclosure in the financial reporting (Spira and Page 2009) and investors expect to get information on implementing ICS in a company (Cavelius 2011). Based on the work of Leng and Ding (2011), the quality of ICS disclosure depends on the corporate governance structures. Different corporate governance structures create different governance effectivities. Corporate governance protects the interest of every stakeholder of a company by performing a supervisory function through the good governance mechanisms. These mechanisms include the board of commissioners and the audit committee.

Empirically, Owusu-Ansah and Ganguli (2010) have proven that the characteristics of corporate governance have an effect on management's decision to disclose ICS voluntarily. Internal mechanisms of corporate governance play a major role in the decision-making of major US companies to disclose ICS voluntarily. This study used variables used by Owusu-Ansah and Ganguli (2010) to represent corporate governance of board of commissioners and audit committee. There are three underlying reasons. First, the audit committee has oversight responsibilities against the enterprise ICS and related financial reporting issues. The audit committee receives delegation of duties from the board of commissioners on supervisory responsibilities. Second, the audit committee has the same characteristics as the board of commissioners. In reality, however, the oversight function of the audit committee depends on the attitude, philosophy and practice of the board of commissioners. Third, there is consistency from previous research in using the commissioner and audit committee variables as good variables to describe the supervisory activities of the board of commissioners (Michelon, Saverio and Beretta 2015).

The research gap on the impact of ICS disclosure on company value and the usefulness of that information for companies and stakeholders, motivates researchers to test it empirically. Hasan et al. (2009) states if an information are useful for stakeholders, then the information will be assessed by the market. Based on the above paragraph, the purpose of this study is to examine and analyze the influence of board of commissioner and audit committee on the extent of ICS disclosure. Moreover, this study aims to determine the effect of the extent of ICS disclosure on corporate value. This study is expected to contribute through the identification of factors affecting the disclosure of ICS and its impact on corporate value, improving the generalization of findings by using the dependent variable of firm value and the addition of the board of commissioners as independent variables.

2. Literature Review and Hypothesis Formulation

2.1. Disclosure Theory

There are three theories that can be used to explain the disclosure of ICS in corporate reporting: the agency theory, signaling theory, and theory of legitimacy. Jensen and Meckling (1976) argue that separation of ownership and control creates agency problems, ie management as an agent tends to prioritize its interests. The agency problem leads to an information asymmetry due to more information owned by management rather than owners. Agency theory provides a framework for linking corporate governance with ICS disclosure. A company with high agency costs will try to reduce it by increasing the extent of voluntary disclosure and using independent commissioners as one of the monitoring mechanisms (Agyei-Mensah 2016).

Based on the signaling theory developed by Spence (1973), prospective workers voluntarily disclose their personal data to the company as a signal that they have advantages over other applicants. According to Agyei-Mensah (2016), information in the financial reporting is derive from management's desire to reveal its good performance. The good performance of the management will enhance the reputation and position of management in the community and the reporting which includes ICS disclosure is considered as one of the aspects of good performance. The management of good performing companies tries to send signal to the public of their superiority over other companies with low performance.

In addition to the above theories, the theory of legitimacy can also be used to explain the voluntary disclosure of ICS by the company. This theory asserts that the company seeks to ensure its operations are within the boundaries of the rules and norms of the society in which the company operates, so the company will voluntarily disclose certain activities if management assumes the activity is of concern to the surrounding community or society (Guthrie, et al. 2004).

2.2 ICS Disclosure

Deng (2016) states that the disclosure of ICS as a measure of management effectivity and the effectiveness of the ICS implementation in the company. The issue of ICS disclosure stems from financial fraud committed by Enron (Agyei-Mensah, 2016). This prompted the emergence of Sarbanes-Oxley-Act (SOX) in the United States requiring every company listed on the New York Stock Exchange (NYSE) to disclose management's assessment of ICS implementation and external auditor's report on ICS. However, in other countries that do not adopt SOX regulations, companies are encouraged to disclose a wider ICS (Mei-Ying 2014). In Indonesia, ICS disclosure is mandatory, but the extent of ICS disclosure/details are not specifically regulated so that the depth and breadth of disclosure are voluntary (Setiawan, Hamfri and Majidah 2016).

2.3 Hypothesis Formulation

2.3.1 The Influence of the Board of Commissioners on the Extent of ICS Disclosure

Supervision and control of management actions is the most important function of the board of commissioners (Agyei-Mensah 2016). Based on the agency theory, the board of commissioners is useful as a supervisory mechanism due to a conflict of interest between management and the owner resulting. The board of commissioners representing the owners is responsible for overseeing the opportunistic actions of management in order that the interests

of the company can be achieved. Companies with high agency costs will try to reduce it by increasing the extent of voluntary disclosure and using the presence of independent commissioners as one of the monitoring mechanisms.
Leng and Ding (2011) states that the size of the board of commissioner reflects the ability of the board of commissioners to participate in important business decision-making processes and to oversee management effectivity. The greater the size of the board of commissioners will improve the board's capacity to oversee management actions (Agyei-Mensah 2016), thereby increasing the transparency and disclosure of the broader ICS. Based on the above research, the first hypothesis proposed is the size of the board of commissioners has a positive effect on the extent of ICS disclosure.
In addition to the size of the board of commissioners, many studies on corporate governance state that the proportion of independent board member of commissioners is related to the independence of the board of commissioners that encourages the effectiveness of the board of commissioners (Said, Zainuddin and Haron 2009). The composition of the board of commissioners is an important factor in ensuring the ability of the board of commissioners to oversee management actions effectively (Fama and Jensen 1983). An independent members of the board of commissioners is a member of the company's board of commissioners from outside the company acting as a controlling mechanism within the company by performing a supervisory function (Agyei-Mensah 2016). According to Michelon et al. (2015), based on agency theory, independent members of the board should support the disclosure to investors in order to communicate that the independent members of the board of commissioners have properly supervised the management and that it may also benefit the reputation of the independent board of commissioners in the eyes of stakeholders. Based on the above research, proposed the second hypothesis is the proportion of independent members of board of commissioner has a positive effect on the extent of ICS disclosure.
Allegrini and Greco (2011) state that there is empirical evidence of the benefits of routine control activities by the board of commissioners proxies by the number of meetings held. They argue that the number of board meetings is related to the level of voluntary disclosure. Based on the above research, the third hypothesis proposed is the number of board meetings has a positive effect on the extent of ICS disclosure.

2.3.2 The Influence of Audit Committee on the Extent of ICS Disclosure

The key roles of supervisory activities of the board of commissioners is conduct by the audit committee (BRC 1999). According to Michelon et al. (2015), the supervisory function of the board of commissioners also depends on the structure and composition of its subcommittee, the audit committee. According to him, the audit committee improves the ability of the board of commissioners in overseeing management due to having a deeper knowledge and understanding of the financial reporting process.
The effectiveness of the audit committee positively influences the disclosure of the ICS (Setiawan, Hamfri and Majidah 2016). Characteristics that can be used as a proxy for the effectiveness of the audit committee is the size of the board of commissioners. Empirically, the size of the audit committee is a characteristic of the audit committee affecting the effectiveness of the audit committee in carrying out its responsibilities (Ratnasari & Prastiwi, 2010 and Setiany, et. al., 2017). This is because the size of the audit committee is designed by the board of commissioners to ensure the effectiveness of supervision by the audit committee. According to BRC (1999), the size of the audit committee enhances the ability of audit committees to discover incorrect recording of transactions from financial statements that impact on the quality of company annual reporting. Based on the above research, the fourth hypothesis proposed is that audit committee size has a positive effect on the extent of ICS disclosure.

Another characteristic of the audit committee that allegedly affects voluntary disclosure is the number of audit committee meetings. Audit Committee meetings are a means of coordination among audit committee members in order to perform their duties effectively in terms of oversight of financial statements, internal controls and corporate governance implementation. Haron et al. (2010) also states that audit committee meetings are a means to solve the oversight responsibilities delegated by the board of commissioners. Empirically, Owusu-Ansah and Ganguli (2010) find positive relationship between the numbers of audit committee meetings with voluntarily disclosure of the company's ICS. Effective coordination is expected to encourage the effectiveness of ICS, so support the increasing ICS disclosure made by the company. Based on the above research, the fifth hypothesis proposed is the number of audit committee meetings has a positive effect on the extent of ICS disclosure.

2.3.4 The Effect of the Extent of ICS Disclosure on Corporate Value

Disclosure of ICS is used as a way to provide information about the company's oversight function to internal control and provide good corporate governance signals to external parties (Hunziker 2013). Setiawan (2012) states that disclosure of internal control becomes an important point for the company's assessment and is often a decisive factor in decision making. According to Setiawan et al. (2016), the wider disclosure of ICS, the better the position of the company to the investor. This is observed from the performance of stocks that have high liquidity and large market capitalization. Based on the above research, the sixth hypothesis proposed is the extent of ICS disclosure has a positive effect on firm value.

3. Research Methodology

This study is quantitative in nature. The aims of this study were to determine the effect of the board of commissioner size variables, the proportion of independent board member of commissioners, the frequency of the board meetings, the size of audit committee and the extent of ICS disclosures and their impact on corporate value. The data used in this study from the annual reports of manufacturing companies listed on the Indonesia Stock Exchange in 2012-2016.

The sample used in this study taken from any company that has a complete annual report from the period of 2012-2016. The research variables were measured as follows: The width of ICS disclosure follows the measurements used by Setiawan et al. (2016). The ICS disclosure scope is measured by (1) ICS components, (2) ICS implementation, (3) ICS objectives, (4) ICS roles, (5) ICS framework and (6) ICS reported in separate sections. The effectiveness of the board of commissioners is measured using (1) the size of the board of commissioners that is the number of boards of commissioners, (2) the proportion of independent member of board of commissioners is the percentage of independent board of commissioners member divided by the number of boards of commissioners and (3) board of commissioners meeting measured from the number of meetings held by the board of commissioners in one year. The effectiveness of the audit committee is measured by (1) the size of the audit committee, namely the number of audit committees member and (2) audit committee meetings, namely the number of audit committee meetings held by the audit committee within one year. Company value is measured by Tobin-Q formula. Leverage is measured by the percentage of long-term debt on the total assets of the company.

The Structural Equation Modeling (SEM) used to analyze and test the hypothesis, analyze the influence between the variables in the research model. SEM can simultaneously test the measurement model as well as test the structural model (Ghozali 2015).

4. Results and Findings

The population in this research is 117 companies, with observation period from 2012-2016, so the total result of the research population is 585. The sample that fulfill the research criteria is 287. The description of data presented in Table 4.1.

Table 4.1 – Descriptive Statistics

No.	Variable	Mean	Min	Max	Std. Dev.
1	COM	4,55	2,00	12,00	2,01
2	CIN	0,41	0,17	0,80	0,11
3	AUC	3,09	2,00	5,00	0,42
4	CMEET	7,48	1,00	50,00	7,26
5	ACMEET	9,19	1,00	96,00	13,80
6	ICD	0,52	0,17	1,00	0,25
7	QRA	1,47	-0,41	18,22	2,82

4.1 Partial Least Square Analysis

Partial Least Square Analysis (PLS) is used to calculate the value of the Goodness of Fit Model calculated by looking at the Average R-Squared (ARS) to show the suitability of the model, Average Path Coefficient (APC) shows the interrelationship between variables and Average Variance Inflation Factor (AVIF) shows the multicollinearity among independent variables and in conducting hypothesis testing. The result of the analysis summarized in Table 4.2 and the test results illustrated in Figure 4.1.

Table 4.2 – Model *Goodness of Fit*

No	Variable	Description	Description
1	APC=0.220, P<0.001	Good if P <0.05	Accepted
2	ARS=0.230, P<0.001	Good if P <0.05	Accepted
3	AVIF=1.078	Accepted if ≤ 5, ideal ≤ 3.3 Accepted	Accepted

Source: *PLS Output*

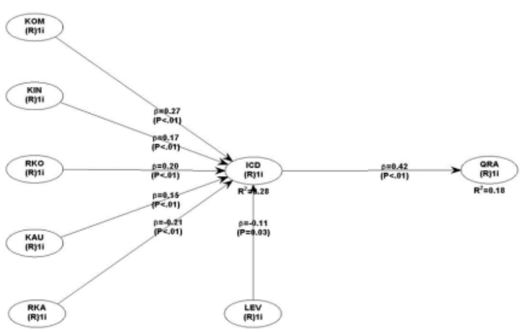

Figure 4.1 - Hypothesis Testing

Table 4.3 – Hypothesis Testing

Hypothesis	Prediction	Relationship	Path Coeff.	P-value	Results
H1	+	KOM → ICD	0,274	<0,01	Accepted
H2	+	KIN → ICD	0,173	<0,01	Accepted
H3	+	RKO → ICD	0,201	<0,01	Accepted
H4	+	KAU → ICD	0,148	<0,01	Accepted
H5	+	RKA → ICD	-0,207	<0,01	Rejected
H6	+	ICD → QRA	0,422	<0,01	Accepted

4.2 Discussion

4.2.1 The Size of the Board of Commissioners Has Significantly Positive Impact on the Extent of ICS Disclosure

Figure 4.1 show that H1 is accepted. This is indicated by the P-value <0.01, smaller than the value of P-value set (≤ 0.05) and the value of the path coefficient positive 0.274. It can be inferred that the size of the board of commissioners has a positive effect on the extent of ICS disclosure. Agyei-Mensah (2016), the disclosure of ICS and oversight of the board of commissioners plays an important role in reducing agency costs and information asymmetry in the capital market. Based on these studies, the size of the board of commissioners has a positive effect on the extent ICS disclosure. This is due to the size of the board of commissioners affecting the effectiveness of the board of commissioners in overseeing the actions and management decision-making with the expertise and experience it has.

4.2.2 Proportion of Independent Commissioners Influence Significantly Positive to the Extent of ICS Disclosure

Figure 4.1 shows that H2 is accepted, P-value <0.01 smaller than the value of the established P-value (≤ 0.05) and the path coefficient value positive 0.173. It can be concluded that the proportion of independent member of board of commissioners has a positive effect on the extent of ICS disclosure. Empirically, the results of this test support the Agyei-Mensah study (2016). The function of supervision and control of management actions is the most important function of the board of commissioners. This function cannot run as it should if there is dominance of strength in decision making by the commissioner. According to Michelon et al. (2015), the composition of the board of commissioners is an important factor in implementing the supervisory function of management behavior. Independent commissioners have little chance to be influenced by management, thereby increasing the effectiveness of supervisory functions of the board of commissioners.

4.2.3 The Number of Meetings of the Board of Commissioners has a Positive Impact on the Extent of ICS Disclosure

The test results in Figure 4.1 show that H3 is accepted. This is indicated by the P-value <0.01, smaller than the value of the established P-value (≤ 0.05) and the path coefficient value positive 0.201. It can be inferred that the number of board of commissioner meeting has a positive effect on the extent of ICS disclosure. Empirically, the research of Allegrini and Greco (2011) indicates that the more meetings held by the board of commissioners the higher the extent of corporate disclosure. There is a benefit of regular supervision by the board of commissioner proxies by the number of meetings held by the board of commissioners in a period of time.

4.2.4 Audit Committee Size has a Positive Impact on the Extent of ICS Disclosure

The test results in Figure 4.1 show that the fourth hypothesis is accepted. This is indicated by P-value <0.01, smaller than the value of the assigned P-value (≤ 0.05) with the path coefficient value positive 0.148. It can be concluded that audit committee size has a positive effect on the extent of ICS disclosure.

The audit committee is present as a sub-committee of the board of commissioners to assist with its task of supervising management. The audit committee is expected to support the implementation of a review of corporate ICS and more objective financial reporting process. To fulfill its duties, the board of commissioners designates the number of audit committees to ensure the effectiveness of supervision by the audit committee. BRC (1999) also suggested that the minimum number of audit committees should be at least three. This is because the size of the audit committee enhances the audit committee's ability to know incorrect listing of transactions from financial statements that impact on the quality of the company's reporting. Supervision of a good audit committee is expected to increase the extent of ICS disclosure (Michelon, Saverio and Beretta 2015).

4.2.5 The Number of Audit Committee Meetings has a Positive Impact on the Extent of ICS Disclosure

The test results in Figure 4.1 show that the fifth hypothesis is rejected. This is indicated by P-value <0.01, smaller than the value of the established P-value (≤0,05) and the coefficient value of the path negative 0.207.

The rationality behind this is because the more often the audit committee meets, considered as there were more problems that need to be discussed, and indicate the ineffectiveness of ICS within the company. Under the signaling theory, poorly performing companies will reveal less corporate information than well-performing companies. Empirically, the results of the fifth hypothesis test could be explained from research conducted by Krishnan and Visvanathan (2007). They found that the more audit committee meets due to the existence of material weaknesses in the company's ICS.

4.2.6 The Extent of ICS Disclosure has a Positive Impact on Corporate Value

The test results shown in Figure 4.1 indicate that the more extensive ICS disclosure has positive effect on company value. P-value <0.01, smaller than the set value (≤ 0.05) and the path coefficient value marked positive 0.422.

Based on previous research, ICS disclosure is used by companies to improve the quality of financial reporting and reduce corporate governance issues, by disclosing ICS information as management accountability to stakeholders, so stakeholders can assess the nature, extent and quality of ICS within the company. The ICS disclosure signals that corporate governance is well implemented within the company. Empirically, Setiawan et al. (2016) indicates that the more extensive disclosure of ICS, the better the company's position seen by the investors and it's reflected in the performance of stock companies that have high liquidity and large market capitalization.

5. Conclusions

Based on the above analysis, it can be concluded that the size of the board of commissioners, the proportion of independent board member of commissioners, the number of board of commissioners meeting, the size of the audit committee have positive effect on the extent of ICS disclosure and the ICS disclosure have positive effect on the company value. However, the number of Audit Committee meetings negatively affect the extent of ICS disclosure. The proxies about the board of commissioner expertise, audit committee expertise and the audit committee independency cannot be used since not all companies disclose of such information in their annual report. Those limitations should be taken into consideration, and future research should use the effectiveness index of board of commissioner and audit committee instead, to capture better phenomena.

The result of this study can be used by the government or OJK as the basis for making mandatory disclosure rules on the corporate ICS disclosure in its annual report. Companies are encouraged to disclose ICS information more widely as it is proved that there are benefits in it, increasing costs, lower funding costs and better effectiveness of ICS followed by the achievement of operational objectives, reporting and compliance with the regulations and legislation by the company.

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