Audit Committee Toward Internal Control Disclosure with the Existence of Foreign Directors as Moderation Variable

Review of Integrative Business & Economics Research

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ABSTRACT

The purpose of this study is to test the impact of the existence of foreign directors toward the relationship between the expertise of an audit committee and the internal control disclosure. The object of the research is non-financial public companies/banks listed on the Indonesia Stock Exchange between 2012-2015. This research employs a purposive sampling technique and multiple regression analysis. This study was able to prove the impact of an audit committee's expertise on the internal control disclosure significantly and was able to test the role of moderation variable of the existence of foreign directors. Expertise of an audit committee and the existence of foreign directors were able to improve disclosures that reflect the internal control. Further, it has implications for the more reliable and qualified financial report and reduces the risk of the mistrust of financial information. The financial expertise of audit committee members was crucial in reducing the complexity of the restatement of financial statements. Audit committee members who have knowledge of financial report have a greater likelihood of detecting material misstatements. In addition, they are able to oversee the financial report process more effectively.

Keywords: Internal control disclosure, audit committee expertise, the existence of foreign directors.

1. INTRODUCTION

Sarbanes-Oxley Act of 2002 (SOX 2002) was effective into force on July 30, 2002, as investors started to pay more attention to the integrity of the financial report of companies. The financial report scandals involving several major US companies, such as Enron, World Com, and public accounting firms Big Five Arthur Andersen in the beginning of the 21st century have made the world aware of the importance of honesty in financial report. The accounting scandals in those American companies have finally pushed the issuance of SOX in 2002 (Zhang et al., 2007).

The disclosures required under SOX in 2002 are mostly related to internal control (Zhang et al., 2007) in which the study focuses on factors related to internal control disclosure. According to Bronson et al., (2006) voluntary management reports on

ISSN: 2304-1013 (Online); 2304-1269 (CDROM); 2414-6722 (Print)

internal control/MRIC) is more common in large companies having audit committees which hold meetings frequently.

In Indonesia, not many companies have implemented the internal control material weakness disclosure because it is voluntary. When an Indonesian company has been listed on New York Stock Exchange (NYSE), USA, however, the company must conduct internal control material weakness disclosure because it is bound by the rules of SOX.

There are two Indonesian companies that have been listed on the New York Stock Exchange (NYSE), i.e. PT Telkom and PT Indosat. Internal control disclosure done by the two companies will certainly motivate other companies to do the same thing if they want to be listed on New York Stock Exchange (NYSE).

Until now Indonesia has no regulations governing internal control material weakness disclosure such as SOX 302 and 404; therefore, this study discusses the concept of 'voluntary'. The decree of the Chairman of Bapepam and LK No. Kep-134/BL/2006, which has been renewed by the decree of the Chairman of Bapepam and LK No. Kep-431/BL/2012, determines that listed companies or public companies have an obligation to submit annual reports voluntarily. The decree also expects that the companies manage to do a more adequate internal control.

A company that has a quality audit committee will have less likelihood of experiencing problems with internal control (Zhang et al., 2007; Krishnan, 2005).

Audit committee in Indonesia is still relatively new compared to those of other countries such as the United States of America, Britain, and Canada even though the existence of an audit committee is important as one of the aspects of the implementation of good corporate governance (GCG). The audit committee was introduced by the government to certain state-owned enterprises in 1999. Meanwhile, in 2000, Bapepam began to give encouragement to companies that have gone public to have an audit committee.

Based on the above background, the research problem of this study is the importance of a voluntary comprehensive internal control disclosure by the company management which is beneficial in improving the reliability of financial report. Further, the question in this study is: What is the influence of the existence of foreign directors in relation to the audit committee on the internal control disclosure?

2. LITERATUR REVIEW

Agency theory is a synergy of economic theory, decision theory, sociology, and organizational theory. This theory was first used by Jensen and Meckling (1976). Agency theory has been used as the basis of operation of the existing business practices. The main principle of agency theory is the relationship between an authority (principal) and the authorized parties (agents). The goal conflict of agency relationships in the form of distortion of information about the company resulted in the emergence of agency problems is responsible for agency costs (Jensen and Meckling, 1976).

Jensen and Meckling (1976) state that the substantial shareholders are expected to have greater strength and encouragement to monitor management because of their wealth in association with the company's financial performance. Fama and Jensen (1983) argue that the spread in the ownership poses a potential conflict between principal and agent. The agency problem can be reduced by substantial shareholders involved in monitoring or controlling activities of potential troubles (Shleifer &

ISSN: 2304-1013 (Online); 2304-1269 (CDROM); 2414-6722 (Print)

Vishny, 1986; Huddart, 1993). Thus the manager compels to disclose more information of the annual report in order to reduce agency costs.

An effective internal control system can prevent large losses (Jaya et. al., 2016). Internal control research has been conducted by Zhang et al. (2007), which examines the truth of the relationship between the quality of the audit committee, auditor independence, and disclosure of the company's internal control weaknesses after the establishment of SOX. The study concludes that audit committees with financial expertise and financial or accounting expertise have a smaller probability of experiencing internal control issues. Furthermore, a company having an independent auditor has a greater likelihood of experiencing internal control issues.

According to the recommendations of the Blue Ribbon Committee (BRC) (1999), to improve the effectiveness of the audit committee of a company, every audit committee should have at least one financial expert who is able to highlight the importance of knowledge in terms of finance and other expertise from other audit committee members. Section 407 of SOX makes the recommendation of the BRC and requires companies to disclose it in their periodic reports.

The financial expertise of audit committee members shows something important in relation to the complexity of the financial statements (Kalbers and Fogarty, 1993) and reduces the restatement of financial statements (Abbott et al., 2004).

DeZoort and Salterio (2001) find that those audit committee members who have knowledge of financial report and auditing will be able to understand the auditor's judgment and to provide support to the auditor in any disputes between auditors and management. Meanwhile, auditors who do not have such knowledge will not be able to do so. In addition, members who have more knowledge in the field of finance have a greater possibility to be able to indicate and detect material misstatements. Audit committee members with financial expertise may also play a significant role in overseeing the financial report process more effectively, such as detecting material misstatements (Scarbrough et al., 1998; Raghunandan et al., 2001).

Abbott et al., (2004) finds a significantly negative relationship between the audit committee which has at least one member with financial expertise and the emergence of financial restatements. Meanwhile the research conducted by Krishnan (2005) shows that the audit committee which has financial expertise is less likely to be associated with the emergence of internal control issues. From the above, hypothesis 1 is formulated as follows:

H1: Expertise of Audit Committee has a positive influence on Internal Control Disclosure.

The existence of foreign directors in a company dramatically changes the balance of control of ownership (Ramaswamy, 2001). The participation of foreign directors of the company sends signals of intent to expand globally. In particular, companies that are looking for an established global market will include foreign technology, or align themselves with foreign competitors who may want to internationalize their governance structure as a signal that the management is serious about its efforts to go internationally.

Foreign Directors have a unique knowledge and understanding of various strategies of overseas market area a company wants. Their knowledge and expertise may be an added value for a company to apply in the movement of expansion. Top managers may have information that the owner might not have or understand (Chen et al., 1993).

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Usually experts are more capable of evaluating the environment and can be effectively deal with them (Day & Lord, 1992). At this point, the owners or their representatives (in this case foreign directors) having knowledge and expertise are more capable of monitoring the top management team and evaluating the strategic direction of the top management (Fama & Jensen, 1983). Therefore, shareholders or their representatives can use their authority, power, and expertise to increase the organization performance they invest in (Kang and Sorensen, 1999).

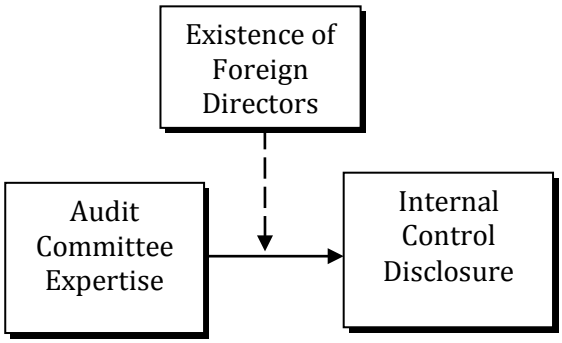
Foreign directors in this case could have their role to effectively monitor by making use of their position as experts to prevent value destruction coming from the manager's interests. The presence of foreign directors clearly offers a mechanism that halts the managerial negative impact. The main difference here is that foreign directors have the ability to train how to control and guide.

From the above explanation, hypothesis 2 is formulated as follows:

H2: The existence of Foreign Directors will strengthen the relationship between the expertise of Audit Committee and Internal Control Disclosure.

Based on this framework, the model is schematically illustrated as follows:

Figure 1: Schematic Research



Source: The scheme is developed by researcher for the purpose of this research

3. RESEARCH METHODS

The population of this research is all companies listed on the Indonesia Stock Exchange between 2012-2015 and published in *Indonesian Capital Market Directory* (ICMD) 2012-2015. The researcher used this population because all the companies reveal internal control.

Samples were selected using purposive sampling with the following criteria: a). The companies are nonfinancial corporations/banks listed on the Indonesia Stock Exchange (BEI) between 2012-2015. b). The companies publish full annual report, including internal control disclosure and it is available to the public. c). The companies publish the expertise of the audit committee and the existence of foreign directors. The analytical tool used to test the hypothesis is multiple linear regression.

4. VARIABLE OPERATIONALIZATION

Disclosure of the companies' internal control is seen from their disclosure of annual reports. If, during the designated year, a company has a detailed disclosure based on the COSO rules (1992), then the company is identified as having a detailed

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disclosure of internal control. These measurements were performed by using Internal Control Disclosure Index (ICDI). ICDI is almost similar to the ICRS (Internal Control Reporting Score) developed by Deumes (2008).

Internal control disclosure is expressed as the dependent variable and its measurement includes integrity and ethical values, the board of directors' understanding of the responsibility and supervision, management philosophy and operation style, effective support of the organization structure to internal control, the competence of financial report, authority and management/employees responsibility, policies and human resources , financial report purposes and the criteria for risk identification, financial report risks, the risk of fraud, integration with risk assessment, selection and development of activity, policies and procedures, information technology, financial report information, and internal control information.

Meanwhile, the independent variable in this study is expertise of the audit committee. According to Defond et al. (2005), Krishnan and Visvanathan (2008), Dhaliwal et al. (2010), the audit committee is an audit committee having financial expertise who has the experience as an investment banker and a financial analyst. The measurement used is the number of people who have a role as an audit committee based on their financial expertise. The audit committee expertise is measured by using: the percentage of the audit committee members who are experts in accounting and finance.

Moderation variables are variables other than the independent variables allegedly influencing the dependent variable. In this research, the moderation variable used is the existence of foreign directors in the company. This variable is measured based on the number of foreign directors in the company. If a company employees foreign directors, how many foreign directors working in the company will determine the variable.

The method used in this research is multiple regression analysis, and the model of the equation is as follows:

$$Y = \alpha + \beta 2\ \beta 1X + Z + X*Z + e$$

Note:
α: constanta,
β: regression coefficient
Y: Internal Control Disclosure
X: The audit committee expertise
Z: The existence of foreign directors
X * Z: Interactions
e: error

5. RESULTS AND DISCUSSION

Normality test results based on the histogram graph and normal probability plots indicate that the data are spread around the diagonal line and follow the direction of the diagonal line. Meanwhile, data on the histogram graph show a normal distribution pattern. Furthermore, the Kolmogorov-Smirnov (K-S) test indicates that the value of the Kolmogorov-Smirnov test was significant at 0.397 and 0.762. Thus, it can be concluded that the regression model met the assumption of normality of data. Multicollinearity test results demonstrate that the value of tolerance of each independent variable is greater than 10% (Tolerance values> 0.1). Meanwhile, VIF value of each independent variable is less than 10 (VIF <10). Thus, it can be concluded that there is no multicollinearity on each variable. The results of Gleisjer heteroscedasticity test

ISSN: 2304-1013 (Online); 2304-1269 (CDROM); 2414-6722 (Print)

generate residual coefficients which are not significant, meaning that it is free from heteroscedasticity. Similarly, autocorrelation test resulting in a Durbin-Watson value is in the region where there is no autocorrelation.

Based on the results of multiple regression analysis, the following regression equation is found: Y = 0.605 + 1.542 X + Z + 0,041 X*Z + e.

Based on the above equation, there are positive impacts of audit committee variables (X) toward the interaction of the existence of foreign directors and audit committee (X*Z). Results of regression analysis to test the feasibility of the model result in probability figures/significance of 0.000 <0.05, meaning that the hypothesis 1 and hypothesis 2 are acceptable. This means that independent and moderation variables simultaneously become a significant modifier of the dependent variable.

The result of this research supports the hypothesis related to the relationship among audit committee expertise and internal control disclosure based on the agency theory.

The finding of this research is that the expertise of the audit committee has positive impacts toward internal control disclosure. The result of regression analysis shows that the value of beta coefficient (b1) is 0,656 with the probability figure/significance of 0,000 < 0,05. This indicates that the expertise of the audit committee is significant and has positive impacts toward internal control disclosure.

The result of this research is in line with Krishnan (2005) which shows that an audit committee having financial expertise is able to increase the internal control material weakness disclosure. This research also supports Abbott et al., (2004) who find significantly negative relationship between an audit committee having at least one member with financial expertise with restatements of financial report. Appointing an audit committee having accountant expertise is expected to improve the corporate governance through better monitoring. Karamanou dan Vafeas (2005) conduct research on several attributes to audit committee, including expertise, and find that any company with effective governance mechanism is most likely to make or renew management forecast. An audit committee plays a key role in cutting agency cost by paying attention to the effectiveness of the management financial report policy (Klein, 2002; Be´dard et al., 2004; Archambeault et al., 2008).

In addition, Cohen et al. (2004) assert that various characteristics of an audit committee influence its effectiveness as a mechanism of the company management. The findings of Zhang et al. (2007) and Krishnan and Visvanathan (2008) show that specific domain knowledge of accounting experts of the audit committee creates effective ways to monitor practices of management financial report and reduces the related agency cost.

Expertise of an audit committee can prevent financial restatements in this way: an audit committee having at least a member knowledgeable of financial expertise is most likely able to understand the internal audit program along with its implication (Raghunandan et al., 2001; Scarbrough et al., 1998; Institute of Internal Auditors IIA, 1993). This, in turn, will ensure the right mechanism to place personnel in the right place to be responsible for the company and increase the effectiveness of internal control to prevent or detect the material misstatement.

The finding of this research recommends that companies are required to have audit committees which have financial experts because such audit committees have been proven to be able to improve internal control disclosure. Result of the test of hypothesis 2 is significant, meaning that the existence of foreign directors strengthens

ISSN: 2304-1013 (Online); 2304-1269 (CDROM); 2414-6722 (Print)

the relationship between the expertise of an audit committee and internal control disclosure. Results of regression analysis with the value of beta coefficient (b2) of 0,139 and the probability/significance of 0,046 < 0,05, show that the expertise of an audit committee has positive impacts and is significant toward internal control disclosure.

The result of this research is similar with that of Ramaswamy (2001) which explains that the existence of foreign directors in a company dramatically changes the balance of ownership control. This finding indicates that the existence of foreign directors is important because their network, educational background, and experiences in technology will broaden the perspective of and be useful for the audit committee so that in the end these will strengthen internal control disclosure.

6. CONCLUSION

This study was able to prove the impact of audit committee expertise on the internal control disclosure significantly and was able to significantly test the existence of foreign directors as the moderation variable.

Thus expertise of the audit committee and the existence of foreign directors are able to address the increase in disclosures to reflect the existence of good internal control, so that these have an implication for the more reliable and qualified financial report. In turn it can reduce the risks of mistrust that the financial information is incorrect, as it is accepted by stakeholders.

The financial expertise of audit committee members is important in relation to the complexity of the financial statements to reduce the restatement of financial statements. Audit committee members who have knowledge of financial reporting have a greater possibility of being able to indicate and detect material misstatements. Audit committee members with financial expertise may also play a crucial role in overseeing the financial report process more effectively, such as detecting material misstatements.

7. RESEARCH LIMITATIONS AND SUGGESTIONS

Limitations of this study lie on the measurement of internal control disclosure by only using items on the 1992 COSO, so that research results do not completely reflect the existence of corporate governance rules (code) in Indonesia.

Future studies are expected to use the measurement rules, i.e. code of corporate governance, internal control disclosure issued by the Indonesia Financial Services Authority to comply with the existing regulations in Indonesia.

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