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THE INTERNAL CONTROL DISCLOSURE, THE EXECUTIVE COMPENSATION, AND THE TIMELINESS OF FINANCIAL REPORTING

Julianti Sjarief[1] and Weli[2]

Abstract: *The important issue of the disclosure of the company's internal control condition has long been the attention of the global capital market, including in Indonesia. To provide a certainty to the investor for their investment in Indonesia, the BAPEPAM-LK (Indonesian Securities Regulator) had issued a decision on August 1, 2012, no X.K.6 regarding the annual emitter's report. One of the important points of that decision was the obligation to disclose more detailed information about the internal control system, the risk management and the whistle blowing system. The purpose of this study is to analyze how extensive the Indonesian Public manufacturing companies disclose their internal control and how is the relationship between the extent of the internal control disclosure, the executive compensation and the timeliness of company's financial report. Data collected from 55 company's annual reports that could be accessed. The result of the analysis had indicated that most of the companies had already disclosed the compliance objectives of the company's internal control that was guided towards the law management and the risk regulations. The hypothetical test had indicated that there was a relationship between the extent of the company's internal control's system and the extent of the executive's compensation and the timely publication of its financial report.*

Keywords**:** *The internal control disclosure, financial report, executive compensation, timeliness.*

1. INTRODUCTION

Internal control is a process conducted by the company's board of management, the management, and other personal designed (1) to give certainty about the effectiveness and efficiency of the company's operation, (2) the reliability of financial statements, and (3) the obedience towards the law and regulations (Ghosh & Lubberink, 2006). The internal control is also needed in generating the financial report so that it reflects the company's real operation. The assurance of the effectiveness of the company's internal control is an obligation for the company which stock is traded at the capital market. An effective internal control system will benefit the company, especially to attract the market. (Shon & Weiss, 2009).

[1-2.] Universitas Katolik Indonesia Atma Jaya Jakarta

However, the investor cannot access the information regarding the company's internal control, if the company does not disclose it. This is because the information regarding the internal control conditions are limited, not all companies fully disclose their internal control condition in their financial report. This condition goes on at the capital market in Indonesia, because the previous Indonesian capital market's authority had not yet explicitly regulated the obligation to disclose the internal control system by the emitter and the public company. However, on August 1, 2012, BAPEPAM-LK as the authority of the capital market in Indonesia had issued a new regulation regarding the financial reporting among others it regulates the disclosure of the company's internal control. This new regulation provides a new access for the investors to get information regarding the application of the company's internal control. Hence, the investors could see whether the financial report presented could be trusted or not, and whether there is an opportunity for fraudulent financial report.

Based on above explanation, it is therefore very interesting to examine how emitters react towards this matter. Because this regulation was applied for the annual report that had ended at or beyond 31 December 2012, this study will see whether this regulation has already been acknowledged by all the emitters. This can be obtained from their annual report for the book year ended 2013. Besides, this study also asses the relationship between the disclosure and the timely publishing of the financial report by the public company. The timeliness of the published financial report is very much needed because it is related to the benefit of knowing the information content in the financial report for the investor's decision making. Hence, although the information contained in the report is of good quality, however, if not timely published, this information will become not relevant.

Therefore, the aim of this study is formulated as follows:

1. To analyze the extent of the internal control system disclosure of Indonesian public companies after the issue of the BAPEPAM-LK regulation no: Kep-431/BL/2012.
2. To analyze the relationship between the extent of the internal control disclosure with the executive compensation.
3. To analyze the relationship between the extent of the internal control disclosure with the financial report timeliness.

Although the previous study regarding the relationship between the internal control and the executive compensation was conducted (Shon & Weiss, 2009;Leng & Ding, 2011; Balsam, Gordon, Li, & Runesson, 2012), however, it was not yet related with the extent of the internal control system disclosure. As well as with the study about the timely publishing of the financial report. Most of the previous studies had studied the characteristics of the company and the audit lag issue with the timely publishing of the financial report, and the addition in the corporate governance issue (Na'im, 1999;Owusu-Ansah, 2000;Karim, Ahmed, & Islam, 2006;Ezat & El-Masry, 2008;Türel, 2010;Akle, 2011;Moradi, Salehi, & Mareshk, 2013).

2. LITERATURE REVIEW

2.1. The Internal Control Disclosure and the Executive's Compensation

The effort to increase the internal control's activities will cause an increase in significant cost for the manager. The manager needs more cost for their efforts to reach an effective internal control system, compared to the benefits that the company will receive. Hence, the incentive is very much needed to reach this benefit. The company will adjust the compensation contract to motivate the managers to create an effective internal control system (Shon & Weiss, 2009).

The result of Shon & Weiss (2009) had proven that there existed a positive relationship between the executive compensation and the effective control system. Also, with the study result of Leng & Ding (2011), they had found that the internal control disclosure at the company's financial report was related with the executive compensation. The same was also concluded from the study by Balsam, Gordon, Li, & Runesson (2012). The result of their analyses had strongly supported the relationship between the obligatory disclosures regarding the executive's compensation, because the obligatory disclosure will motivate the management to increase the control and responsibility.

Based on this explanation, the hypothesis 1 is defined as follows:

H1: There is a relationship between the extents of the internal control disclosure with the size of company's executive compensation.

2.2 The Extent of the Disclosure and the Timely Reporting of the Financial Report

Referring to the regulation no. 104 Sarbanes-Oxley Act 2002 regarding the obligation to disclosure the internal control system, the consequence for the company is, that it must be able to timely identify the internal control problem. With a timely information presentation, it is hoped that the company can have a reliable financial report that will increase the confidence of the investors. However, due to some reason, the obligation to disclose the weakness of the internal control will not always result in a presentation of a timely financial report (Ghosh & Lubberink, 2006). The weakness of the internal control system of the company influences the ability of the company to begin, to note, to process, and to report the financial data. The weakness of the material internal control happens if there is a lack at one or more of the useful components of the company's internal control which is useful to detect and to avoid one of the materials in its timely financial report. A previous study related to the timely financial statement report was conducted by Karim, Ahmed, & Islam (2006), who had conducted a study about the timely financial reporting in Bangladesh, and its result indicated that there was no improvement in the timely reporting after the government regulation regarding the delivery of the financial reporting.

Based on above mentioned analysis, the Hypothesis 2 is defined as follows:

H2 : There is a relationship between the extent of the company's internal control disclosure with the timelines of company's financial reporting.

3. RESEARCH METHOD

The population of this study was the Indonesian public manufacturing company. The data collected from company's annual report year ended 2013. Based on the fact book of 2013, published by the Indonesian stock exchange, 135 companies were found to be in the basic industry and chemicals, miscellaneous industry and consumer goods industry. Using the Slovin's formula, there were 101 samples chosen at random, however, only 55 companies, in which their reports could be accessed as obliged.

In order to reach the study's aim, the data analysis used the quantitative content analysis based on the texts at the company's annual report, regarding the internal control system in accordance with the index list of the items as exposed by the internal control system that had already been issued. This index disclosure is made with the aim to understand and to measure the difference in the disclosure praxis between companies. The calculation of the real index of the voluntary disclosure was formed by dividing the real total items disclosure with total items that can be disclosed by the company. The internal control items used in this study, was adopted from Ashbaugh-Skaife, Collins, & Kinney Jr (2007) consisting of 9 items. To test the relation between the variables that were proposed in the hypothesis of this study, the data processing used the correlation technique.

3.1. Operational Variable

3.1.1. The extent of the disclosure of the internal control at the company's annual report

The extent of the internal control disclosure of the company's annual report describes how much information about the company's internal control was disclosed to the public through the company's annual report.

The measurement of the extent of the internal control disclosure used the dichotomy score, that is, 1 for items disclosed, whereas 0 was for the items that were not disclosed in accordance with the disclosure of the internal control items. The extent of the disclosure was calculated by the amount of items disclosed, and thereafter the extent was grouped into 4 levels, one for lower disclosure and 4 for the highest disclosures. The following is the explanation of the nine items of internal control disclosure in the company's financial report.

1. The scope of the internal control, consisting of the risk identification, risk management and the aim of the internal control
2. Description of the internal control system
3. Specific risk, improvement or significant change in the internal control system.
4. The valuation of the effectiveness of the internal control system and the pronouncement of the internal control in the financial report.
5. The obligation of the management towards the company's internal control.
6. The role of the commissioners and the audit committee, in the company's internal control system.
7. The company's policy that is directed towards the adoption of the standard, manual, or the international internal control criteria such as COSO.
8. The role of the external auditor in the company's internal control system.
9. The role of the internal auditor in the company's internal control system.

The extent is measured by comparing the items that were explained in the company's annual report with above mentioned items that had to be disclosed.

3.1.2. Executive Compensation

The executive compensation variable shows the amount of compensation received by the Management Board. Balsam, Gordon, Li, & Runesson (2012) had only used the CFO compensation to measure the executive compensation variable related with the IFRS adoption by 16 countries compared with 5 countries that have not yet adopted the IFRS. This was carried out because the CFO had a direct interaction when compiling the financial report, so that it provided an incentive for the CFO's. Shon & Weiss (2009) had used one of the four executive compensation proxies, that is, the natural logarithm from the total CEO annual cash compensation, the natural logarithm from the annual CEO total cash compensation, the natural logarithm from the total CEO's annual cash compensation, the natural logarithm from the total annual CEO's bonus compensation, and the natural logarithm from the annual CEO equity. While Armstrong, Blouin, & Larcker (2012), had used the total compensation value, which was received for one year by the company's executives and the compensation mix which consisted of the ratio of each compensation component towards the total compensation value received. Armstrong, Blouin, & Larcker (2012) had measured the executive compensation from the whole types of compensations provided to the Management board. In difference with the previous study, this study had used the categorical measurement, in which 1 was for the lowest level and 4 for the highest level. The grouping was done towards the total compensation's value received by the company's executives during one year, which was disclosed in the Notes on the company's financial report.

3.1.3 The company's Timely Financial Report

According to the BAPEPAM-LK's regulation no. Kep-431/BL/2012 regarding the annual reporting of the emitter's or the public company, the emitter and the public company are obliged to send the annual report to the BAPEPAM-LK at the latest 4 (four) months after the end of the book year. Therefore, the disclosure after this time limit will have no more of will have lost its benefit when making decisions. Hence, the regulation in Indonesia which is related with the capital market has regulated the timeliness as an obligation for the registered company at the Indonesian capital market (BEI) to report its financial reports regularly.

The timely financial reporting variable in this study is measured at the time of the annual report presentation to the BEI. The company's are categorized as timely (=2) if the annual report is published at the latest on 30 April, whereas companies that are late (=1) are companies that publish their annual reports after April 30th.

4. RESULT AND DISCUSSION

4.1. Result of the Statistical Description Analysis

An analysis result had indicated that only the identification of risk item that was disclosed by the whole company, while the other items were disclosed had variations between companies. Also, only 3 companies had fully disclosed.

Most items that were not disclosed were about the external auditor and reports regarding the internal control, the standard adoption, the manual or criteria of the internationally internal control.

Table 1
The internal Control Disclosure

No.	*Internal Control Disclosure*	*Yes*	*No*	*%*
1a	Identification of risk	55	0	100%
1b	Management risk	54	1	98%
1c	Objectives of risk – strategic	29	26	53%
1d	Objectives of risk - financial reporting	23	32	42%
1e	Objectives of risk – compliance	41	14	75%
1f	Objectives of risk - safeguarding of assets	25	30	45%
1g	Objectives of risk – operations	37	18	67%
2	Disclose on the description of the internal control system	41	14	75%
3	The disclosure of specific risks, improvements or significant changes in the internal control	32	23	58%
4	The internal controls over financial reporting	31	24	56%
5	Management's responsibility for internal control	44	11	80%
6a	The supervisory board in the functioning of the internal control system	39	16	71%
6b	The audit committee in the functioning of the internal control system	43	12	78%
7	Reference made to established international code, guideline or other criteria with respect to internal control	6	49	11%
8a	The external auditor and his role in the internal control system	9	46	16%
8b	The external auditor and his reporting over internal control, internally	5	50	9%
8c	The external auditor and his reporting over internal control, externally	7	48	13%
9	Disclosure concerning the role of the internal auditors in the firm's internal control	30	25	55%

Table 2
Percentage of Companies and Items Disclosed

Items Disclosed	*Number of company*	%
4	2	4%
5	1	2%
6	1	2%
7	4	7%
8	11	20%
9	4	7%
10	6	11%
11	5	9%
12	14	25%
13	4	7%
15	3	5%

The data analysis regarding the timely annual report publication of 2013 to the Indonesian Capital Market indicated that only 38 companies had timely delivered their annual reports, while 17 companies had not delivered their annual reports of 2013 on time or after April 30th, 2014.

Table 3
The Timely Presentation of the Annual Report to the BEI

	Quantity	%
Timely	38	65,5%
Not timely	17	34,5%
Total	**55**	**100%**

From table 4 it can be seen that the average total compensations received by the Executive during 2013 were IDR. 24.372.469.718 while the minimum of the total compensations were IDR 430.000.000,- and the total maximum of compensations were IDR. 187.324.000.000,

Table 4
Received Compensation by the Executives during 2013

Description	*Qty*	*Min*	*Max*	*Mean*
Komp < 1000m	25	430	187324	24372.47
Komp 1000m – 5000m	23			
Komp 5000m – 10000m	5			
Komp > 10000m	2			
Total	**55**			

Result of the data processing using the IBM SPSS v 22 for the correlation analysis "Rank Spearman" had indicated that there was a relationship between the extent of the disclosure of the company's internal control condition and the extent of the company's executive compensation, as seen from the correlation coefficient value of 0,322 and a significant at 0.017. There was also a relationship between the extent of the company's internal control condition with the timely presentation of the financial report as seen from the correlation coefficient value of 0,512 and significant at 0.000.

Therefore, the hypothesis of 1 and 2 can be accepted.

Table 5
Result of the correlation test

	Compensation by the Executives	*Timely Presentation of the Annual Report*
Internal Control Score	0.322	0.512
Sig. (2-tailed)	0.017	0.000
Description	Low	Moderate

5. CONCLUSION

The condition of the internal control disclosure at Indonesian Public manufacturing companies in the annual report of 2013 indicated that the companies had not yet completely responded towards the BAPEPAM-LK regulation no: Kep-431/BL/2012. This fact was indicated because only 3 companies from the 55 companies that had disclosed the internal control item completely. This might have been caused because the regulation was still new and had not yet been rightly socialized, and further, the task and function of BAPEPAM-LK had been transferred to the OJK (Financial Service Authority), as from 31 December 2012.

The result of the analysis had indicated that there was a relationship between the extent of the disclosure of the internal control with the executive compensation and the timely publication of the company's financial report. This means that the more extensive internal control disclosure the higher compensation received by the executive. The more extensive disclosure of the internal control indicated a good executive performance so that it could push the effective internal control. The good executive performance will push the compensation higher.

The result of this study was in accordance with Shon & Weiss (2009), which had proven that there was a positive relationship between the executive compensation and the effective internal control system. Also, with the study result of Leng & Ding (2011), in which they had found that the disclosure of the internal control system at the company's financial report was related towards the executive compensation. The same could also be concluded from Balsam, Gordon, Li, & Runesson (2012) study. Their analysis had given a strong support to the relationship between the obligatory disclosures of the executive compensation, because the obligatory disclosure will compel to management to increase their control and responsibility.

Therefore, it can be concluded that the efforts to increase the internal control effectiveness will cause a significant increase in cost for the managers. The managers need more cost for their efforts to achieve an effective internal control, compared to the benefits that the company will receive. Hence, incentive is very much needed in their effort to reach that benefit. The company will adjust the compensation contract to motivate the mangers in creating an effective internal control (Shon & Weiss, 2009).

As many as 38 companies or 65.5% had already timely published their annual report. The result of the analysis had also indicated that there was a relationship between the extent of the company's internal control disclosure with the timely financial report of the company. This indicates that most of the companies had already fulfilled the BAPEPAM-LK regulation no. Kep-431/BL/2012 regarding the publication of the emitter's and the public company's obligation to publish their annual report to the BAPEPAM-LK not longer than 4 (four) months after the annual book year had ended. This indicated that the higher the disclosure of the company's internal control, the company tend publish their annual report in a timely manner, because the extent of the internal control disclosure had shown that the company has a good internal control system. One of the aims of the internal control is to prepare a better financial reporting and internal control which will have an impact on the timely annual report that can be relied on. The result of this study differs from Karim et al. (2006) that had conducted a study about the timely financial reporting in Bangladesh and the result indicated that there was no improvement in the timeliness after the government regulation regarding the financial report publication.

Considering that the regulation issued was new, the next study could be done using annual reports of more than one year in order to look at the development of the awareness regarding the need for the disclosure of the internal control in the company's annual financial report. Besides, the test could also be done by adding the other independent variables, such as that is related to the independency of the board of commissioners, the profit quality, and the size of the company.

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