ISSN (Online) 2456 -1304

International Journal of Science, Engineering and Management (IJSEM)
Vol 4, Issue 8, August 2019

The Making of Financial Reporting Affected by Internal Control

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***Abstract:* - Financial reporting have to provide information on how a company earns and spends cash, about getting and repaying loans, about capital transactions, including cash dividends and distribution of other company resources to shareholders, and about other factors that can affect company liquidity or solvency. Out of several literatures, it is stated that improvement of financial reporting quality is affected by internal control variables. This study was conducted on banking industry with respondents of 50 accounting staff using explanatory survey methods. The data testing used is simple linear regression with the analysis tools approach SPSS. The results of the study showed that internal control affects the quality of financial reporting. Therefore, to make a good quality financial reports, it is mandatory to pay close attention to internal controls designed in the organization.**

Key words: internal control, financial reporting quality, financial reporting, financial information, manufacturing company.

INTRODUCTION

The recent world economic conditions are still not stable, thus efforts are needed to achieve and meet the world economic stability. Responding to these conditions, economic business people, include parties in the company (management) and parties outside the company (investors, creditors, and other interested parties) need sufficient information to be able to make a strategic decision to achieve the goals. These information can be seen through the company's financial statements.

Gibson [1] mention that financial reporting aims to provide useful information for decision making in economic business. However, on its practice in the scope of provincial and district/city government institutions, a poor financial reporting is still found. Pudjianto [2] as a Directorate General of Regional Finance, Ministry of Home Affairs, stated that there were 209 regional governments or equivalent to 40% of 524 provincial, district / city governments found to have poor financial reporting. There are two main issues that have caused regional finance to remain poor. The first issue is that human resources who handle regional finance in local governments mostly is not a professional staff. The second issue, namely the recording of regional assets that are still not maintained well by the local government, one of the causes of regional balance sheet inaccuracy is the assets are not recorded properly.

Elliot & Elliot [3] revealed that the importance of financial matters in financial reporting is that the assumptions used in financial management decisions can provide evidence of expected economic condition. Furthermore, Fauzi [4] as the Minister of Home Affairs said that the poor internal control system which had not functioned optimally was the biggest cause of the poor financial reporting management of the local government.

Internal control is a process, which is affected by the board of directors, entities, management, and other personnel, which is designed to provide logical certainty regarding the achievement of goals that categorized as follows: operations effectiveness and efficiency, reliability of financial reporting, and compliance with existing laws and regulations [5]. This is in line with Romney & Steinbart [6] which states that internal control is a process that is carried out to provide sufficient guarantees that control goals have been achieved. The intended purpose is an action to secure assets, make detailed records so that assets can be reported accurately and fairly, provide accurate and reliable information, present financial reports in accordance with established criteria, encourage and improve operational efficiency, encourage compliance with managerial policies predetermined and subject to applicable laws and regulations. Moreover, since the release of SOX, there have been dramatic changes in the role of internal controls, internal audits, and external audits of public companies, specifically in article 404, which causes company to be legally obliged to report internal controls on the financial reporting process. The main parts that must be covered in the financial reporting of public companies are as follows: (1) statement of responsibility of the company management for the arrangement and management of the internal control structure that is proper with the company's financial reporting system. (2) Identification of the framework used by management in evaluating internal controls for financial reporting. (3) An evaluation of internal financial reporting effectiveness conducted by management through the internal auditor. (4) Attestation of External Auditors [7].

With the existence of an internal control system for financial reporting, it is expected that it will give a positive impact on the economy. Based on the background described above, the authors are interested in discussing more about internal control that affects the company's financial reporting as it affects the economy as well.

LITERATURE REVIEWS

Internal Control

Internal control is a process, which is influenced by human resources and information technology systems, which are designed to help an organization achieve a certain goal or objective. As explained in the previous section, the Sarbanes-Oxley Law requires strong and effective internal control over the recording of transactions and the preparation of financial statements. The principle of internal control is very important because it can prevent fraud and make misleading financial statements. Furthermore, effective internal control can help companies direct the company's operations and prevent theft and other abuse. As an integral part of the operational process, the internal controls used by management must be harmonious to guide operations and not separate parts of an entity. Internal control consists of plans, methods, policies, and procedures used to fulfill the mission, strategic plan, objectives and objectives of the entity [8]. Trenerry [9] reveals that internal control is a system with the same way as accounting, which is a system consisting of a series of components built as a whole and integrated. Internal control is a system because it required to developed to achieve a series of goals. Internal control is carried out to monitor whether company's operational or financial activities have been running according to the procedures and policies that have been determined by management [10].

Financial Reporting Quality

Financial reporting is the activity of providing and presenting financial information. Information that is reported consist of four reports (income statement, statement of retained earnings, balance sheet, and statement of cash flow) and notes to financial statements [11]. Financial reporting quality is defined as reporting that is able to provide complete and transparent financial information, and is not designed to manipulate and mislead users [12]. Quality Reporting is two procedures for user needs and protection of investors. The first procedure is based on user needs and qualifications determined with consideration of the report benefits for the user. The second procedure emphasizes on the investor protection and quality which is defined as fair and complete for the shareholders [13].

The Effect of Internal Control Towards the Financial Reporting

As previously explained in the background that internal control is a process, which is structured to provide a clear and logical certainty related to the objectives to be achieved by the entity. In broad, the objectives and risks associated with this matter can be classified into categories, as follows:

Operations – Operation Effectivity and Efficiency.

Reporting – Reliability of financial reporting

Compliance – Compliance with existing laws and regulations [5] [8].

According to points above, good quality financial reporting is required to obtain sufficient information that can be used for the users of financial reporting to make decision. One of the sources of the United States accounting literature that covered the purpose of financial reporting is the Statement of Financial Accounting Concepts by Business Entities issued by the Financial Accounting Standard Board (FASB) in 1978 [14] which states there are two main points, namely:

Financial Reporting aims to provide information to make various kind of decisions (such as; investment, credit, resource allocation and management performance)

The purpose of financial reporting is affected by economy, law, politic and social environment.

According to previous research, Mokoginta, Lambey, & Pontoh [15] found that the internal control system implemented by the entity was good, but it had not been implemented effectively and efficiently, causing a lack of quality of the financial statements made. Same as the research conducted by Darwanis & Mahyani D.D. [16] which concluded that partially the internal accounting control variables had an effect on increasing the reliability of local government financial reporting.

The results of research conducted by Kiranayawati & Erawati [17] shows that human resource competencies, internal control systems, and comprehension of accrual-based government accounting systems regulations have a positive and significant impact towards the quality of local government financial reports.

METHODOLOGY

This study aimed to examine and analyze how much influence internal controls had on financial report. Based on the research objectives, this type of research was explanatory research. The research that was used by the author used a quantitative approach, and the type of data used was quantitative data. The method taken to obtain data and information in this study, conducted data collection using questionnaire techniques. Djaali and Muljono [18] said that the questionnaire is a data collection tool in the form of questions that would be filled in or answered by respondents. The filling out in the questionnaire in this study used a Likert scale. After the data from all respondents were collected, data analysis techniques were carried out. Data analysis carried out in this study were validity, reliability, classical assumption, and Pearson correlation test. Ghozali [19] stated that the validity test is used to measure the validity of a questionnaire. Manimala [20] to measure reliability or consistency with the Cronbach's Alpha statistical test with values> 0.60 it is considered acceptable and the value of 0.70 is considered good.

RESULT ANALYSIS AND DISCUSSIONS

The objective of this study was to test and find out how much influence internal controls had on financial report quality. Respondents who participated in this study were 50 accounting staff at banking industry in Bandung.

From the results of validity test of internal control variables and financial report of quality variables, the Pearson correlation values obtained already had more correlation values than r table 0.254 and the sig value was also less than 0.05. So that all questionnaires that were used to measure internal control variables and financial report of quality variables were stated valid.

Based on the reliability test, the Cronbach's alpha value of the internal control variable 0.903 was greater than 0.6. These results indicated that the items in the statement on the questionnaire were stated reliable to measure internal control variables and the Cronbach's alpha value of the financial report of quality variable amounted to 0.903 was already greater than 0.6. These results indicated that the items in the statement on the questionnaire were stated reliable to measure the financial report of quality variables.

The hypothesis in this study were:

H0: There is no influence of internal control over financial report quality

H1: There is an influence of internal control over financial report quality

Based on the results of partial test calculations by looking at the sig value, the internal control variable was 0.000 which was smaller than 0.05, so that the decision of the hypothesis test decision was H1 was accepted, so the conclusion obtained was that there was an influence of internal control over financial report quality. The coefficient of determination can be seen from the R Square value of 0.590. This shows that the internal control variable is able to influence the quality of financial reporting by 59%, while the remaining 41% is influenced by factors other than internal control.

CONCLUSIONS

The company's internal control has a role to provide reliable and trustworthy financial information. This will happen if the financial reporting that is produced is complete, includes all the required information, and is accurate of the transaction. To maintain the quality of financial reporting can be accounted for, it is better to pay attention to internal controls, especially in the supervision of company property, by divisions that use the assets, and need to pay attention to the level of data security as well. Data security can be done by building a physically integrated information system both from hardware, software and networks so that there is a standard work completion. This study has not revealed all the variables that can affect the quality of financial report and further research is expected to examine other variables such as organizational culture, management commitment, business strategy and others.

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