

Does Internal Control Affect the Quality of Financial Reporting?

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Abstract

Mistakes in financial reporting are still a phenomenon that has occurred to date. Internal control is one component that can influence the quality of financial reporting. However, based on the results of previous research, there is still inequality, which is what motivates this research. This research aims to find out whether internal control influences the quality of financial reporting. This research uses a purposive sampling method. The sample in this study was 70 financial employee respondents who worked in the service, manufacturing, finance, and health industries—hypothesis testing using SEM PLS. The research results show that internal control influences the quality of financial reporting. This research contributes to enriching the literature and contributes to companies improving and maintaining internal control so that they can produce good quality financial reporting.

INTRODUCTION

The quality of financial reporting has always been an interesting topic to discuss in both the public and private sectors (Pham et al., 2022). This is because there are still many scandals related to low-quality financial reporting (Pham et al., 2021). In Indonesia, this problem is reflected in the case of PT Bukalapak, which made errors in financial reporting. Fairuza Ahmad Iqbal (2022) Head of Communications at Bukalapak, has admitted that there was an error in recording the acquisition value, which should have been 1 million US dollars to 1 billion US dollars. Apart from that, in South Korea, Yang Jeong-sook (2022) as a Member of the South Korean Parliament, said that Apple South Korea manipulated the ratio of profits to total sales to pay taxes at a lower nominal rate.

Problems with the quality of financial reporting also occur in the manufacturing industry, such as the case with PT Tiga Pilar Sejahtera. Judge Akhmad Sayuti (2021) decided that the former directors, Joko Mogoginta and Budhi Istanto, were guilty of manipulating the 2017 financial statements because to increase the brand's share price, they transformed six affiliated distributor companies into third parties, this resulted in inflated receivables (overstatements) amounting to IDR 1.4 trillion, apart from that, Judge Akhmad also mentioned the alleged flow of funds from the company worth IDR 1.78 trillion to management without adequate disclosure. Member of the Panel of Judges Arlandi Triyogo (2021) stated that the violations committed by PT Tiga Pilar Sejahtera had harmed shareholders and investors.

Financial reporting functions to convey financial information to its users (Muraina & Dandago, 2020). Financial information can be conveyed through various means, such as press releases, websites, interim reports, conferences, and annual reports (Mahdi Sahi et al., 2022). The information presented will be useful for users if it consists of two main characteristics, namely relevant and appropriate representation, and four supporting characteristics, namely comparable, verifiable, timely, and understandable (Pham et al., 2022).

The high quality of financial reporting can have a significant impact on stakeholders because it relates to the accountability of managing public funds and other assets entrusted to them. This will also help resource providers such as donor agencies, local investors, and foreign investors make important decisions (Muraina & Dandago, 2020). Financial disclosure is very

important for businesses and stakeholders because it is the main way management communicates with market participants and outside investors (Mahdi Sahi et al., 2022)

Research related to factors that can improve the quality of financial reporting has been widely carried out (Mahdi Sahi et al., 2022). One of them is related to the influence of internal control on the quality of financial reporting. Internal control is an integral process of actions and activities carried out continuously by management and all employees to provide adequate confidence in the achievement of organizational goals (Sujana et al., 2020.). An effective internal control system ensures the efficiency of the company's operations, achievement of financial and operational indicators, security of assets, reliability of financial reporting, and compliance with legal requirements (Selezneva et al., 2020). Internal control plays an important role in a company to protect the effectiveness and efficiency of processes, the reliability of financial reporting, and compliance with existing rules and regulations (M.S., 2021). Phornlaphatrachakorn (2019) also highlights that one of the important results of good internal control is the reliability of financial reporting.

The results of research conducted previously by (Pham et al., 2022), (Pham et al., 2022), (Anuruddha, 2021), and (Setiyawati et al., 2020) revealed that the effectiveness of internal control influences the quality of financial reporting. However, this is different from the results of research conducted by Simon et al. (2016) which revealed that internal control does not influence the quality of financial reporting. Because there are still gaps in research results, this research aims to find out further whether internal control influences the quality of financial reporting.

This research contributes to enriching the literature regarding the influence of internal control on the quality of financial reporting. Apart from that, this research also contributes to companies being able to improve and maintain the quality of their internal controls to be able to produce quality financial reporting so that it can be relied on by its users.

LITERATURE RESEARCH

Internal control

The control system is the main defense against false financial reporting (M.S., 2021). Internal control is very important because the accounting system as an information system that produces financial information can result in errors, both intentional and unintentional, so an adequate control system is needed (Anto & Yusran, 2023).

Internal control is the set of policies, procedures, and information systems used to protect assets and maintain the accuracy of financial data (Rahman P.6, 2021). Sujana et al (2020) internal control system is an integrated process that is carried out continuously to ensure the achievement of organizational goals.

Several studies have shown that internal control is fundamental in producing financial information that is useful for making decisions (Pham et al., 2022). Thus, internal control is a system that functions to protect assets and maintain the accuracy of financial data to achieve organizational goals.

Quality of Financial Reporting

Disclosure of financial reports is very important because it is a means for management to communicate with investors and the market (Mahdi Sahi et al., 2022). The general objective of financial reports is to present information regarding financial position, budget realization, cash flow, and financial performance, which is useful for making and evaluating decisions regarding resource allocation (Meinarsih et al., 2020). Therefore, quality financial reports will increase accountability and good governance in public companies (Anto & Yusran, 2023).

Quality financial reporting emphasizes transparency, which is assessed based on the accuracy of the company's objectives and the quality of the information disclosed therein (Ellili, 2022). Improving the transparency and quality of financial information is a way of showing public accountability of a company, which will affect the company's image (Anto & Yusran, 2023)

(Rezaei Pitenoedi et al., 2020) reveal that the quality of financial reporting focuses on increasing the relevance, reliability, and expansion of transparent accounting and financial information to facilitate monitoring of manager accountability for appropriate disclosure. Information in financial reports is considered relevant if it influences user decisions by helping to evaluate past or present events, predict the future, and confirm or correct the results of previous evaluations, while information is considered reliable if it is presented honestly and verifiably, and is free from misleading information. and material errors (Anto & Yusran, 2023)

Thus, overall, the quality of financial reporting emphasizes relevance, reliability, and transparency, which are assessed based on the quality of the information disclosed and can influence the decision-making of financial report users.

Hypothesis Development

Internal control over the quality of financial reporting

Starting from financial scandals that are increasingly occurring in the world, the role of internal control on the quality of financial reporting is increasingly emphasized (Pham et al., 2022). Internal control is seen as a mechanism used to monitor and secure financial reporting (Pham et al., 2021)

The results of previous research conducted by (Anto & Yusran, 2023) revealed that internal control influences the quality of financial reporting. Other similar results expressed by (Setiyawati et al., 2020) revealed that the application of internal control has a positive influence on the quality of financial reporting. In addition, (Pham et al., 2021), (Hammood & Dammak, 2023) and M.S. (2021) reveal something similar, namely that internal control has a significant influence on the quality of financial reporting. Based on this, researchers argue that internal control influences the quality of financial reporting.

H1: Internal Control Systems Have a Positive Influence on the Quality of Financial Reporting.

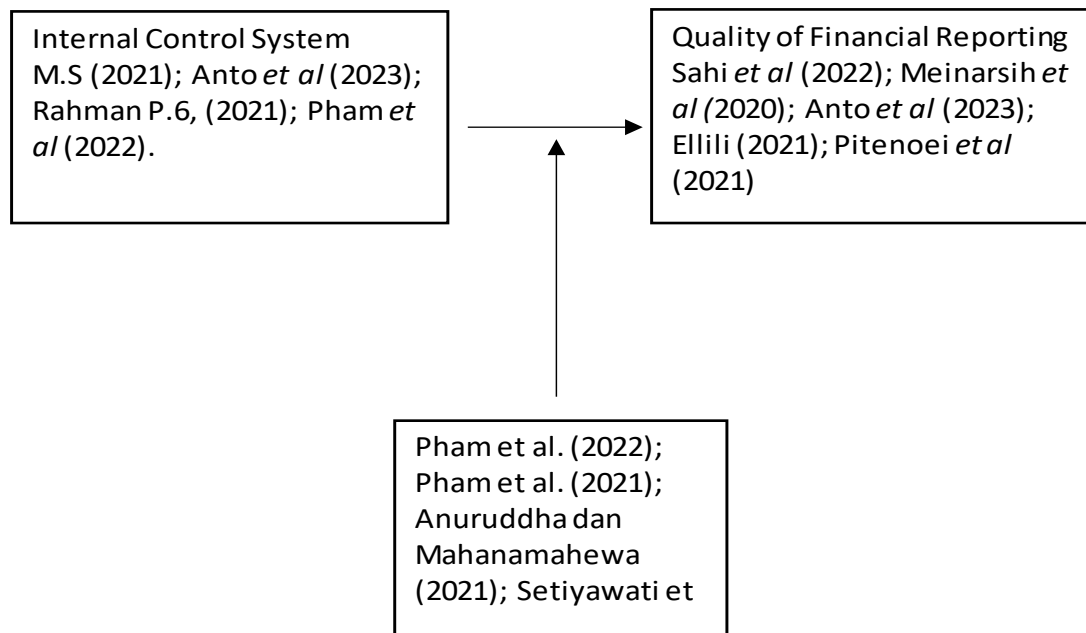


Figure 1 Research Model

RESEARCH METHODS

This research is quantitative, using primary data. The population in this study is made up of employees who work as financial staff. Sampling will be carried out randomly, not probability, with purposive sampling.

Variabel	Dimensi	Indikator	
Internal controls are policies, procedures and information systems used to protect company assets from loss or corruption, and to maintain the accuracy of financial data (karlina Ghazalah Rahman P.6 of 2021)	Protecting assets is safeguarding assets against possible losses arising from unintentional or intentional errors in asset processing and handling transactions (AICPA in the behavioral accounting book p 148 R.A. Supriyono 2018)	Securing assets against possible losses	
		Asset processing and handling	
		Unintentional mistake	
		A deliberate mistake	
The accuracy of financial data, namely the data recorded is precise and accurate (Ade Onny Siagian et al. P 142 of 2023)	The accuracy of financial data, namely the data recorded is precise and accurate (Ade Onny Siagian et al. P 142 of 2023)	Appropriate	
		Exactly	
		Noted	
Quality of Financial Reporting Financial Reporting Quality emphasizes the transparency of financial reporting, which is assessed by the accuracy of the objectives and the quality of the information disclosed in the company's financial reports. (Nejla Oule Daoud Ellili, 2021)	Transparency This transparency ensures that the company can provide reliable information to shareholders about the company's values and activities and motivates managers to maximize company value rather than pursue personal goals. (Fabio Albuquerque and Paula Gomes dos Santos. P 114)	Provide information	
		Maximizing company value rather than pursuing personal goals	
	Quality of information The quality of accounting information is determined by Primary Quality (relevance, reliability) and Secondary Quality (comparability and consistency) (Donald E Kieso, Intermediate Accounting 2009 P 35)	Quality of information The quality of accounting information is determined by Primary Quality (relevance, reliability) and Secondary Quality (comparability and consistency) (Donald E Kieso, Intermediate Accounting 2009 P 35)	Relevance
			Reliability
		Comparability	
		Consistency	

Table 1

Sugiyono (2018) stated the non-probability sampling method does not provide the same chance or opportunity for each component or member of the population to be taken as a sample whereas purposive sampling is a sampling technique that has special considerations. The sampling criteria in this research were financial staff who work in the service, manufacturing, finance, and health industries. The data collection technique was carried out by distributing closed questionnaires using a 5-point Likert scale, while interviews were conducted to enrich the research. The definition of variable (DOV) used to create questionnaire questions will be shown in Table 1.

The analysis technique in this research will use Partial Least Square – Structural Equation Modeling (SEM-PLS). SEM-PLS is a clause modeling approach designed to increase the variance of critical latent variables that can be explained by predictor latent variables. (Sholihin and Ratmo, 2021).

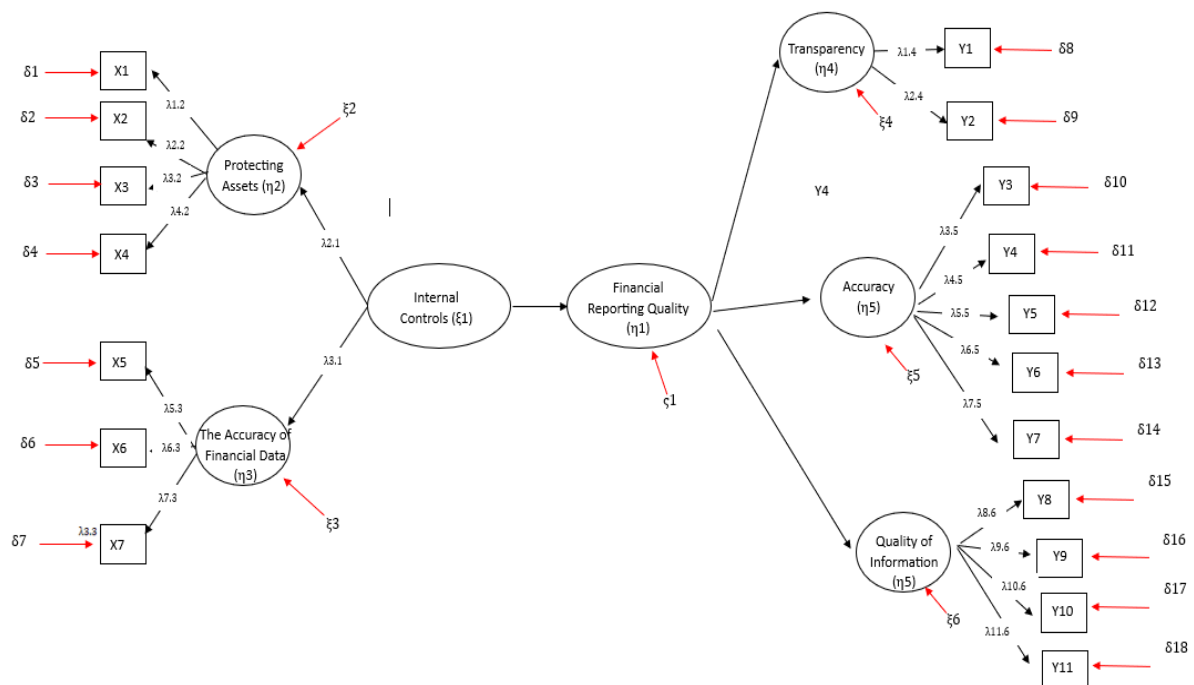


Figure 2: Path Diagram for the Combination of Measurement and Structural Models.

RESEARCH RESULTS AND DISCUSSION

Test Outer Model Measurement Model

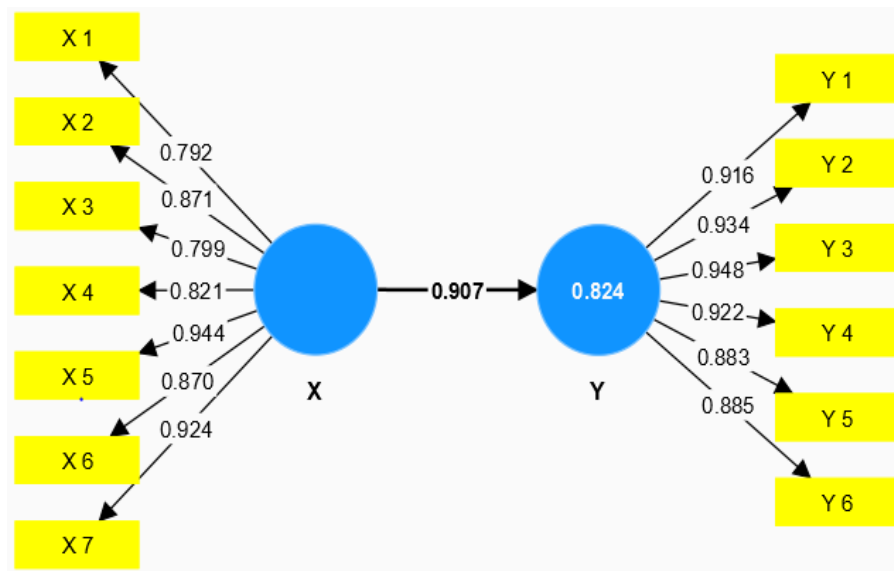


Figure 3: PLS-SEM Algorithm test results

The test outer model was carried out to assess construct validity and reliability. Construct validity testing in PLS-SEM consists of convergent validity and discriminant validity, while reliability testing can be done in two ways, namely test Cronbach's Alpha and composite Reliability (ρ_c) (Hamid and Anwar, 2019: 41).

Convergent Validity

	X	Y
X 1	0,792	
X 2	0,871	
X 3	0,799	
X 4	0,821	
X 5	0,944	
X 6	0,87	
X 7	0,924	
Y 1		0,916
Y 2		0,934
Y 3		0,948
Y 4		0,922
Y 5		0,883
Y 6		0,885

Figure 4: Convergent Validity

A construct is considered valid based on the convergent validity test if it exceeds 0.7 (Hamid and Anwar, 2019: 42). The results show that each construct exceeds 0.7, which shows that the constructs of this research have passed the convergent validity test.

Discriminant Validity

	Cronbach's Alpha	Composite reliability (rho_a)	Composite reliability (rho_c)	Average variance extracted
X	0,942	0,952	0,953	0,743
Y	0,961	0,963	0,969	0,838

Figure 5: Discriminant Validity (Average Variance Extracted)

This research uses tests Average Variance Extracted in the discriminant validity test. Average variance Extracted is said to be good if it exceeds 0.5 (Hamid and Anwar, 2019: 42). The results show that each construct exceeds 0.5 (Figure 5) which indicates that this construct has passed the discriminant validity test.

Reliability

	Cronbach's Alpha	Composite reliability (rho_a)	Composite reliability (rho_c)	Average variance extracted
X	0,942	0,952	0,953	0,743
Y	0,961	0,963	0,969	0,838

Figure 6: Reliability (Cronbach’s Alpha and Composite Reliability (rho_c))

The construct must also go through a reliability test which can be seen in Figure 5. The construct is said to be reliable if Cronbach’s Alpha above 0.7 (Savitri et al.,2021:35) and Composite Reliability (rho_c) above 0.7 (Hamid and Anwar, 2019: 42). It can be seen that the construct value for the test Cronbach’s Alpha and Composite Reliability (rho_c) above 0.7 which shows that the construct is reliable.

Test Inner Model or Structural Model

The second stage in the PLS-SEM test is the structural model test. The component that is the criterion in the structural model test is the R-value Square significance (Hamid and Anwar, 2019: 43).

R-Square

	R-Square	R-Square adjusted
Y	0,824	0,821

Picture 7: R-Square

The value of Adjusted R-Square financial reporting quality variable is 0.821, this indicates that the internal control variable can explain the financial reporting quality variable by 82.1%. So, it can be concluded that the model is considered strong.

Significance

	X	Y
X		4,667
Y		

Figure 8: Significance

Test results significance shows a result of 4,667, this shows that the influence of internal control on the quality of financial reporting is considered very strong.

Hypothesis testing

Hypothesis testing can be seen from the probability and T-statistic values > 1.96 (5% significance level) (Ghozali and Latan, 2015: 85).

	Original Sampel (O)	Sample mean (M)	Standard deviation (STDEV)	T statistic (I0/STDEV)	P values
X -> Y	0,907	0,906	0,031	29,442	0,000

Figure 9: Bootsrtaping (T Statistic dan P Value)

The test results obtained a T-statistic value of 29,442 > 1.96 and a P value of 0.000 < 0.05 , this shows that the hypothesis accepted. These results are inconsistent with research results (Simon et al., 2016) which state that internal control does not influence the quality of financial reporting however, in line with research conducted by (Pham et al., 2022), (Pham et al., 2021), (Anuruddha, 2021), (Setiyawati et al., 2020) which says that internal control influences the quality of financial reporting.

Various types of errors in financial reporting will be able to be identified, whether intentional or not if an organization has good internal controls. Internal controls help organizations produce good financial reporting and ensure compliance with laws and regulations, reliability of financial data and reporting, and reduce efficiency and effectiveness. With good internal control, a company's financial reporting will be reliable for stakeholders.

CONCLUSIONS AND RECOMMENDATIONS

Conclusion

Financial reports are a tool used by stakeholders to make important decisions, so quality financial reporting is needed. Quality financial reporting indicates that the information presented is reliable and unbiased. One thing that can influence the quality of reporting is internal control.

The results of this research show that good internal control can produce quality financial reporting. By having good internal control, you can ensure that the organization complies with existing regulations and that the data presented in the financial reports is reliable. Therefore, internal control is a tool used by organizations to ensure the reliability of financial reporting, where the information presented will be very influential for stakeholders.

Suggestion

Suggestions for companies regarding the implications of this research are that companies pay more attention to and improve the quality of internal control within the company so that they can produce good quality financial reporting. This is because the better the financial reporting, the more likely it is to avoid biased decision-making.

Suggestions for future researchers are that this research has not revealed all the variables that can influence the quality of financial reporting, so further research can include other variables that can influence the quality of financial reporting, such as human resources, accounting information systems, internal audit, and others.

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