

THE EFFECT OF THE CONTROL ENVIRONMENT TO EFFECTIVENESS INTERNAL CONTROL SYSTEM (Research in PT XXX, Tbk)

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ABSTRACT

This research is motivated by the data not yet achieved the target of audit result of internal control in PT XXX, Tbk. Although there is no material weakness, there are still some records that need to be acted upon. This encourages us to examine the Control Environment as the most important component within the scope of the internal control system and is the foundation for other internal control components.

In this study, tested the principles of Control Environment and its effect on the effectiveness of internal control system. Control Environment has 5 (five) principles, namely: (1) commitment to integrity and ethical value; (2) responsible oversight; (3) the determination of structure, authority and responsibility; (4) commitment to competence; (5) enforcement of accountability. While the effectiveness of internal control system includes 3 (three) dimensions, namely: (1) effectiveness and efficiency of operational activities; (2) reliable financial and information reporting; (3) compliance with laws and regulations.

The data has been collected and then analyzed further, and the data processing technique using Partial Least Square (PLS) technique using SmartPLS software support 2. The result of the research on Control Environment principles indicates that the principle of Commitment to Integrity and Ethics and the principle of Accountability Enforcement have a significant effect on the effectiveness internal control system. Simultaneously, the Control Environment gives 75.3% influence on the Effectiveness of Internal Control System in XXX.

Key Words: COSO, Control Environment, Tone at the Top, Internal Control.

1. INTRODUCTION

As listed and traded listed on BEI and NYSE, in addition to complying with applicable laws and regulations in Indonesia, XXX also complies with the Sarbanes Oxley Act ("SOX") and other SEC regulations. At least, there are two SOX rules that are relevant to the company. First, SOX Section 404 which states that management is responsible for internal control over financial reporting, Internal Control over Financial Reporting (ICoFR), to ensure the reliability of financial reporting and preparation

of financial reporting. Secondly, SOX Section 302 requires management's responsibility for the creation, maintenance, and evaluation of the effectiveness of procedures to ensure that the information in the report complies with the provisions of the US Capital Market Regulation.

Internal control is a process undertaken by the Board of Commissioners, Directors, management and other personnel within an organization, designed to provide reasonable assurance, that the organization can achieve its objectives which are divided into three parts:

- a. Effectiveness and efficiency of operational activities
- b. Reliable, timely, and reliable company reporting
- c. Compliance with laws and regulations

On the other hand, XXX has implemented a transition of the COSO Internal Control Integrated Framework framework from the previous version of 2006 to the 2013 version that has been effectively implemented in 2014/2015, as shown below:

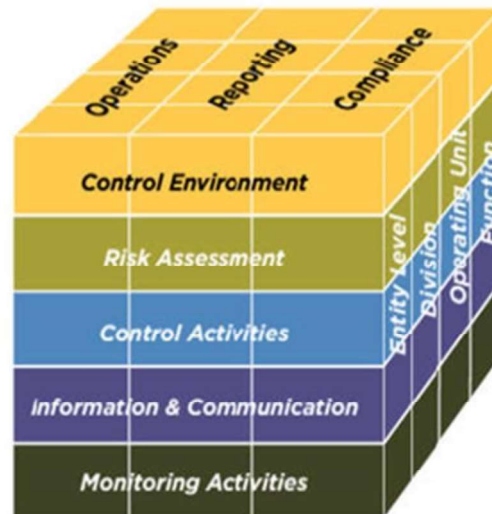


Figure 1. *COSO Internal Control-Integrated Framework*

One of the most important components within the scope of the company's internal control system in the drawings of the COSO framework and the foundation for other internal control components is the control environment reflecting the overall commitment, behavior, concern, and steps in implementing operational control activities company. In this context, the control environment is placed as a key factor for XXX in supporting an effective internal control system, in accordance with the following statement:

- 1) The control environment is the foundation of the discipline and structure of all other internal control components (Guy et al, 2002).
- 2) The principles embedded in the control environment component are essential to ensure the overall effectiveness of the internal control system (The Institute of Internal Auditors, 2011).
- 3) The control environment is a set of standards, processes, and structures that provide the basis for internal control throughout the organization (COSO, 2013).

- 4) The control environment shows sets or tones within an organization that affects the control consciousness of the people within the organization and is strongly influenced by the atmosphere created by the company leadership or tone at the top (COSO, 2013).
- 5) The resulting control environment has a pervasive impact on the overall internal control system (COSO, 2013).

The implementation of internal control in XXX is still accompanied by the following phenomena: (1) identified several findings or findings in internal audit controls that are repeatable. This may indicate that 'management did not track whether deficiencies are remediated on a timely basis'. Management has difficulty in identifying the root causes of various gaps or audit findings; (2) There is an issue of indiscipline and a lack of support/ tone at the top for integrity at both management and staff levels; (3) Non-achievement of target of Directors and Board of Commissioner that is Zero Significant Deficiency in audit internal control for years. In the framework of COSO Internal Control-Integrated Framework (ICIF) 2013, it is deemed necessary to examine Control Environment as the foundation of internal control.

2. LITERATURE REVIEW

COSO (2013) states, internal control is a process, effected by an entity's board of directors, management, and other personnel, designed to provide reasonable assurance regarding the achievement of objectives relating to operations, reporting, and compliance. This definition reflects certain fundamental concepts. Internal control is:

- 1) Geared to the achievement of objectives in one or more categories-operations, reporting, and compliance.
- 2) A process consisting of ongoing tasks and activities-a means to an end, not an end in itself.
- 3) Affected by people-not merely about policy and procedure manuals, systems, and forms, but about people and the actions, they take at every level of an organization to affect internal control.
- 4) Able to provide reasonable assurance-but not absolute assurance, to an entity's senior management and board of directors.
- 5) Adaptable to the entity structure-flexible in an application for the entire entity or for a particular subsidiary, division, operating unit, or business process.

In the Chartered Accountant Module of the Indonesian Institute of Accountants, internal control is an applied process to provide reasonable assurance that control objectives can be achieved. The control objectives are:

- 1) Maintain assets, prevent or detect unauthorized acquisitions, use or deletion.
- 2) Ensure that the reports record and report the company's assets accurately and reasonably.
- 3) Provide accurate and reliable information.
- 4) Preparing financial statements based on predetermined criteria.
- 5) Encourage the achievement of compliance with managerial policies.
- 6) Compliance with applicable laws and regulations.

In accordance with the latest framework of COSO (2013), the control environment is the set of standards, processes, and structures that provide the basis for carrying out internal control across the

organization. The directors and senior management establish the tone at the top regarding the importance of internal control including expected standards of conduct. Management reinforces expectations at the various levels of the organization. The control environment comprises the integrity and ethical values of the organization; the parameters enabling the board of directors to carry out its governance oversight responsibilities; the organizational structure and assignment of authority and responsibility; the process for attracting, developing, and retaining competent individuals; and the rigor around performance measures, incentives, and rewards to drive accountability for performance. The resulting control environment has a pervasive impact on the overall system of internal control.

The variables of the control environment principle are as follows:

1. Commitment to integrity and ethical values
2. Responsible oversight that demonstrates independence in internal control
3. Determination of structure, authority, and responsibility
4. Commitment to competence
5. Enforcing accountability for internal control responsibilities

Rachmat (2006) stated that the elements of control environment influence significantly to the effectiveness of the internal control system. Elements of the control environment that have a significant influence are external factors, management directives, and human resources.

Gonen (2009) stated that there is a significant relationship between control environment and internal control.

Zaenuddin (2013) stated that integrity, structural and external control variables significantly influence internal control system. Human resource variable and management attention variable have not influence the internal control system.

Meanwhile, Kabir (2014) stated that all the control environment variables are highly rated by respondents, with the smallest number in 65% of respondents who believe that integrity and ethical values have been well executed.

3. METHODOLOGY

3.1 PARTICIPANTS

Respondents are divided into groupings into three lines of defenses:

1. Respondents related to the implementation of internal control business processes, namely in business units and functional (first layer) as many as 52 employees.
2. Respondents related to internal control in terms of policy, corporate reporting, ethics, and risk (second layer) as many as 52 employees.
3. Respondents to units related to compliance supervision and evaluation of internal control, namely in legal and audit function (third layer) as many as 14 employees.

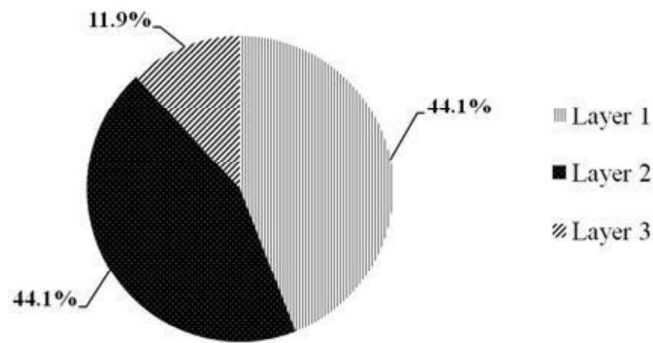


Figure 2. Percentage of Respondents

3.2 MEASUREMENTS

We decided to use PLS-SEM because of the number of respondents obtained in the 100employee range, and the main purpose of this study was to predict a pre-existing theory or framework on a new study object.

The Partial Least Square (PLS) model is defined to consist of two linear equations called the structural model (Inner model) and the measurement (Outer model). The structural model represents the relationship between latent variables that can not be measured directly, whereas the measurement model shows the relationship between latent variables and a group of manifest variables that can be directly measured.

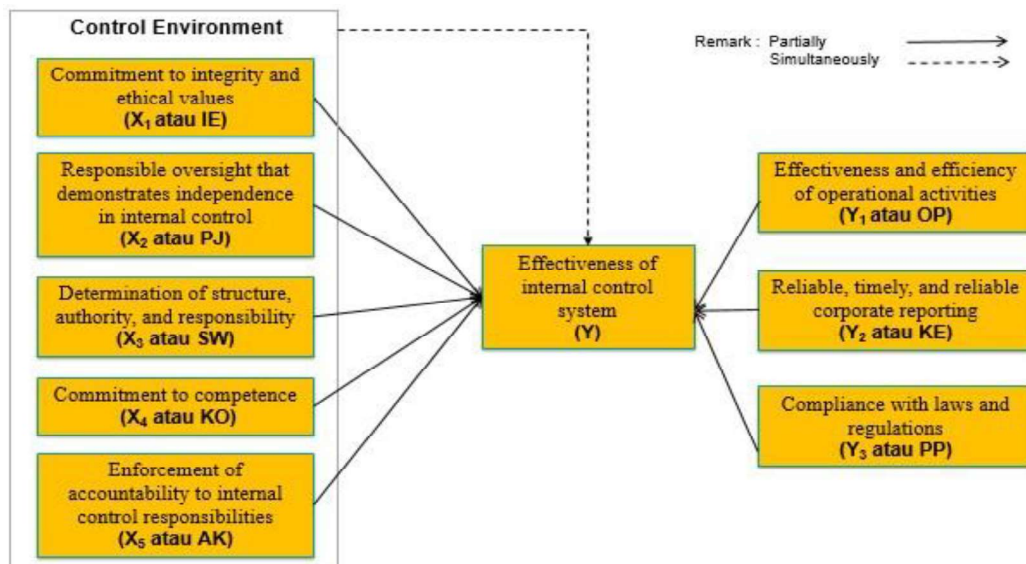


Figure 3. Inter-variable Relation Templates

This research model is described with 6 constructs, namely variable of control environment and variable of effectiveness of internal control system which will be further analyzed the influence and significance. Measurement models consist of 27 indicators used in this research.

The dependent variable consists of the principles of the control environment: (1) Commitment to integrity and ethical values; (2) Responsible oversight that demonstrates independence in internal control; (3) Determination of structure, authority, and responsibility; (4) Commitment to competence; (5) Enforcement of accountability to internal control responsibilities.

Independent variables used in this study is the effectiveness of internal control system consisting of indicators: (1) Effectiveness and efficiency of operational activities; (2) Reliable, timely, and reliable corporate reporting; and (3) Compliance with laws and regulations.

3.3 DATA ANALYSIS

In this study, data collection is done through an online questionnaire. The questionnaire was distributed via email, chat, and direct communication to the respondents who became the object of study. From the spread has been collected as many as 118 data of respondents. Respondents' answers are transformed into Likert 1 (strongly disagree) to 7 (strongly agree). Overall we do not do data reduction because all respondents fill the question completely, no answer bias and all data can be analyzed further.

4. RESULTS AND DISCUSSION

After done running model then obtained standardized value as presented in next picture.

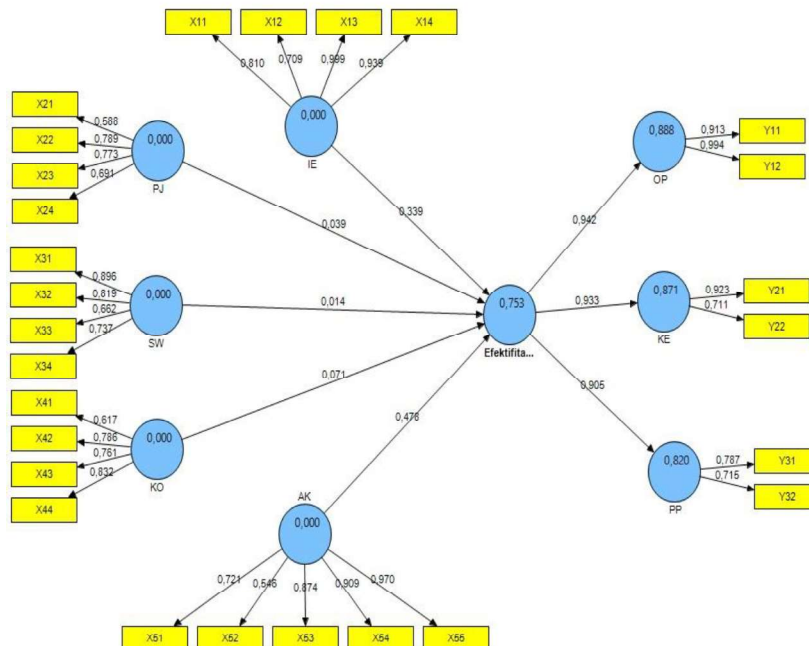


Figure 4. Smart Partial Least Square Analysis Analysis on Research Model

Table 1. Reliability

Variable	AVE	Composite Reliability	Cronbachs Alpha
IE (commitment to integrity and values of ethics)	0,760	0,926	0,887
PJ (responsible oversight)	0,511	0,805	0,893
SW (the determination of structure, authority and responsibility)	0,614	0,863	0,893
KO (commitment to competence)	0,567	0,838	0,842
AK (enforcement of accountability)	0,670	0,907	0,881
Effectiveness of internal control system	0,620	0,905	0,935

Table 1 shows the measure of Reliability for the measurement model, where each construct has a composite of reliability > 0.8, AVE > 0.5 and Cronbach Alpha > 0.6 so that all constructs have an adequate reliability value.

Table 2. Inner Model Evaluation

Variable	R Square	Q-Square
IE	-	0,542
PJ	-	0,527
SW	-	0,546
KO	-	0,439
AK	-	0,507
Effectiveness of Internal Control System	0,753	0,708

The value of R square > 0.67 (strong), and Q square (Stone-Geisser's) is greater than 0.35 (large), so it can be concluded that the inner model is fit.

Table 3. Calculation of Statistic Value

Relationship between Variables	Standardized Value (g)	SE (g)	t statistic	Structural Model
IE -> Effectiveness of Internal Control System	0,339	0,138	2,463*	$EF = 0,339IE + z_1$
PJ -> Effectiveness of Internal Control System	0,039	0,099	0,396	$EF = 0,039PJ + z_2$
SW -> Effectiveness of Internal Control System	0,014	0,113	0,124	$EF = 0,014SW + z_3$
KO -> Effectiveness of Internal Control System	0,071	0,143	0,498	$EF = 0,071KO + z_4$

AK -> Effectiveness of Internal Control System	0,478	0,123	3,873*	EF = 0,478AK + z ₅
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* significant on $\alpha=0.05$ (T table = 1.98)

Table 4. Hypothesis testing

Hypothesis		Parameter	statistic test	Conclusion
1	Control Environment -> Effectiveness of Internal Control System	0,753	62,50**	Ho rejected
2	IE -> Effectiveness of Internal Control System	0,339	2,463*	Ho rejected
3	PJ -> Effectiveness of Internal Control System	0,039	0,396	Ho accepted
4	SW -> Effectiveness of Internal Control System	0,014	0,124	Ho accepted
5	KO -> Effectiveness of Internal Control System	0,071	0,498	Ho accepted
6	AK -> Effectiveness of Internal Control System	0,478	3,873*	Ho rejected

* significant on $\alpha = 0.05$

**F count (F Table = 2,295)

Table 4 shows that Hypotheses 1, 2 and 6 are significant at $\alpha = 5\%$. Hypothesis 1 shows that simultaneously the principles of Control Environment significantly influence the Effectiveness of Internal Control System with R² of 75.3%. While partially, only Commitment to Integrity and Values of Ethics (IE) and Enforcement of Accountability (AK) have a significant effect on the Effectiveness of Internal Control System, where Accountability Enforcement is more dominant influence with the effect coefficient of 0.478, compared to Commitment to Integrity and Ethics with influence coefficient of 0.339.

Simultaneously, the Control Environment gives 75.3% influence on Effectiveness of Internal Control System in XXX. This is in accordance with the statement that the Control Environment becomes the foundation of the Internal Control System, stated in COSO (2013), that "control environment is the foundation for the other control components. Reflects the tone set by top management and the overall governance, incentives, organization, and actions of the board of directors and management".

However, not all principles in the Control Environment have a significant effect on the effectiveness of the Internal Control System. There is a difference in the results of previous research, which is due to differences in the nature of the business, industry, culture, and COSO framework referred to.

The implications for XXX are:

- a. **Commitment to Integrity and Values of Ethics**

This principle has a significant influence on the effectiveness of the internal control system. Evaluation of compliance of standards of conduct for employees by Directors and senior leaders reflects the importance of this activity in XXX. It is fair, that as a large-scale business enterprise and have the obligation to comply with regulations, both national and international scale.

Against such deviations from such standards of business conduct or ethics, management is deemed necessary to identify problems and then make timely and consistent improvements. Directors and senior leaders must consistently demonstrate the importance of ethical integrity and values through their direction, actions, behaviors, and example as tone at the tops and always update behavioral or business ethical standards in accordance with best practice provisions stipulated by the Financial Services Authority (OJK) and US SEC, as a consequence XXX listed its shares in both stock markets.

Directors and senior leaders can articulate and demonstrate the importance of integrity and ethical value throughout the organization, using news services or corporate portals to reinforce the importance of integrity and ethical values. Particularly for employees or units running internal controls or preparing reliable financial and information reports, it may be necessary for management to define more firmly and communicate more in order to support the goal of providing reasonable assurance of financial and information reporting, in accordance with the business process carried out.

b. Enforcement of Accountability

This principle has a significant influence on the effectiveness of the internal control system. Evaluating individual performance and responsibilities for internal controls should be rewarded or disciplinary actions that reflect the importance of this activity in XXX, so that internal controls are deemed to be efficient and provide reasonable assurance of financial reporting. It is possible that the success or failure of internal control should also affect the employees who run it.

In establishing its responsibilities and performance, management must take into account the level of pressure it carries, as it relates to important goals in financial reporting. In addition, management defines the description of multiple roles to support internal responsibility for effective internal financial reporting.

Management defines performance benchmarks, incentives, and rewards and regularly evaluates the suitability of performance measures used to determine how employees respond to pressures, incentives, and rewards. Management designs objective evaluations of employees and compensation systems that periodically provide rewards or disciplinary action, as necessary.

5. CONCLUSIONS AND RECOMMENDATIONS

Based on the results of research that has been done, it can be concluded as follows:

1. Principle of Commitment to Integrity and Ethics and principle of Accountability Enforcement, as part of the principles of environmental control, have the significant effect on the effectiveness of the internal control system in XXX.
2. Principle of Responsible Oversight, principle of Determination of Structure, Authority, and Responsibility, and principle of Commitment on Competence, as part of the principles of control environment, have no the significant effect on the effectiveness of internal control system in XXX.

3. Simultaneously, the principles of Control Environment significantly affects the effectiveness of the internal control system in XXX. The value of influence is 75.3%.

This is in accordance with the statement and supports the theory that Control Environment becomes the foundation of the Internal Control System, stated in COSO (2013), that "control environment is the foundation for the other control components. Reflects the tone set by top management and the overall governance, incentives, organization and actions of the board of directors and management".

Based on the research conclusions that have been obtained, it is suggested as follows:

1. Directors and senior leaders must consistently demonstrate the importance of ethical integrity and values through their direction, actions, behavior, and role models as the realization of 'tone at the top', and always update the standards of conduct or business ethics in accordance with the terms and best practice. Directors and senior leaders can articulate in various methods including digital media being developed.
2. Management should define performance benchmarks, incentives, and rewards, and periodically evaluate the suitability of the performance measures used to determine how employees respond to pressures, incentives, and rewards. Management should design objective evaluation of employees and compensation systems that regularly reward or discipline, such as rewarding improved internal control, and so if otherwise.
3. In addition to this, we propose suggestions for the phenomenon mentioned in this study can be mitigated, through the following steps:
 - a. Step I, developing awareness, expertise, and alignment:
 - 1) Studying COSO Internal Control-Integrated Framework 2013.
 - 2) Building awareness.
 - 3) Understanding internal control requirements.
 - 4) Understanding deficiencies.
 - b. Step II, design an initial impact assessment:
 - 1) Re-mapping the business document design process.
 - 2) Re-mapping the business process implementation.
 - c. Step III, facilitating awareness, training, and comprehensive assessment:
 - 1) Rebuild awareness at the level of Directors and Board of Commissioners.
 - 2) Conducting Training.
 - 3) Implement a comprehensive self assessment.
 - d. Step IV, develop and implement the transition plan:
 - 1) Doing documentation and evaluation.
 - 2) Validation testing and remediation.
 - 3) Review by external parties.
 - e. Step V, driving continuous improvement:
 - 1) Customize 'tone at the top'.
 - 2) Make internal controls as part of the culture, business processes, and procedures.
 - 3) Improve control over reporting and communication.

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