WHAT IS THE IMPACT OF INTERNAL CONTROL SYSTEM ON THE QUALITY OF BANKS' FINANCIAL STATEMENTS IN JORDAN?

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ABSTRACT

This study aims to investigate the impact of the internal control system on the quality of financial reporting for Jordanian banks. The five components of the internal control system defined (control environment, implementation of control procedures, risk assessment, information and communication and monitoring framework) were utilized to collect information from 20 Jordanian banks and to test the study hypotheses. Using a questionnaire as a data collection method, the study collected 88 valid responses from various staff levels. The SPSS analysis confirms that the internal control system in Jordanian banks has a positive effect in the quality of financial reporting. The study recommends that Jordanian banks can further improve their internal control system, enhancing the role of internal auditors and integrating their incentives and rewards with the performance and control reporting.

Keywords: Internal Control, Quality of Financial Statements, Control Environment, Implementation of Control procedures, Risk Assessment, Information, Communication and Monitoring.

INTRODUCTION

Jordanian Banking sector is considered as one of the most sensitive and important sector due to its contribution on the country's economic growth. Recently, Jordanian banking sector are found to be exposed to various types of challenges and risks (e.g bad debit and bankruptcy) which necessitate the issuance of high quality and reliable financial reports for enhancing the decision making process.

To inform this debate, this paper investigates the role of internal control on the quality of Jordanian banks' financial reporting. Internal control includes various types of procedures, policies and plans which are ad hoc to improve safeguarding the assets, maintaining the accuracy and validity of the accounting information in company's financial reporting. Moreover, internal control is also designed to ensure that management policies are espoused by the staff for achieving organizations goals and objectives. Therefore, this study aims to investigate the impact of the internal control system on Jordanian banking sector in term of reporting quality.

THE STUDY'S PROBLEM

The main problem of this study to answer the question "*What is the Impact of Internal Control System on the Quality of Banks' Financial Statements in Jordan?*" Accordingly, it is possible to answer the following questions:

1. Is there statistically significant relationship between control environment and the quality of financial reporting in Jordanian financial sector?

2. Is there a statistically significant relationship between the implementation of control procedures and the quality of financial reporting in Jordanian financial sector?

3. Is there a statistically significant relationship between risk assessment and the quality of financial reporting in Jordanian financial sector?

4. Is there a statistically significant relationship between information and communication and the quality of financial reporting in Jordanian financial sector?

5. Is there a statistically significant relationship between monitoring and the quality of financial reporting in Jordanian financial sector?

THE STUDY'S OBJECTIVE

This study aims to investigate the impact of internal control (control environment, implementation of control procedures, risk assessment, information and communication and monitoring) on the quality of Jordanian banks' financial reporting.

THE STUDY'S HYPOTHESES

This study established the following primary null hypothesizes:

Ho1: There is no statistically significant relationship between control environment and the quality of financial reporting in Jordanian financial sector.

Ho2: There is no statistically significant relationship between the implementation of control procedures and the quality of financial reporting in Jordanian financial sector

Ho3: There is no statistically significant relationship between risk assessment and the quality of financial reporting in Jordanian financial sector

Ho4: There is no statistically significant relationship between information and communication and the quality of financial reporting in Jordanian financial sector

Ho5: There is no statistically significant relationship between monitoring and the quality of financial reporting in Jordanian financial sector

THE DEFENITION OF INTERNAL CONTROLAND IT'S OBJECTIVES

Internal control is an established process by the company's top management to ensure achieving the company's primary goals and objectives, such as an effective and efficient operations, safeguarding the assets, ensuring the accuracy and validity of accounting information, following the organizations policies and procedures and preparing reliable reports in timely bases (COSO, 2013).

The Canadian centre for certified accountant define the internal control as an organized plan that includes all the processes, procedures and measurement applied in an organization to ensure safeguarding the assets, ensuring the accuracy and reliability of the accounting information, achieving sufficient operation and encouraging the employees to follow the organizations polices. The ISA 400 define the internal control as "all the adopted procedures by the organization's management in order to achieve its objectives of ensuring as far as practicable, the orderly and efficient conduct of its business, including adherence to management policies, the safeguarding of assets (Hyde, 2011).

According to Turner & Weickgenannt (2009) internal control objectives falls under three categories; accounting control, management control and internal monitoring.

Types of Internal Control

As discussed in the previous section, there are five main elements of internal control namely control environment, implementation of control procedures, risk assessment, information and communication and monitoring.

The first type is the internal environment which is considered as an important indication for an effective internal control. COSO indicates that internal environment is paramount significance to an internal control system were all other types of controls are built around it. Internal environment consists of ; Management's philosophy, operating style, risk appetite, commitment to integrity, ethical values, competence, organizational structure and the Methods of assigning authority and responsibility (Birien & Senecal, 1984; McNally, 2014).

The second type is the control activity which represents the policies, rules, and procedures adopted by the organization in order to maintain reasonable assurance that control objectives are met and risk responses are accomplished through matching actual and budget performance (Mawanda, 2011).

The third type is risk assessment. The management is responsible for assessing all threats regarding financial reporting integrity, reliability and accuracy within the organization control environment. Risks must be identified and analysed in order to measure their impact on financial reporting and to establish a base for the risk response (Thomas, 2007). According to Suhail (2007) information technology has significantly increased the risk exposure in organizations due to the wide spread of its use.

The fourth type is information and communication. Gaban & Mustafa (2010) define this type of control as all tools and mediums used to capturing, recording and exchanging organization's activities. The fifth type is monitoring which is the process of assessing the internal control performance over time.

THE QUALITY OF FINIANCIAL REPORTING

The main objective of issuing financial statement is to provide high quality financial information which reflects the organization performance over a period of time (Hanini, 2014). As a matter of fact, maintaining a high quality financial reporting can enable investors and other decision maker in selecting their economic and financial decisions based on reliable and transparent financial information (Salameh, 2011).

Achim & Chis (2014) define reporting quality as a financial report which reflects comprehensive and transparent financial information in order to avoid deceiving investors from decision making.

PREVIOUS STUDIES

The first study titled "*The Impact of Internal Control on the Quality of Financial Reporting for Palestinian Listed Companies*" (Shath, 2017; Sati, 2007). The study aimed to explore the impact of environmental, monitoring control, risk assessment on the quality of accounting information listed in Palestinian stock exchange market (Bagaeva, 2010). Results showed that the adoption of internal control system considered as an effective tool for enhancing

the quality of financial reporting. In addition, the studies recommended enhancing the electronic internal control function and boosting the role of audit committees in the Palestinian list companies.

The second study titled "*The Impact of Internal Control System on The Quality of Financial Reporting*" (Samriraay, 2016). The study aimed to investigate the impact of the internal control system on the quality of pharmaceutical sector's financial reporting, as well as the role of the internal control system in rationalizing decisions from internal auditing perspective. The results indicated a positive relation between strong internal control system and the quality of the financial information. Furthermore, the study suggested to enhance the role of the internal auditing department in those companies and to adopt a continuous risk assessment procedures to avoid risk exposure in the pharmaceutical sector.

Third study titled "*The Impact of Some Factors That Affect the Reporting Quality*" (Albatat & Mahmoud, 2015). The study aimed to explore the reliability, validity and objectivity of the financial reporting. It also investigated the sobriety of accounting treatments in order to measure the impact of these procedures on reporting quality. The results indicated that any weakness or deficiency in the internal control system can reduce the objectivity and the quality of financial information. The study also argued that the adoption of computerized internal control system can overcome internal control system weaknesses (Ayagre et al., 2014).

The fourth study titled "*The Role of Internal and External Auditors Independence on The Quality of Financial Reporting: An Applied Study on Sudanese Auditors*" (Abdul Aziz, 2014) the study explored the role of auditors' independence on the quality of financial reporting. The main findings of the study signified that a well-established internal control system can reduce the audit fees and improve the reliability and integrity of the financial reporting.

Fifth study titled "*Institutional Investors' Perceptions on Quality of Financial Reporting in Kenya*" (Kariuki & Jagongo, 2013). The study aimed to investigate the impact of financial information quality on the effectiveness of investors' decision in Kenya. The finding suggested that Kenyan investors are inclining to rely on information provided on the total assets, total non-current liabilities, retain earning, cash flow from investing activities and dividend per share. The study also revealed that Kenyan's companies provide a good quality of financial information regarding the completeness, matching and constancy of information but failed to provide understandable, objective, predictable financial information.

STATISTICAL ANALYSIS METHODS

The analysis procedures were conducted as follows:

1. Cronbach Alpha was used to measure the reliability of the questionnaires statements

2. Frequencies, mean and standard deviation.

3. One sample T- test to test the hypothesis.

STUDY SAMLE AND SAMPLE SIZE

In seeking to explain the suggested relationship, the study's population determined as all currently active Jordanian banks. There are 25 banks in Jordan all were included in the current study. Furthermore, 100 questionnaires were distributed randomly and 88 valid questionnaires have return and used to answer the study hypotheses. Table 1 posits the main demographic data regarding the participant.

Table 1 DEMOGRAPHICAL DATA		Frequency	Parentage (%)
Description		**Frequency**	**Parentage (%)**
Banks' type	Commercial	64	72.7
	Islamic	24	27.3
Age	Less than 25 years	8	9.1
	from 25 years - 35	16	18.2
	from 36 years -45 years	41	46.6
	more than 46 years	23	26.1
Qualifications	High Diploma	1	1.1
	Bachelor	70	79.5
	Master	16	18.2
	PhD	1	1.1
Experience	Below 4 years	1	1.1
	From 5 to 8 years	49	55.7
	From 9 to 15 years	34	38.6
	16 years and above	4	4.5
Position	President	1	1.1
	CEO	8	9.1
	Chief manager	23	26.1
	Branch manager	29	33.0
	Staff	27	30.7
Total		88	100%

DATA ANALYSIS

SPSS version (20) were used to analyse the data retrieved from the questionnaires, the following tests were conducted:

First: Cronbach's Alpha test reliability test was conducted to measure the internal consistency and reliability of a psychometric test for the correspondence. Nunnaly (1978) indicated that a (0.7) is an acceptable level of reliability coefficient in Cronbach's Alpha test. Thus, our results (α) of (92.9%) indicate a good level of internal consistency.

Second: We conducted a normal distribution test using The One-Sample Kolmogorov-Smirnov test. Table 2 shows the normal distribution for this study's sample as (z) was found to be above (5%) for all hypotheses:

Table 2 ONE-SAMPLE KOLMOGOROV-SMIRNOV TEST					
Hypothesis	**H1**	**H2**	**H3**	**H4**	**H5**
Kolmogorov-Smirnov Z	2.558	4.433	3.259	1.909	4.277

Hypotheses testing

In seeking to test the study hypotheses, this study adopted the following methods:
First: A one sample T-Test at a level %5 or less of the of P-value was conducted.
Second: A descriptive analysis which include number of occurrences, means and the standard deviations for accepting or rejecting the hypotheses.

Hence, the five hypotheses speculated in prior section was tested with the following conclusions:

Ho1: There is no statistically significant relationship between control environment and the quality of financial reporting in Jordanian financial sector.

Table 3 THE FIRST HYPOTHESIS RESULTS					
Calculated T	T Table	SIG T	Result	Mean	Std. Deviation
12.839	1.986	0.000	Rejected	3.83	0.61

The T-Test result indicates that the calculated T is greater than the T Table which led to reject the null hypothesis and accepting the alternative hypothesis. In simple terms, there is a significant positive relationship between the internal environment and the quality of the financial reporting in Jordanian banking sector. Above Table 3 shows the descriptive results for each factor affecting the environment control organized in ascending order based on their means.

Table 4 DESCRIPTIVE ANALYSIS FOR THE ENVIRONMENTAL CONTROL			
NO.		Mean	Std. Deviation
1-	Management attention to the internal auditors' reports increases the quality of financial reporting	3.97	0.734
2-	Banks employees sharing the responsibility of control will increases the quality of financial reporting	3.91	0.839
3-	Continuous review for the banks' policies and strategies will increases the quality of financial reporting	3.78	0.669
4-	Salaries and compensations are based on the employ yes performance will increases the quality of financial reporting	3.76	0.802
5-	Written and documented procedure, responsibilities and authorities for the staff will increases the quality of financial reporting	3.73	0.798
The impact of internal control on the quality of financial reporting for Jordanian banks		3.83	0.61

Table 4 shows positive responses regarding most of the environmental control elements in the first hypothesis. The means for these elements were above 3 while the standard deviations were below 1.

Ho2: There is no statistically significant relationship between the implementation of control procedures and the quality of financial reporting in Jordanian financial sector.

Table 5 THE SECOND HYPOTHESIS RESULTS					
Calculated T	T Table	SIG T	Result	Mean	Std. Deviation
13.718	1.986	0.000	Rejected	3.76	0.52

The T-Test result indicates that there is a significant positive relationship between the control procedures and the quality of the financial reporting in Jordanian banking sector. Table 5 shows the descriptive results for each factor affecting the control procedures organized in ascending order based on their means.

Table 6 DESCRIPTIVE ANALYSIS FOR THE CONTROL PROCEDURES			
NO.		Mean	Std. Deviation

1-	The availability of continuous control reports in the bank can enhance the internal control functions which lead to improve the quality of financial reporting	3.85	0.63
2-	The existence of recommendations and advices about potential improvement in the control reports lead to improve the quality of financial reporting	3.88	0.71
3-	The existence of Matching and reasonableness reports for different periods in i the control reports lead to improve the quality of financial reporting	3.78	0.75
4-	Segregation of duties lead to improve the quality of financial reporting	3.68	0.65
5-	A clear determination for the responsibilities and authorities among departments lead to improve the quality of financial reporting	3.63	0.76
The impact of the implementation of control activities on the quality of financial reporting for Jordanian banks		3.76	0.52

Table 6 shows positive responses regarding most of the control procedures elements in the second hypothesis. The means for these elements were above 3 while the standard deviations were below 1.

Ho3: *There is no statistically significant relationship between risk assessment and the quality of financial reporting in Jordanian financial sector*.

Table 7 THE THIRD HYPOTHESIS RESULTS					
Calculated T	T Table	SIG T	Result	Mean	Std. Deviation
10.805	1.986	0.000	Rejected	3.74	0.64

The T-Test result indicates there is a significant positive relationship between the risk assessment and the quality of the financial reporting in Jordanian banking sector. Table 7 shows the descriptive results for each factor affecting the risk assessment organized in ascending order based on their means.

Table 8 DESCRIPTIVE ANALYSIS FOR THE RISK ASSESSMENT			
NO.		Mean	Std. Deviation
1-	The management ability to prepare a quick response procedure for risky events lead to improve the quality of financial reporting	3.84	0.83
2-	The continuous internal auditors' assessment for risk lead to improve the quality of financial reporting	3.80	0.75
3-	Categorizing risk according to their potential impact by the management lead to improve the quality of financial reporting	3.68	0.77
4-	A Pre-determined risk assessment mechanism by the management lead to improve the quality of financial reporting	3.65	0.86
The impact of the risk assessment on the quality of financial reporting for Jordanian banks		3.74	0.64

Table 8 shows positive responses regarding most of the risk assessment elements in the third hypothesis. The means for these elements were above 3 while the standard deviations were below 1.

Ho4: *There is no statistically significant relationship between information and communication and the quality of financial reporting in Jordanian financial sector.*

The T-Test result indicates that the calculated T is greater than the T Table which led to reject the null hypothesis and accepting the alternative hypothesis. In simple terms, there is a significant positive relationship between the information and communication and the quality of the financial reporting in Jordanian banking sector. The following Table 9 shows the descriptive results for each factor affecting the information and communication organized in ascending order based on their means.

Table 9
INFORMATION AND COMMUNICATION ORGANIZED IN ASCENDING ORDER

Calculated T	T Table	SIG T	Result	Mean	Std. Deviation
13.908	1.986	0.000	Rejected	3.82	0.55

Table 10
DESCRIPTIVE ANALYSIS FOR THE RISK ASSESSMENT

NO.		Mean	Std. Deviation
1-	The availability of a secure financial system in the bank lead to improve the quality of financial reporting	3.97	0.76
2-	The existence of a clear communication channels between employees enable for better understanding of internal control function which will lead to improve the quality of financial reporting	3.85	0.82
3-	The existence of well documented and written rules and policies will lead to improve the quality of financial reporting	3.76	0.73
4-	The existence of an accurate and audited bank software will lead to improve the quality of financial reporting	3.68	0.72
The impact of information and communication control on the quality of financial reporting for Jordanian banks		3.82	0.55

Table 10 shows positive responses regarding most of the information and communication elements in the fourth hypothesis. The means for these elements were above 3 while the standard deviations were below 1.

Ho5: *There is no statistically significant relationship between monitoring and the quality of financial reporting in Jordanian financial sector*

The T-Test result indicates there is a significant positive relationship between the monitoring and the quality of the financial reporting in Jordanian banking sector. The following Table 11 shows the descriptive results for each factor affecting the monitoring organized in ascending order based on their means.

Table 11
THE FIFTH HYPOTHESIS RESULTS

Calculated T	T Table	SIG T	Result	Mean	Std. Deviation
18.976	1.986	0.000	Rejected	4.04	0.51

Table 12
DESCRIPTIVE ANALYSIS FOR THE MONITORING

NO.		Mean	Std. Deviation
1-	A daily encounter with control procedures by the employees lead to improve the	4.08	0.61

	quality of financial reporting		
2-	A serious adoption of the internal auditors reports by the management lead to improve the quality of financial reporting	4.07	0.56
3-	Internal audit independence lead to improve the quality of financial reporting	4.02	0.62
4-	A knowledgeable and well educated internal control employees lead to improve the quality of financial reporting	3.99	0.67
The impact of monitoring on the quality of financial reporting for Jordanian banks		4.04	0.51

Table 12 shows positive responses regarding most of the monitoring elements in the fifth hypothesis. The means for these elements were above 3 while the standard deviations were below 1.

RESULTS

The statistical analysis was conducted by using SPSS version (20), the outcomes reveals the following results:

1. There is a statistical significant relationship between the control environment and the quality of financial reports in Jordanian banks. The study argues that banks' management are considering internal control system to have a significant merit in the banks'.

2. There is a statistical significant relationship between control activities and the quality of financial reports in Jordanian banks. The results indicate that the existence of a continues reporting in regard to control activities, segregation of duties, clear determination of authorities and responsibilities.

3. There is a statistical significant relationship between risk assessment and the quality of financial reports in Jordanian banks. This indicates that Jordanian banks are meeting all the expected procedures for assessing the risk based on COSO framework.

4. The study finds that the existence of a written control policies in the bank, having a system that is able to generate relevant and high-quality information to support internal control.

5. There is a statistical significant relationship between monitoring and the quality of financial reports in Jordanian banks. The results indicate that internal auditor independence, skills, educational background and abilities can enhance the quality of internal control functions

RECOMMENDATION AND FUTURE STUDIES

The implications of our findings are manifold. Hence, the main recommendations for this study are depict as follow:

1. Managements in Jordanian banks should pay extra attention toward enhancing their internal control system. This can be accomplished by establishing an independent and skilful team of internal auditors with predetermined responsibilities and authorities.

2. Jordanian banks should consider adopting a more modern accounting and financial systems with extra focusing on system security in order to maintain the reporting quality.

3. Human resources department should consider integrating the salaries and compensations system with the staffs' performance and the control report as they both can enhance the banks internal control.

4. Training and workshop for the internal control staff should be conducted in continues bases in order to boost their performance.

5. We also identify some potential areas for future research, the importance of the internal control system in other financial institution and the role of internal control system in providing competitive advantages for the organization are still an open area for further investigations.

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