

# Internal Control Reporting: A Study on Dhaka Stock Exchange 30 Index

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## Abstract

This report aims at showing an overall picture of the internal control reporting practice of DS 30 (constructed with 30 leading companies, which can be said as an investable index of the Dhaka Stock Exchange). This study covers five years' (2014 to 2018) annual reports of each of the companies included in DS 30. The sample includes 147 firm years. Content analysis has been conducted considering 10 disclosure issues to show the effectiveness of the internal control reporting practice of DS 30. Study findings claim that 97% of the DS 30 include management reports regarding internal control mechanisms in their annual reports. However, different companies report the respective companies' internal control scenario under different names and in different formats, so there is limited scope for comparability. A significant number of companies have included detailed descriptions of various components of their internal control system. In contrast, others used just a few sentences. Overall, the study results reveal that despite some inherent limitations, internal control reporting practice of DS 30 is increasing with time.

**Keywords:** Corporate Governance, Dhaka Stock Exchange (DS 30), Internal Control Reporting

## Introduction

James and Alvin said a system of internal control consists of policies and procedures proposed to provide management with reasonable assurance that the company achieves its objectives and goals. These policies and procedures are often called controls, and collectively they comprise the system of internal control (Alvin, 2000). A system of internal control delivers an organization with an opportunity to fulfill general and some specific objectives. At the organizational level, internal control objectives relate to the trustworthiness of financial reporting, timely feedback on accomplishing operational or strategic goals,

and compliance with laws and regulations. Besides, at the specific transaction level, internal control refers to the actions taken to achieve a specific objective. Moreover, internal control procedures reduce process variation, leading to more predictable outcomes.

A large body of literature noted that adequate internal control suggests the organization generates consistent financial reporting and considerably complies with the laws and regulations that apply to it. Effective internal control is of utmost importance for attaining objectives by every company (Iulian, 2012).

However, whether a firm achieves operational and strategic objectives may be subject to factors outside the enterprise, such as competition or technological invention. These issues are outside the scope of internal control; therefore, an effective internal control system delivers only timely information or feedback on attaining operational and strategic objectives but cannot guarantee their achievement. Numerous prior studies have intensively examined the benefits an organization can achieve from a sound system of internal control. The internal control component is most influential within a particular organization; an effective internal control system can prevent FCPA violations.

This study extends the literature as the study focuses on the internal control reporting practice of DS 30, the way of presenting the internal control system by the companies in their annual reports. This study attempts to show a transparent scenario of the internal control reporting practice of DS 30, considering the recently increasing attention to the inclusion of management reports on internal controls in the annual reports of public companies.

DS30 (Dhaka Stock Exchange 30 Index) is designed by Standard and Poor's (S&P), one of the world's leading

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credit-rating agencies. This index is developed based on the free-float methodology used by the world's major indices. Under free-float methodology, market capitalization is calculated by taking the equity's price and multiplying it by the number of shares readily available in the market. The free-float method excludes locked-in shares held by promoters and governments (<https://www.dsebd.org/>, n.d.).

In the context of Bangladesh, to the author's best knowledge, there is a dearth of significant study on the internal control scenario of DS 30 (Dhaka Stock Exchange 30 Index) and the way of reporting about their internal control activities in annual reports. This study reports several key findings, including the most highlighted components in annual reports of DS30. Annual reports of DS 30 typically discuss the following topics regarding their company's internal control system- financial statement presentation and also the purpose, nature, and components of the company's internal control system, the responsibilities of the audit committee, the role of the Board of directors and internal auditor to launch a sound system of internal control, the number of committees formed to ensure operational efficiency.

This study is primarily aimed at demonstrating the overall scenario of the internal control reporting practice of DS 30. The specific objectives of this study include evaluating the effectiveness and efficiency of the internal control reporting practice of DS 30, examining the contents of internal control in the annual reports, exploring the role of the audit committee, internal auditors, and BOD in establishing a sound system of internal control, identify the lacking (if any) in the internal control reporting system of DS 30.

In measuring the effectiveness of internal control reporting, the study analyzes a total number of 10 variables (disclosure issues) relating to internal control categorized under control environment, information and communication, risk assessment, control activities, and monitoring activities. Moreover, the limitations of internal control practices by DS 30 have been revealed, which are likely to be helpful for the modernization of the existing internal control system of DS 30. As part of its internal control reporting practice, firms' details should be disseminated to the stakeholders to facilitate their decision-making process. Whether this information is provided or not and the adequacy of such disclosures has been analyzed in this study. Study findings indicate that 97% of the companies under study have included at

least a sentence about their internal control system in their annual reports to provide stakeholders a clear view of their organizational efficiency. A notable variation exists in the reporting pattern of companies from different industries.

The study's findings will redound to the improvement of the overall internal control reporting practice of DS 30 if the firms effectively follow recommendations. For this study, annual reports of only five years of each company are studied. So there is a likelihood that the companies' overall internal control reporting scenario throughout their lifespan may not be reflected by studying only five years of annual reports.

## Literature Review

Banks and other financial service firms have more robust monitoring controls than do other services firms. Also, some organizations do not seem to examine and document all deviations from established policies. However, in other organizations, management override of controls is not always appropriately documented and explained (Hermanson, 2012).

A study on the effectiveness of listed firms' internal control systems in Ghana scrutinized annual reports of a sample of 33 firms listed on the Ghana Stock Exchange to measure the level of internal control effectiveness. It found an overall internal control system showing an average level of effectiveness in this study, and out of the five categories assessed under an internal control system, the control environment showed a higher level of effectiveness (Onumah, 2012).

(Iulian, 2012) analyzed the effectiveness of internal control in companies listed on the Bucharest Stock Exchange. They found that adequate internal control leads to a fair presentation of the financial statements and increases stakeholders' confidence in the financial statements. Their findings suggest the essential linkages exist between the two fields of corporate governance and internal control. A study on Korean listed firms found that the proportion of internal control personnel is negatively related to the disclosure of internal control weaknesses. A change in internal control personnel is positively associated with the likelihood of a reduction of internal control weaknesses (Choi, 2013).

A significant study revealed that, while investigating accounting problems or implementing internal controls,

particularly expense controls, companies often discover the Foreign Corrupt Practices Act of 1977 (FCPA) violations. This study suggested that if a company gives efforts in improving components of internal control, it will help investigate accounting problems and also designing an organizational structure to prevent and detect FCPA violations; as a result, the company is in a better position to detect fraudulent activities well in advance (Cerensey, 2015).

A notable study examined whether internal control weakness increases the risk of fraudulent reporting by top management. The study also found a robust association between internal control weakness and fraudulent financial reporting risk in the future (Donelson, 2016).

## Research Methodology

This study has used a descriptive or exploratory research technique. Here in this study, the current status of information disclosure on internal control in annual reports of DS 30 is analyzed. In this regard, 147 annual reports (covering the years 2014 to 2018) of DS 30 are studied. As one company was listed in the Dhaka Stock exchange in the year 2017; thus, Annual reports of previous years are not available. The website of the firms under study also provided useful information. In a particular year, the internal control system of a company may be quite convenient, but the scenario may change in the next year. So studying the annual report of a given company of a particular year is not adequate to present the overall internal control reporting practice.

The study used only secondary sources of information in order to build up the framework of the study. As companies included in DS 30 do not publish internal control reports separately, they provide internal control related information in their annual reports, so primarily annual reports are the base to construct the study's framework.

This study has processed and analyzed data collected from annual reports of DS 30 manually and with Microsoft Excel. A qualitative approach is adopted for data analysis and interpretation, taking the processed data as the base. After analyzing the data, the information is presented in different segments according to their category, in a compact way.

Data collected from the annual reports are presented below in the graphical form, highlighting the ten variables selected. The variables are selected to present the internal

control reporting practice of DS 30 conveniently. Ten variables selected to present general internal control reporting practices of DS 30 are listed below.

- Form of internal control reports.
- The number of independent directors
- Frequency of BOD (Board of Directors) meeting
- Existence of an audit committee
- The number of members in the audit committee
- The number of committees to ensure operational efficiency
- Review of internal control by the BOD and audit committee
- Reporting audit committee activities to BOD following each meeting
- Review of the financial statements by the audit committee
- Segregation of organizational duties

## Findings and Discussion

The study reveals that specific components of internal control reporting are by no means consistent across companies. The differences noted in this report reflect the variations in how companies structure their internal control systems, and also they reflect the differences in different companies' reporting philosophies. This study finds that the content of internal control reports varies considerably across companies. Management of most of the companies studied has taken 'reporting on internal control' as a unique opportunity to discuss issues and concerns not communicated elsewhere in the annual report.

This study found that different companies of DS 30 have a varied number of objectives for establishing an internal control system. Most companies have mentioned they want to enhance their operational efficiency, and a sound internal control system helps in this regard. A significant number of other objectives are also evident; companies have mentioned that they want to safeguard their assets and maintain transparency of transactions in their annual reports. The next part will discuss the study findings based on the ten disclosure issues.

Board of Director's report is the most common format of internal control reporting used by DS 30. Other internal control reporting formats include the Chairman's report, the Managing Director's report. This study finds that

97% of DS 30 companies include a management report regarding the company’s internal control in their annual reports. Besides, 97% of companies have mentioned that their financial statements conform with GAAP in their annual reports. Only 3% of annual reports have not mentioned the existing internal control scenario of the firm.

**Table 1: Format of Internal Control Report**

Form of Internal Control Report	Number of Samples	Percentage (%)
Board of Director’s Report	65	44%
Audit Committee Report	42	29%
Corporate Governance Report	20	14%
Chairman’s Statement	5	3%
Independent Auditor’s Report	5	3%
Internal Control & Risk Management Report	5	3%
Not Mentioned	5	3%
Total		100%

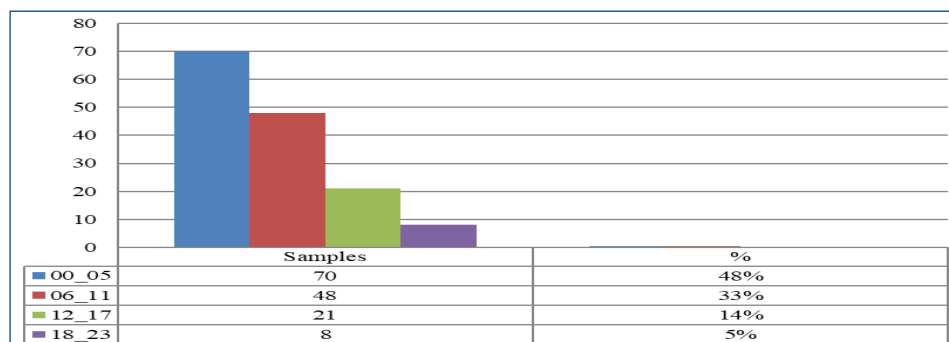
This study finds that most of the firms have mentioned in their annual reports that they always work on bringing about operational improvements, especially on internal control, integrity, compliance, and risk management, to improve overall profitability in the long term. Consistent with the study findings (Cohen, 2004), all the companies

under study have mentioned that their BOD is primarily responsible for establishing and maintaining adequate internal control to fulfill their organizational objectives. By analyzing the annual reports under study, it is also evident that management and staff’s specific responsibilities in establishing an effective internal control system.

**Table 2: The Number of Independent Directors of the Selected Firms**

The Number of Independent Directors	Samples	Percentage (%)
0	0	0%
1	41	28%
2	74	50%
3	23	16%
4	6	4%
5	2	1%
>5	1	1%
Total	147	100%

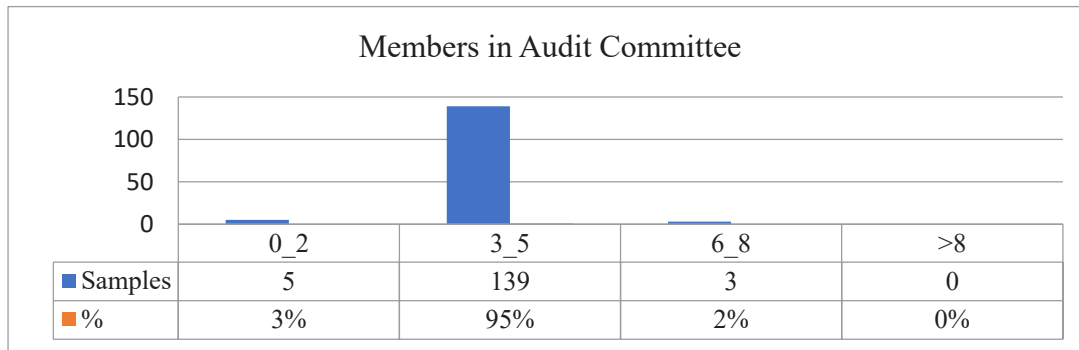
To comply with the corporate governance compliance framework, one-fifth of the BOD should be independent directors who hold less than 1% share. This study found that 31% of firms have less than the required number of independent directors, while 69% of firms have satisfied the compliance criteria.



**Fig. 1: Frequency of BOD Meeting (Each Year)**

The study reveals that 48% of the firm’s BOD has met 0 to 5 times each year. At the same time, the BOD meeting frequency indicates that firms have an excellent internal communication system. This study finds 97% of firms reported to have an audit committee. These high rates of assertions are quite understandable as those are part of the mandatory compliance report of the Securities and Exchange Commission. Again, 97% of firms having an audit committee have also included the audit committee’s

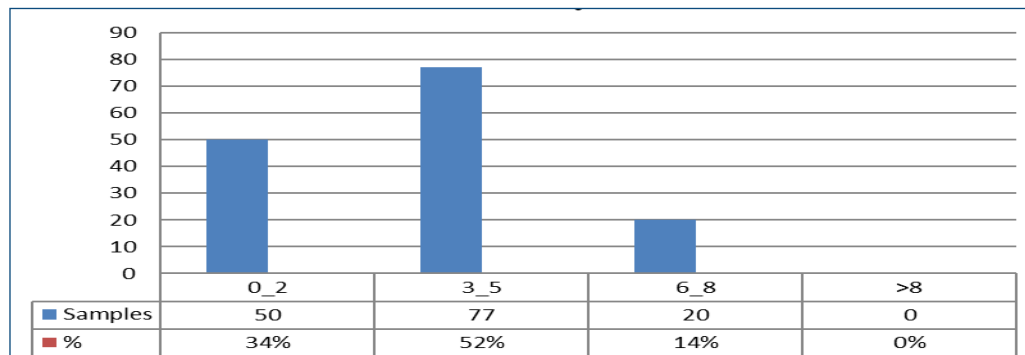
role, and 43% included the role of the independent external auditor in their Director’s report. This study revealed that 95% of firms have 3 to 5 members in their audit committee. According to the corporate Governance compliance framework, the audit committee should comprise a minimum of 3 members and beheaded by an independent director. Only 3% of firms were unable to meet the criterion. So the composition and effectiveness of the audit committee in an efficient internal control system is satisfactory.



**Fig. 2: Number of Members in Audit Committee**

Analysis of the annual reports finds that firms have made up various committees to enhance their operational efficiency. The most common one is the audit committee found in every firm. Other committees include the risk management committee, internal control committee,

communication committee, corporate governance compliance committee, and information committee. The study reveals that 34% of DS 30 have 0 to 2 such committees, while 52% of firms have 3 to 5 committees, and 14% have 6 to 8 committees.



**Fig. 3: Number of Committees to Ensure Operational Efficiency**

73% of the firms studied mentioned in their annual reports that an adequate system exists within the firm to review their internal control performance. They have also noted that the audit committee and BOD regularly review their system of internal control. Corporate governance compliance requires the audit committee should hold at least four meetings in a year, and it can sit any time as it may deem fit. The committee may invite the Chief Executive officer, head of the internal auditor, any other Officer to its meetings if it deems necessary. A detailed memorandum should be distributed to committee members well in advance (at least three days) before each meeting to ensure active participation and contribution by the members; This study finds that audit committees of 67% of companies regularly report their activities to the Board of Directors following each meeting. In contrast, such evidence is inexistent in 33% of firms of D 30.

This study finds that 87% of firms have mentioned their audit committee reviews their respective Financial Statements. Another point to note is that all of the companies studied reported that financial statements represent the company’s financial position and results of operations. In 97% cases, management report regarding internal control has discussed presentations of financial statements. The same number of firms has included the purpose, nature, and components of the internal control in their director’s report. No significant variation is found in the pattern and format of internal control reporting by a given company over the five years

This study finds that only 54% of companies mentioned initiatives to ensure proper segregation of duties within their companies. No significant detailed description is found regarding the company’s initiatives to ensure

proper segregation of duties in the annual reports of a significant number of companies. Since the presentation of organizational hierarchy in the selected companies' annual reports is inadequate to provide evidence that there is a productive environment of segregation of duties in the firm. Most of the companies of DS 30 just used a diagram in their annual reports to demonstrate their organizational hierarchy, which is unable to provide the proper delegation of authorities. Companies should provide a detailed description of their organizational hierarchy and delegation of authorities in their annual reports.

Several reports identified specific components of the internal control structures of DS 30 companies. The most frequently cited are the existence of an internal audit function and an audit committee (97%), and segregation of duties (54%), followed by the maintenance of policies and procedures (71%), the selection and training of the right personnel (98.5%). Also mentioned is a periodic and special inspection in branches. Several annual reports noted that the internal control policy addresses such elements as a conflict of interest, compliance with applicable laws, and confidentiality concerns.

The study results reveal that 97.06% of annual reports included an unqualified opinion from the external auditor. Only 2.4% of annual reports contained a qualified opinion. 97% of reports have mentioned the company's independent audit, the appointment of independent auditors, and 100% of them referred to the audit report included in the annual report. Audit reports have mentioned the basis of the audit work and sufficiency of the management's information for the audit purpose. This study found several limitations regarding the internal control reporting practice of DS 30. None of the annual reports mentioned any definite statement regarding the effectiveness of internal control.

Another notable limitation found is that a statement included in the annual reports mentioning that the independent auditor has "considered" "reviewed" or "examined" the company's internal controls unintentionally might cause a reader to infer that the auditor has indicated the internal control system is working effectively. In most cases, such an inference would be misleading since the auditor was not engaged to express an opinion on the controls' adequacy. Unless specifically engaged in assessing or evaluating a company's internal control system, independent auditors only examine

internal controls to design their overall financial records' overall audit test.

All the annual reports studied have included the "Corporate Governance Compliance Report". Interestingly, this study reveals that several companies mentioned in their compliance report that they comply with all the compliance requirements, but their annual reports do not support their state of compliance if criteria like "Number of independent directors should be one-fifth of the total number of BOD." This study finds all the companies have claimed that they have complied with this criterion. However, in reality, only 69% of companies are found to have complied with this compliance criterion. Moreover, this study reveals that only some companies of DS 30 consistently followed internal control policies. To sum up, banking companies provide a detailed description of their internal control systems compared with other companies included in DS 30, while some companies just used a few sentences regarding their existing internal control system.

## Conclusions and Recommendations

This study aims to present the internal control reporting practice of DS 30. The study reveals that although neither the Securities and Exchange Commission nor the Company Law-1994 require them, reports prepared by public limited companies of DS 30 regarding internal control have existed for more than a decade. The debate on the mandatory inclusion of reports on internal control has been a big issue for a long time.

DS 30 includes highly popular investment companies, so they should carefully design their internal control reporting structure. A standard format of internal control reporting should be followed by all the companies of DS 30 to facilitate comparability. The companies' specific measures to improve the existing internal control system should be presented in detail in their annual reports to have a clear idea about the firms' internal control structure. A clear internal control reporting framework would enable potential investors to make a more informed decision regarding the firm. Companies should also avoid making floating statements like "A sound system of internal control is established within the organization." Companies should justify why they use such statements.

Moreover, integrity should be a fundamental requirement in choosing corporate officers and board members by the

companies of DS 30. The Board of directors has one of the essential roles to play in establishing and maintaining a system of internal control, which will help attain organizational objectives. Companies should develop a code of conduct for their directors and executives that promote ethical and responsible decisions. Besides, the organization should clearly define management responsibilities. Besides, all the companies should make up a risk management committee that enables identifying and assessing risks that are likely to impact business performance and objectives and ensures. The risk management committee should make appropriate mitigation plans are in order to minimize the residual risk.

Another point is that senior management should ensure that adequate control activities are integral parts of all relevant personnel's daily functions. All the person needs to be competent and trustworthy, with clearly established lines of authority and responsibility documented in written job descriptions and procedures manuals. Further, companies should build up a practical information and communication system which enables all the employees to know about their respective duties. Furthermore, internal control deficiencies identified by the Board of directors, internal audit, audit committee, or other control personnel must be reported in internal control reports. Also, companies should present the initiatives taken to overcome those limitations in internal control reports. Annual reports of DS 30 should also present an accurate and fair view of their existing internal control system. Reports should not present an appealing picture by overestimating the real internal control scenario. A significant body of literature investigated whether existing reporting requirements meet the needs of financial statement users and whether management should issue a report on internal controls. Whether it should be attested by the independent auditors are matters of further investigation.

This study also reveals that internal control reports of DS 30 include disclosures on internal control as a voluntary initiative. The level of disclosure varies with different companies. Methods and presentations of such information also have varying forms. The main problem involved in the internal control reporting practice of DS 30 is the lack of a standardized format from a regulatory body. Most of the annual reports have mentioned they have established a sound internal control system though some inherent limitations include floating statements in these

reports. Even then, in this study, findings suggest that the internal control disclosure is at an entirely satisfactory level in DS 30.

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