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EMPIRICAL EVIDENCE ON INTERNAL CONTROL DISCLOSURE IN ITALY STOCK EXCHANGE AND POLISH STOCK EXCHANGE

1. Introduction

The corporate governance has been received higher and higher attention in the last year by academics, regulators and professional bodies. One of the key topics is constituted by internal control and voluntary/mandatory reporting by companies of internal controls information and procedures internally adopted.

The disclosure of such information with description of tools and instruments used is useful for reducing information asymmetry between company and stakeholders. In fact, from this source of communication the market can appreciate and understand the effectiveness of internal control procedures.

Previous studies on governance identify board of directors, ownership structure and internal control as the core internal mechanism (Gillan, 2006).

The internal control has a vital function because next to the external one can guarantee the quality and reliability of financial reporting identifying possible risks related to specific companies.

For this reason stakeholders have high interest in knowing the functioning and possible issues or concerns regarding internal control.

There are a lot of frameworks on Internal control system (ICS). Among others the general accepted framework applied worldwide is the Internal Control System – Integrated framework, established in 1992 by Committee of Sponsoring Organization and updated in the 2013.

COSO identifies internal control as a tool can affect the effectiveness of operations and the quality of financial reporting and, finally, the level of compliance with laws and rules. The new release of COSO framework presents a new vision regarding the external reporting on Internal control

system in order to put more attention on the significance of the information on the adequacy and application of ICS for the stakeholders.

Control activities are put in action by management to enforce companies' performance and to mitigate risks. At the same time the data are collected and externally reported in a continuous process from inside to outside.

Moreover, the influence of the information on internal control pushes the national standard setter to enhance the rule on the reporting of ICS.

This paper analyses the ICS disclosure in the financial reporting of two countries: Italy and Poland. We choose these two countries in order to verify if the cultural, economic and social difference between them affected the disclosure on ICS. Moreover, the comparison of this two countries would like to test if the implementation of the general accepted rules on internal control mechanism of corporate governance that ensure the capital market efficiency is the same in a relative new member (Poland) as in the founder (Italy) of the of the European Union.

2. Literature review

The first studies on internal control were quite descriptive aiming the purpose to identify effective/ineffective internal control. Some studies in particular analyse the relationship between ineffective internal control on the cost of audit (Ettredge et al., 2006; Hoitash et al., 2008).

Other studies focused on the importance of internal control in contributing to reduce information asymmetry. For instance some studies analysed the relationship between internal control and the quality of reporting (Doyle et al., 2007; Feng et al., 2009). Furthermore, internal control is seen as a quality factor and plays a central role in the auditors illustrated in annual reports (Pae, Yoo, 2001).

Internal control received also attention given that is important regarding the protection of firm's assets. Clathworthy and Jones (2003) highlighted that UK companies show to favour credit for good performance and allocate to external factors bad performances.

Then, after the new rules provided by SOX, some studies analysed market perception and effects in relation to company's quality reporting after the new requirements of SOX (Cohen et al., 2008).

Other works in this field looks for the relationship between the credibility of financial reporting system and auditor characteristics and auditor actions (i.e. Becker et al., 1998).

While, looking at voluntary disclosure of internal control system and specific requirements, Deumes and Knechel (2008) identified six disclosure

elements that permit to map internal control information provided by companies in their annual reports.

3. Italian and Polish background

The Italian and Polish economies are very different and they are naturally influenced by historical, cultural and social factors that characterized the two country.

Following the Gray's model (1988) that developed a theoretical framework of four accounting values, we focus our attention on a specific dimension: transparency vs. secrecy.

This dimension express the "preference for confidentiality and the restriction of disclosure of information about the business only to those who are closely involved with its management and financing as opposed to a more transparent, open and publicly accountable approach" (Gray, 1988, p. 8).

The secrecy/transparency is the perfect starting point to analyse the internal control disclosure in a cross countries research: Gray argues that secrecy is the most relevant accounting value in influencing disclosure of information, and indicates that the Italy is less influenced by secrecy than Poland.

The difference between the two countries is highlighted by the diverse requirements present in the regulation on corporate governance and on the different rules regarding the disclosure on ICS of the Italian and Polish countries.

In last years the Italian corporate governance system adopted many legislative reforms. Among others the Draghi Law (Consolidated Law on Finance, TUF) in 1998 that underlines the autonomy of each firm in choosing its corporate governance model. The finding consisted in the adoption of the first version of the Italian Corporate Governance Code in 1999, as a set of self-regulatory best practices that Italian listed companies should select voluntarily. The Code stresses the attention on the role of the Board of Directors in determining and improving the strategic objectives of the company, the autonomy of its non-executive members and the presence of a considerable number of independent directors. The Code affirms the necessity to adopt an internal control system and internal audit committees. The Preda Code was amended in 2002 and in 2006 to reinforce the international evolution in this matter. Among the main innovations a central role is played by the growing emphasis on the presence of non-executive directors who should be competent and professional in order to consider various matters from different standpoints, and the significance of the ICS and Enterprise risk management (Allegrini, D'Onza, 2003).

Each company needs to put in action an internal control and risk management system composed of policies, procedures and organizational structures

with the purpose of identifying, measuring and monitoring the main risks. It is an essential part of the management of the company according with the objectives stated by the Board and is linked with the other control activities (internal auditor, risk manager, audit committee, auditor and so on).

Moreover, the ICS is significant also for its role on ensuring the adequacy and transparency of the corporate financial reporting in order to disclose information concerning the company, in compliance with the rules and procedures governing the disclosure of price-sensitive information.

On the other hand Poland are both characterized by the continental model of corporate governance with a two-tier system, high concentration of ownership and the weak investor protections (Aluchna, Kołodkiewicz, 2010; Dobija, 2015).

Poland is also an example of a country that is in a fast transition, where corporate governance standards are developing simultaneously with the development of the capital market (Dobija, Klimczak, 2010). In such a model, the supervisory and management board are kept separate unlike in mature markets, where strong corporate governance mechanisms are considered to be a precondition of the effectively functioning capital market.

Poland's first corporate governance code was written and adopted by the public companies in 2002; however, the implementation of external monitoring mechanisms and transparency rules is considered to be rather low (Kuchenbeker, 2008). In 2005 the updated corporate governance code was issued and established a rule to implement an internal control system.

One of most controversial part of the new release of the Polish Code of Best Practice 2012 is that, despite it requires that listed companies establish the ICS and Audit Committee, it does not explain in details how the internal control system works.

4. Methodology

The first step of our analysis is to create an Internal Control Disclosure Score (ICDS) of the Italian and Poland companies.

The first step of this disclosure index is to set up the list of optional information items carried out from an Italian format on the Corporate Governance disclosure and on the requirements of the COSO Report.

On this basis, we compiled a list of items that may give a good level of internal control disclosure and we use it to find the information in the company annual reports of the sample Italian and Polish firms.

We follow the voluntary disclosure strategies of the sample in the 2013 in order to capture the effect of the new COSO requirements on internal control disclosure.

Once we calculate the ICDS we investigate the correlation between the level of disclosure on internal control and the corporate governance structure of the companies.

The final sample of companies disclosing information on internal control and on corporate governance variables is composed by 185 companies (103 Italian and 82 Polish) for year 2013.

At first, the sizeable body of literature affirms the significant role of the corporate governance for the market transparency and for the high quality of the voluntary disclosure.

Moreover, a lot of researchers investigate the impact of corporate governance on the voluntary disclosure of the various public company sectors, showing that the monitoring function of corporate governance significantly influences the propensity toward disclosure (Lang, Lundholm, 1993; Bushman, Smith, 2001; Abraham, Cox, 2007; Lim et al., 2007).

On the basis of these motivations, this study investigates the impact of audit governance on internal control disclosure practice with the following model:

$$ICDS = \beta_1 board_ind + \beta_2 board_size + \beta_3 board_meeting + \beta_4 country + \varepsilon$$

The variables are:

- board_ind: number of non-executive members in the board (Patelli, Prencipe, 2007; Karamanou, Vafeas, 2005),
- board_size: number of the member of the board (Ajinkya et al., 2005; Karamanou, Vafeas, 2005),
- board_meeting: number of meeting of the board (Vafeas, 1999; Xie et al., 2003),
- country: dummy variable with a value of 1 if the company is Polish or 0 if Italian.

Table 1

Descriptive statistics

Variable	Obs	Mean	Std. Dev.	Min	Max
firm	0				
score	185	8.745946	2.597092	0	11
country	185	.5567568	.4981163	0	1
directors	185	10.06486	3.48539	2	22
independent	185	3.583784	2.229924	0	14
frequency	185	6.994595	4.415262	1	23

5. Findings and conclusion

The preliminary findings of the current analysis do not show any significant relationship between ICDS and the country effect but it emerges a relationship between ICDS and the size of board of directors (Tab. 2).

Table 2

Findings

Score	Coef.	Robust Std. Err.	t	P> t	[95% Conf.	Interval]
country	-.6412366	.4956696	-1.29	0.197	-1.619307	.3368339
directors	.2427523	.0558661	4.35	0.000	.1325156	.352989
independent	.0320277	.0750255	0.43	0.670	-.1160148	.1800703
frequency	.0247447	.0401592	0.62	0.539	-.0544987	.1039881
cons	6.37183	.7696404	8.28	0.000	4.853152	7.890508

This study analyses the behaviour in terms of Polish and Italian listed companies ICS disclosure. With a first attempt on year 2013 regarding a sample of companies on which was possible calculating ICDS score and that provide information regarding some corporate governance factors we find that the country does not influence statistical analysis but instead there is a clear effect of board of directors confirming previous studies regarding firm performance and board of directors dimension.

The first draft of this study provides so evidence of the effects of the regulation regarding ICS and may be helpful for Regulators and Professional Bodies.

The main limitation of the current study is linked to the consideration of only one year; in next draft we will fill this lack involving more years and, if possible, more companies. In the next development of the work we will also look for control on possible relationship between ICDS and companies' characteristics.

Finally, once finalised the model with possible adjustments, it will be important to increase the sample with the inclusion of other countries.

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Abstract

The vast academic research evidenced that corporate transparency has favorable effects on markets and on external stakeholder judgment and decision making (e.g. Lang, Lundholm, 1993). As an important part of corporate governance, voluntary disclosure on internal control system has received a great attention after the introduction of the COSO frameworks and the requirements of the US Sarbanes Oxley Act (SOX).

The Italian Corporate Governance Code and the Polish Code of Best Practice ask to increase the disclosure on internal control system in order to give more information on the effectiveness and efficiency of the companies.

Using content analysis we define an Internal Control Score Disclosure (ICSD) of the Italian Stock Exchange companies and of Polish Stock Exchange companies for the year 2013 in order to investigate corporate gov-

ernance influence on internal control disclosure. The ICSD will be examined in order to provide empirical evidence for the significant increase in the disclosure level of internal control system and to test if, as Beeks and Brown (2006) stated, companies with better governance disclose more information, while those with a weak governance are lacking of financial disclosure and transparency.

Preliminary findings show a clear relationship between ICSD and the dimension of board of directors. In next stages we will involve more years and, if possible, more companies. In the next development of the work we will also look for control on possible relationship between ICDS and companies' characteristics.

Keywords: corporate governance, disclosure, financial statements, internal control system.

Zakres ujawniania informacji w obszarze systemu kontroli wewnętrznej przez włoskie i polskie spółki giełdowe – badania empiryczne

Streszczenie

Liczne badania naukowe dowodzą, że przejrzystość spółki ma korzystny wpływ na rynki, oceny dokonywane przez zewnętrznych interesariuszy oraz proces podejmowania decyzji (np. Lang, Lundholm, 1993). Od czasu wprowadzeniu ram COSO i wymagań amerykańskiego Sarbanes Oxley Act (SOX) wiele uwagi poświęcono ważnemu obszarowi nadzoru korporacyjnego, jakim jest dobrowolne ujawnienie informacji z zakresu systemu kontroli wewnętrznej.

Włoski Kodeks ładu korporacyjnego i polski Kodeks dobrych praktyk zalecają zwiększenie zakresu ujawniania informacji w obszarze systemu kontroli wewnętrznej. Ma to pozwolić na zwiększenie zakresu informacji o skuteczności i efektywności przedsiębiorstw. Autorzy, wykorzystując metodę analizy treści, zdefiniowali wskaźnik ujawniania informacji o systemie kontroli wewnętrznej (WUISKW) spółek notowanych na włoskiej i polskiej giełdzie papierów wartościowych w roku 2013 r. Ma to na celu zbadanie wpływu ładu korporacyjnego na zakres informacji ujawnianych o systemie kontroli wewnętrznej spółek. Wykorzystanie WUISKW ma pokazać czy zakres ujawnianych informacji o systemie kontroli wewnętrznej rośnie i równocześnie zweryfikowanie tezy Beeks i Brown (2006), że przedsiębiorstwa o efektywniejszym nadzorze korporacyjnym ujawniają więcej informacji,

podczas gdy te o mniej efektywnym nadzorze ujawniają ich znacznie mniej i spółki te są mniej przejrzyste. Wstępne wyniki wskazują na wyraźny związek między WUISKW oraz składem rady dyrektorów. W następnym etapie czasookres badania zostanie wydłużony jak również zwiększony zostanie zbiór spółek objętych badaniem. Dalsze badania będą miały także na celu ustalenie związków pomiędzy WUISKW a cechami spółek.

Słowa kluczowe: ład korporacyjny, zakres ujawniania informacji, sprawozdania finansowe, system kontroli wewnętrznej.