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# **The Role of Internal Control in the Operation of Hotels**

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## **Preface**

We acknowledge that this thesis can be completed because of the support from many people.

First, we would like to thank the Directors of Finance and the hotels that are participating in our research for providing time and sharing valuable knowledge and experiences with us. We really appreciate for their openness to be participated in this study although in their busy work.

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*Lund, May 2011*

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## **Abstract**

**Title:** The role of internal control in the operation of hotels

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**Keywords:** Internal Control, COSO Framework, Director of Finance, Hotel Accounting, Hospitality Management

**Purpose:** The purpose of this thesis is to examine the role of internal control implementation that plays in the enterprises' operation. We evaluate it from the Head of Finance (as Director of Finance in the enterprises) perspective and see whether adequate internal control implementation is important for the enterprises' operation.

**Methodology:** This thesis is based on a qualitative and deductive approach. Our empirical materials have been collected by semi structured interviews.

**Theoretical background:** The thesis theoretical perspective describes COSO framework as a guideline of internal control implementation. It explains about the needs of internal control and how it is regulated in the enterprises. Further, the hotel industry in general is described as an introduction to the case study in hotel sector.

**Empirical findings:** The empirical investigations were made based on semi structured interviews with the Head of Finance of five reputable hotels in Sweden and Indonesia with different business scale: international and local hotels. Besides, two interviews with external auditors from Audit Firm in Sweden and Indonesia had been made to get objective views.

**Analysis:** This part describes and analyzes the findings on the internal control implementation, with the help of five internal control components from COSO

Integrated Framework and Sarbanes-Oxley Act. The gaps between theories that are used as a base for this research and the facts are also examined in this chapter.

**Conclusion:** The result of this study shows that with implementing internal control system based on COSO Framework helps on ensuring efficiency and effectiveness of operation. Based on the completed case studies, a well implemented internal control system is truly a tool to safeguarding assets, prevention of possible fraud and losses and a guideline for the enterprises to keep followed the good standards to produce accurate and reliable financial reports. In addition, it also increases the reliability of financial reports for the stakeholders of the enterprises.

## **Abbreviation**

AICPA - American Institute of Certified Public Accountant

COSO - Committee of Sponsoring Organizations of the Treadway Commission

ECIIA – European Confederation of Institutes of Internal Auditing

FAR – Föreningen Auktoriserade Revisorer (the Swedish Association of Certified Public Accountants)

FERMA – Federation of European Risk Management Associations

FPCA - Foreign Corrupt Practices Act

GAAP - General Accepted Accounting Principles

IDV – Individualism versus Collectivism Index

IFAC – International Federation of Accountants

IIA – The Institute of Internal Auditors

ISA – International Standards on Auditing

MAS – Masculinity versus Femininity Index

PCI – Payment Card Industry

PDI – Power Distance Index

SAS - Statement of Auditing Standards

SEC - US Securities and Exchange Commission

SOX - Sarbanes-Oxley Act

UAI - Uncertainty avoidance

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# 1. Introduction

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*In this first chapter we will present an introduction of this thesis, the background about the chosen topic, the purpose, the delimitations and the thesis outline. It will also verify the relationship of the implementation of internal control in an organization.*

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## 1.1 Background

Internal control is discussed even more often in the auditing world recently. It has been believed to have close connection with risk management on helping the enterprise avoid bankruptcy. In addition, it has been seen as played an important role to help the enterprise to keep producing its profit and also reduce the unfavorable events. (IFAC, 2007) Internal control also assists management when facing the fluctuating economic condition. According to The Committee of Sponsoring Organizations of the Treadway Commission (2010), internal control also gives competitive advantage with encouraging the enterprise to be more efficient and as a safeguarding assets and helping to provide reliable and accurate financial statements according to the standards. Further, it is also appropriate for the external auditors to lower their consideration of Control Risk assessment in the enterprise and use the internal control system in the enterprise as their audit evidence, after they test its effectiveness by themselves (HKICPA, 2004). We can expect that material misstatement in the enterprise's financial statements will be in minimum level or not material, because effective internal control policies and procedures are assumed to be able to detect and prevent it (Hayes et al., 2005). This consequently will benefit the enterprise with paying lower audit fees to the external auditors. It is because internal control system is one of the considerations on deciding audit fees (Hayes et.al, 2005).

There are different views of internal control and debates about how to measure a good internal control system. Internal control can be seen from external auditing view, organization theory and also economics perspectives. From external auditing theory, it examines the details regarding how internal control impacted to auditors' role on doing their audit work. While on organization theory and economic perspective, it studied on the relation with management or people in the organization.



Nevertheless, the difference between organization and economics perspective is also founded as the economics perspective focuses more on agency theory and corporate governance. It is not on the people behavior like organization theory perspective. These three perspectives have been important to studies on internal control. (Maijoor, 2000). Organizational theory, however, can be the most related theory to the internal control implementation. It is because organizational theory involves all people in the whole organization. An effective internal control implementation possibly needs effort from all employees from top to bottom as well. Refer to this, we believe that it will be very interesting to discuss about internal control with the help from organizational theory perspective. We see that Directors of Finance is a person who is very influential on the business operation for the whole company. Then we know that Director of Finance is also a top controller for the whole organization, which are employees, customers and also the owners to achieve the goal of the company.

Although some sources have explained the importance of internal control, but we believe it will be very interesting to examine the roles of internal control more specifically by looking deeper into just one industry. It is because each industry has different business treatment to each other and also has its own difficulties on implementing internal control on their operation. We see that hotel is a unique industry and therefore we would like to see if internal control is truly helping the operation in the hotel to be effective and efficient, like to the other industries.

## **1.2 Problem discussion**

Problems in Enron downfall occurred because of lack of internal control which allowed frauds to be spread in the organization (Cunningham & Harris, 2006). Moreover, people on top management positions in the organizations began to put more attention to the power of internal control (Locatelli, 2002), that is expected to make their business more efficient and profitable. Further, implementation of internal control could even affect the works of external auditor and, of course, to their audit opinion as well. The external auditors would also increase their risk assessment when they see that there is weakness of internal control in their client's operation that could lead to any possible

misstatement. Moreover, we saw that internal control has some important effects to safeguard assets, and then it will keep the going concern of an organization (US Securities and Exchange Commission (SEC), 2013). From this, we can see that internal control is very interesting because it has given significant effects to almost all stakeholders of the organization. From internal organization, they are the owners, top management, internal auditors and employees. From outside organization, it is external auditors and possibly customers. Therefore, we chose internal control as our topic, to examine the subject and see how it works in the organization. In addition, we wanted to see if internal control can help the company in the long term for a more economical and efficient organization.

We chose to examine the issue of internal control in the hospitality industry, particularly hotels. This is because we consider hotels as one of the growing businesses (Singh, 1997), along with the rise of the tourism promotion in many countries in Asia Pacific lately, and it also has been creating competitive situation in hotel business in Europe (Wang & Wang, 2009). The hotel industry is believed as a cyclical business that can be up and down in anytime. This situation has been a strong reason that this industry needs good management team in all time to maintain the going concern of its business. We also noticed that hotel industry is a special industry because service is its main business. Therefore, the relationship with its guests is very important to keep the hotels run its business. This has become an interesting topic to discuss, where implementing good internal control might be important but also challenging to the hotels and the hotels' Director of Finance. As part of top management, the Directors of Finance are responsible for establishing an internal control system in the hotel which sometimes strict procedures can give unfavorable impact to the guests. But, on the other way, they also have to ensure that the business keep coming to the hotel. Based on this reason, we think it would be interesting to see if good internal control truly works as a tool to keep the hotel operation effective and efficient, from the Directors of Finance' perspective.

### **1.3 Purpose of Research**

With this thesis, we aim to see how the implementation of internal control affects the whole business organization in general. Later after having good understanding on the role of internal control in the operation of the company, we expect to get clear idea whether internal control can truly be useful to keep the company safe from fraud, operating more efficient and become profitable. Further, the company can ensure its going concern as a healthy entity. However, we know that any procedures cannot be implemented in the same way to different companies in different business sectors.

Hotel sector is a service industry. This industry is rather special from other 'selling goods' industry. It means that in hotel sector the management has to be more careful on implementing some internal control procedures on their daily operation, because it will also affect the services that are offered to the guests. Any wrong implementation will possibly disrupt their business. Therefore, in this thesis, we also expect to get an understanding on how they can manage the internal control implementation to be in line with the guest satisfaction to achieve their company's goals.

This study is also aimed to give inspiration and possibly new knowledge for students and researchers in business administration, especially those who have a focus on auditing. Nevertheless, we also hope that this paper may be useful for hotel managers, controllers, internal auditors and their stakeholders. The purpose of this thesis is to examine the role of internal control that plays in the hotel industry and investigate if there is any importance of adequate internal control implementation in this specific industry. We evaluate it from the Director of Finance (as the head of Director of Finance in the enterprises) perspective and see whether internal control is important for the enterprises' operation and then lead to an effective and efficient way of operation.

### **1.4 Research Question**

When writing this thesis, we are focusing on one main question:

*What is the role of internal control in the operation of hotels?*

To answer this question, we use some supporting questions as below, in relation to our case study in hotel sector.

1. What is internal control, and how is its usefulness for the enterprises' operation, in general?
2. How is internal control being implemented in the hotels from Directors of Finance' perspective?
3. Are there any challenges on implementing internal control in the hotel?
4. Does internal control implementation bring any usefulness to the hotels' operation?

### **1.5 Definitions**

On writing this thesis, we are inspired by several factors which are combined together to formulate this thesis. They are internal control, hospitality, and hoteliers. Firstly, we begin with the definition of internal control. Looking into ISA handbook (International Federation of Accountants, 2009, p.264), internal control is described as

*”The process designed, implemented and maintained by those charged with governance, management and other personnel to provide reasonable assurance about the achievement of an entity’s objectives with regard to reliability of financial reporting, effectiveness and efficiency of operations, and compliance with applicable laws and regulations. The term “controls” refers to any aspects of one or more of the components of internal control”.*

From COSO Integrated Internal Control Framework in 1992 (Maijoor, 2000, p.105), internal control is defined as:

*“A process, effected by an entity’s board of directors, management, and other personnel, designed to provide reasonable assurance regarding the achievement of objectives in the following categories:*

- *Effectiveness and efficiency of operations*
- *Reliability of financial reporting*
- *Compliance with applicable laws and regulations”.*

Secondly, when we are talking about the hospitality industry, we noticed that many people are not really familiar with the word ‘hospitality’. To get more understanding, as cited in the book “The Introduction of Hospitality Industry” 7<sup>th</sup> edition (Barrows & Powers, 2009, p.4), hospitality can be defined as follow.

*“The reception and entertainment of guests, visitors or strangers with liberality and good will”*

From this definition, we can conclude that hospitality industry is about giving service to other people, which can be very broad including hotels and lodgings and restaurants. But, in this thesis, we will limit by using the term of hospitality industry for hotels only.

We define international hotels as hotels that part of hotel chain or have branches in more than five countries around the world, while local hotels are hotels that operate within one country and do not have any other branch or chain in other country.

Lastly, we would like to define the word hoteliers. Who is a hotelier? Oxford Learner’s Pocket Dictionary (Bull, 2008, p.215) defines hotelier as a *“person who owns or manages a hotel”*. Refer to this definition, we can describe that hotelier is someone who works in hotels. It includes the hotels’ employees from the front-liners until the top management persons and also the owners.

## **1.6 Scope and Limitation**

We decided to study only in reputable hotels in the place(s) they are operated, for our case study. We do not cover budget hotels and other smaller type of hotels as we considered that they do not have complicated operation like the operation in bigger hotels. Nevertheless, we also include outlets or places that provide food and beverage services inside the hotels, and later we will mention this with the term ‘Food and Beverage Department’. This department has to be operated by the hotels and supposes to have same policies and procedures like any other department in the hotels. There are different types of outlets, as mentioned in Frankfinn Hospitality Assessment (Kumar and Lalitha, 2010), such as coffee shops, banquets, room services, discotheque, bar, pub and restaurant.

We also felt that it would have been too intrusive to interview both the Director of Finance and internal auditors for the same hotel. In this case, there was possibility that the respondents would be less inclined to do an interview, which then would decrease our opportunity to be able to do interviews with competent and experienced respondents, like we had done for this thesis.

## **1.7 Structure of the thesis**

### *Chapter I: Introduction*

The thesis begins with an introduction which gives the reader an overview of the subject and a summary of the whole thesis.

### *Chapter II: Theoretical Background*

The second part will give an overview of the theoretical background, starting with the history of internal control and the detail discussions about internal control. Next, the reader will be taken into the overview regarding internal control in hotel sector. This chapter is aiming to clarify for the reader the theoretical grounds that are essential for understanding the thesis.

### *Chapter III: Research Methodology*

The third part is aiming to clarify to the reader the methodological process that is related to describing the process of data collection and explaining the chosen approach.

### *Chapter IV: Case Study and Empirical Findings*

The fourth part consists of empirical results. Interviews have been made with Directors of Finance of five hotels in Sweden and Indonesia in different business scales. The interviews have been done to get a deeper insight on writing this thesis. Through the

findings, we want to present the real implementation of internal control in the enterprises through these hotels.

#### *Chapter V: Analysis of the Findings*

In this chapter, we analyze the findings from our case study. We do this with the help of five internal control components on COSO Integrated Framework. We examine the advantages and challenges on implementing good internal control in the enterprises, particularly in hotel sector. Further, we also discuss about how the internal control should be implemented in order to maximize its usefulness.

#### *Chapter VI: Conclusion and Suggestions*

In the last section, we draw the conclusion of this study to examine the role of internal control in the enterprises' operation through our hotel sector's case study. We also provide the suggestions based on our findings and analysis. Finally, comments on the empirical results of this thesis are given based on the analysis and we try to give suggestions for further researches in this field.

## 2. Literature Review

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*This second chapter presents the theoretical backgrounds and explains models of internal control. Its aim is to clarify and give the potential reader theoretical grounds that are essential for understanding the thesis.*

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### 2.1 Brief History of Internal Control

Step to the recent histories, internal control actually mentioned for the first time by George E. Bennet through his book on 1930s, but then officially defined by American Institute of Certified Public Accountant (AICPA) in 1949. AICPA described the roles of internal control as a “safeguarding of assets”, the “ensuring of the accuracy and reliability of accounting data”, the “promotion of operational efficiency” and the “adherence to prescribed management policies”, though this finally led to the criticism. The critics was questioning about the responsibility expansion of the auditors, which was seen would be very broad. This finally stimulated the suggestion to simplify the scope of internal control concept. As a result of the event of the scandal involving US corporations regarding overseas illegal payments, Foreign Corrupt Practices Act of 1977 (FPCA) was published in 1977. The act firstly initiated the obligatory implementation of the internal control systems. This also led the spread of the practices of internal control in the US (Nakano, et al., 2009). After this act issued, people started to hire persons to evaluate their internal controls and demonstrate their compliance, which was finally recognized as internal auditors. During the period 1976 to 2001 powerful organizations and individuals employed active strategies worked to avoid companies from committing fraud (Shapiro and Matson, 2008). The companies were building up with a duty to report on internal control with a true and fair requirement and thereby built up a true and fair view in the whole accounting society (Noguchi and Batiz-Lazo, 2010).

In 1980s, AICPA issued the SAS No. 20 about the Reporting on Internal Control. This standard explained about the concept and process of the internal accounting control report in the companies by the independent accountants. Continuously, it was followed by SAS No. 55, in 1988, about Consideration of the Internal Control Structure in a Financial Statement Audit, which describing the element of internal control structure



and the detail about control risk concept. After almost twenty years, SAS No. 78 was issued by AICPA as an amendment for this standard. This amendment refined the definition and description of internal control. These changes were to follow the COSO Integrated Internal Control Framework who is issued three years before, in 1992. With the advanced technology these days, in 2001, the AICPA finally issued SAS No. 94 with the explanation about using information technologies as a tool of ensuring internal control on auditing the financial statement. Furthermore, in 2006, the AICPA issued about communicating internal audit issues on auditing process in SAS No. 112, but this was finally replaced by SAS No. 115 two years after (Nakano, et al., 2009).

## **2.2 Understanding the Internal Control**

### **2.2.1 Introduction to Internal Control**

During the years, many events have been occurred in business world as a result of ineffective internal control, for example, the scandal in the US junk bond and insider trading scandals in the early 1980s, the costly savings and loan crisis in the late 1980s and the costly accounting scandals from the late 1990s onward. These scandals, among others, showed that the voluntary reporting on internal control system was mainly ineffective. An alarm clock for independence started to ring while there were many wrongdoings that happened in the corporations. The accounting profession was criticized to not controlling the corporate abuse in a responsible way. The goal of this criticism was to minimize the gap between the public expectation about what auditors should do and what auditors could actually accomplish. Besides, they also discussed about how the regulations should be implemented and thereby enforced in the corporation (Shapiro and Matson, 2008).

In 1992, COSO published the Internal Control Integrated Framework which also explained the needs of internal control to form and maintain good companies. Good companies here can be described as companies who are in accordance with GAAP and most importantly fulfilling the SAS No. 59 regarding the going concern assumption of the companies (AICPA, 2010). Later, after the Enron scandal in 2001, the SEC, as a government influential standard setter in the US, emerged all US public listed companies to have adequate internal control procedures and policies. They believed that

a good internal control system would be able to prevent the scandal occurring again in the future. The scandal led to the establishment of Sarbanes-Oxley Act. The act requires the public listed companies in the US to include the management assessment on internal control over financial reporting. This report about internal control requirements, specifically in the Sarbanes-Oxley Act Section 404, is more focused on the financial statement. With the issuance of this Act, it was like an alert for the needs the internal control as an important factor on minimizing the possibility of frauds (The Institute of Internal Auditors, 2008) and thereby to reduce the risk of company failure (Vanstraelen, 2002).

It was discovered that the enterprises that do not implement effective internal controls would have higher possibility to produce inaccurate management forecasting report rather than the enterprises who implement effective internal control systems (Feng et al., 2009). After the bankruptcy of Enron, the role of internal control on minimizing fraud in the company's operation was become more visible. The companies who have good internal control system seem to give more assurance to the external auditor when they do audit. With an effective internal control system in the company, the external auditors expect that the possible fraud can be detected earlier, and then they will lower the control risk. With the adequate internal control system, the companies will benefit lower external auditor fees, which then reduce the companies' costs (Knowles, Diamantis and El-Mourhabi, 2004).

Internal controls can be compared with a special type of feedback with looking on the quality and functionality of different aspects of a business. It can be defined as actions and procedures which company can use to monitor and ensure efficiency in operations and legal compliance (O'Farrell, 2011). Internal control is most often described as a *process* "a means to its end, not an end in itself" and that internal control is affected by *people* at every level in the organization. Internal control can only provide *reasonable assurance* and not absolute assurance on detecting misstatements and ensuring that the financial reporting is reliable, trustworthiness and compliance with law and regulations. However, an effective internal control can function as a protection of assets in the companies. In addition, internal control leads the companies to be in line with the standards and minimize the unfavorable surprise events along the way (Hayes et al.,

2005). Therefore, with having a good internal control system in the company, the companies can convince the public that they provide reliable information in their reports and that they are minimizing any possible fraud. In order to implement it, the managers have a responsibility to inform the employees about the companies' needs of internal control and make sure that they comply and implement it in a correct way (VanBaren, 2010).

Internal control should be implemented into the design of the enterprise's organization structure and business operation, from the top to the lowest level. By implementing an internal control system in the enterprises, it will simplify and clarify perspectives on how to do things in the right way. The management has the main responsibility to ensure that the internal control procedures are well developed in the hotel. It has to be adapted to the organizational environment and when there is a change that impacted to the enterprise, and then it is necessary to look over the internal control and see if there are any changes needed to keep it effective. It is possible that there are some new parts that need to be adopted or re-changed. But every time when changes are done in the company, it is very important to inform the employees about them and make them feel confident to implement the new procedures. It is also a good idea to involve the respective employees into the process of changes is to let them give new ideas and feedback. Further, good communication between management and employees shall be considered as the first step to positive changes within an organization. Nevertheless, the employees are responsible to follow the direction that is given to them according to internal control. It is also important that each of them get clear information about what their duties are. With adequate segregation of duties help the company avoids fraud (VanBaren, 2010).

Nowadays, internal control has more function to "prevent and monitor", while previously it was regulated to "detect and correct". Internal control is based on systems of checks and balances. Everyone in the organization should concern about the risks and put effort to minimize it. Accordingly, it is very important to have a good communication in the whole organization, on all levels. An effective planning and budgeting, supported with unannounced physical controls, are some of the techniques

that can be implemented in the organization to implement internal controls (Dopson and Hayes, 2009).

A well implemented internal control system reduces the risk of accounting errors and abuse. It also help the organization to keep detailed records, manage and organize important financial transactions and set a high standard for the organization's financial management structure and protocols, which can be important for them to keep. Special computer programs and web-based applications can be used to assist the implementation of internal control. It will make it easier for the companies to control all departments and thereby collect information that clarifies the actual situation. It can also be a base for collecting information about the process of the accurate financial assessments (O'Leary and Watkins, 1995).

Nevertheless, after considering all those procedures, there is always a risk for collusion that lead to fraud in the company. If some workers decide to go behind the company and cooperate while they have the access to the same type of financial information in the hotel, and when they for example have the passwords for entering the information, they can create false transactions and steal money from the company at the same time as they approve each other's transactions (McIntosh, 2010). Most importantly, an open mind behavior and proper observation should be done to avoid limitations. Limitations for internal controls (like human error, collusion among employees, errors caused by the installation of new software or other basic carelessness in the organization) can be avoided with good training, practice and feedback. In addition, good teamwork can also avoid limitations or challenges to internal control implementation. When more people are involved, it would be harder to not detect the errors (Cetawayo, 2010).

Further, it is important for the company to have control over its physical assets, e.g. cash, and over its non-physical assets, e.g. account receivable. They must also secure the place where they store all the important documents so it would not be stolen, misused or destroyed, and the personnel should be reliable and follow the confidentiality. The manager is then responsible, both legally and professionally, to make sure that the information will be prepared accordingly with the accounting standards (Hayes et al., 2005).

According to a survey made by FAR and IIA (The Institute of Internal Auditors) Sweden, internal and external auditors should cooperate because they have much to learn from each other. The co-operation is like a win-win situation. The internal auditors work full time in the company and have thereby good knowledge about the routines and process while the external do not have the same deep knowledge about the company but can instead bring experience from other companies. It is though important that the internal and external auditors have good and clear communication with each other. By cooperating they will reach a synergy effect where one plus one will be more than two and the worth of the company will thereby rise (Halling, 2010).

Different stakeholders have different demands on the quality of information. Banks and other external stakeholders are often expecting more general information about the accounting while people working in the company want to have more detailed and specific information. An example is that their properties can be valued at the estimated market value or the purchase price. External (banks and other outside parties) may prefer to value it to the purchase price because they are concerned that the management otherwise often have an ability to influence it to the selling price. On the other hand, intern in the company, they would probably use the market value while they would like to have a good confidence in future values and valuations. Accounting is divided between the information that external stakeholders want and the information that focus more on the internal information. (Lönnqvist and Lind, 2002)

An important difference between external and internal reporting is the definition of what constitutes a commercial transaction. An example is when banks are interested to see the companies' ability to capital repayment and their profitability, and then they are less interested in all the small detailed about product profitability. Internal it is on the other hand more important for the company to evaluate their entire product and see which generate more profitability and which generate less. Internal users of accounting information are therefore usually more often interested in data on a single department or an individual product. Within the company the internal report a series of events where no third party needs to be involved (Lönnqvist and Lind, 2002).

The external auditor gives the audit opinion about the year-end closing, the account report and financial risks. The internal auditor focuses more on those parts of the internal control that are not primarily covered by the external audit mission, which means that the internal audit work primarily focus at the assessment of business risks. Basic standard for the auditor is to get as much information about the company as possible and identify significant discrepancies compared with the audited financial statements. (Tunbjörk and Wikland, 2009)

It is always a risk that fraud occurs in the organization. Fraud can be very costly for the company, especially uncovered fraud in the entity. Fraud should not take over and become the major problem in the company. There is also a difference between external and internal auditors when it comes to fraud. When external auditors investigate fraud, they tend to focus on financial statement fraud, whereas internal auditors are more concerned with a wider variety of frauds, including misappropriation of assets. For the structure of the corporate governance, the internal audit is playing an important part of the whole entity. The Institute of Internal Auditor's (IIA) explains the importance of good knowledge of internal auditors. They can help to detect fraud of an organization by having good knowledge about the companies' ethical culture (Coram, Ferguson and Moroney, 2008).

Internal control can be used as a tool in the organization to get good knowledge of the risks and thereby eliminate or reduce hazards and improve safety. Efficiency and ability to comply with requirements such as laws, regulations, rules and owner directives are related to good risk management. Internal control is an assurance that the entire field inside the company is reviewed with laws and rules (Tunbjörk and Wikland, 2009).

### **2.2.2 Internal Control in Relation to Risks**

Educated personnel that know the importance of good internal control and risks that can occur in the enterprise is seen as a major advantage for the enterprise. Risks exist in every enterprise and need to be identified as soon as possible to minimize the possible losses. Doing analysis of the risks on the enterprises, it will help to understand the situation better and thereby prevent the same risk to be occurred again in the future. One

way to understand the risks better can be by evaluating the errors and trying to answer questions about the enterprise's problem. The better understanding on the risks will surely help the enterprises to build up better protection too. Risks are threats that will affect the hotels ability to achieve its strategy successfully in proper way, and it is good to think about these three steps in the process; first to identify the risks, then to source the risk and finally prioritize the risks (Protiviti, 2011).

'Audit risk' and 'business risk' need to be differentiated. Audit risk is related to internal and external audit efforts. It is often compared to risks that can occur of incorrect audit. Business risk, also defined as Enterprise Risk Management (ERM), which in the other hand related to the enterprise's goals. Primarily it is about cost that incur when the enterprise cannot achieve its strategic plans. COSO is describing ERM as: " *A process, effected by an entity's board of directors, management, and other personal, applied in strategy setting and across the enterprise, designed to identify potential events that may affect the entity, and manage risk to be within its risk appetite, to provide reasonable assurance regarding the achievement of entity objectives.*" Further, internal auditing is managing its own audit risk and performing its own assessment of business risk, and together with the management's risk assessment it can become more efficient (Dan Swanson, 2010).

If there is no internal control existed in a company or exists but ineffective, then there will be bigger chance that fraud will be committed in the organization. According to Hillson et.al, good controls are needed to prevent fraud as many as possible. Some common failures in the control system that increase the opportunity for fraud are: "*lack of segregation of duties, failure to inform employees about company rules and the consequences of violating them or perpetrating fraud, poor accounting records, and lack of access to information*" (Hillison, Pacini, and Sinason, 1999).

### **2.2.3 Internal Control from Auditing Perspective**

The controls made by the auditor need to be regularly updated. The auditor measures the effectiveness in the organization, control that all laws are followed correctly and review that no fraud will be found. Other duties for an internal auditor is to review all

accounting activities, assets, liabilities, expenses, revenues, cash flow statements and stocks. If any wrongdoings are found it is up to the auditor to determine if they occur by mistakes or by attention (Tavangaran, 2011).

The internal auditor needs to be a critical thinker. This means that the evaluation should come from the auditors own mind, where ideas should be compared from different perspectives. The validity of the situation should be questioned (Schleifer and Greenawalt, 1996). When auditors follow ethical rules, they can keep a professional honesty and avoid conflicts. As critical thinker, the internal auditors need to tolerate ambiguity and accept that there can be more than just one solution to a given problem, as well as be open to change the beliefs when new evidence and experience arise that are based on previous audit findings in the organization. One of the auditor's main functions is to collect data and analyze it carefully for its value and content. How does it look like, what are the findings, and what kinds of evidence exist? How will it all have an impact on the auditor's judgments? The auditor needs to question the logical strength in the process of obtaining information. Both in the interviews and in the field study. All the collected data will then be implemented in the auditor's paper as support for the conclusion and findings and it will also be transferred from the prior audits to new. (Schleifer and Greenawalt, 1996)

Internal auditors' critical thinking skills include:

*“To solve problems, organize different ideas, design plans of action, evaluate arguments, apply knowledge to know situations, critically evaluate the logic and validity of information, and carefully analyze situations”* (Schleifer and Greenawalt, 1996, p.8).

## **2.3 The Theories and Regulations on Internal Control**

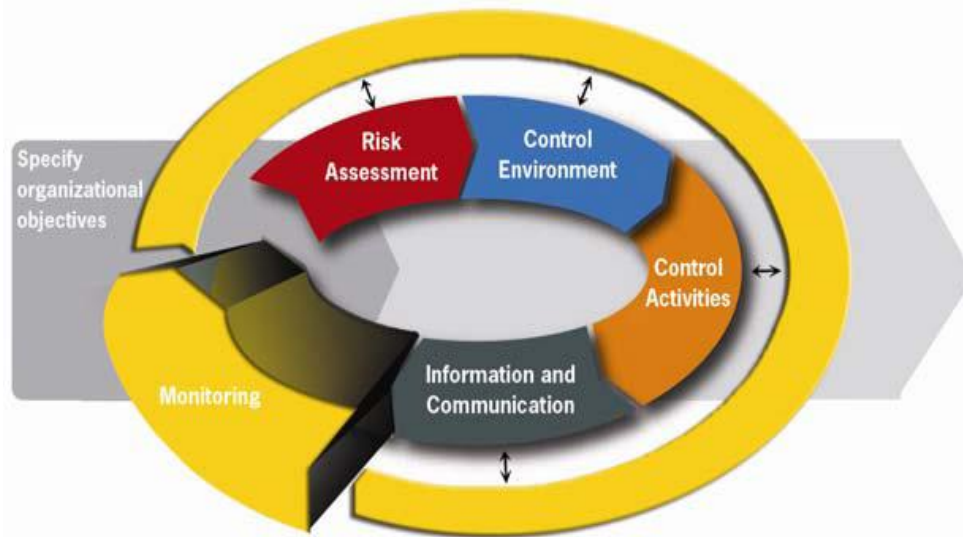
### **2.3.1 COSO Framework**

COSO was formed in 1985. The organization is focusing on improving the quality of financial reporting through business ethics, effective internal controls and corporate governance. The COSO Report serves as the essential foundation of internal control and



is offering a conceptually holistic approach to internal control. (The Committee of Sponsoring Organizations of the Treadway Commission ,2009)

The COSO Integrated Framework consists of the following five components:



*Figure 3. Internal control is related to five different components on the COSO Integrated Framework. (The Committee of Sponsoring Organizations of the Treadway Commission ,2009)*

The five components represented in the figure above, work together to eliminate unexpected fraud and other organizational failure. The COSO framework is used as a tool for internal control and will help organizations to implement it in their whole entity so it will operate effectively in the organization. (The Committee of Sponsoring Organizations of the Treadway Commission, 2009) The explanations of each component are as follow:

**Risk Assessment** consists of monthly risk control meetings and internal audit risk assessment. It includes all of the five components of internal control. The risk assessment can differ between them but they are closely related to each other (Hayes et al., 2005). Both internal and external risks have to be assessed and identified. Because of the continuously change of situation, mechanism are needed to identify and special risks will thereby be associated with the changes. It is also connected to earlier detected

types of risks that are facing the company, both high and low risks. Thus, it is easier to prevent them before they will threaten the company. The goal here is to establish clear and consists goals of the departments. The objective for the risk assessment can be for the organization's department level and for its activity, program or mission level. It is very important to always analyze every risk that has been identified in the organization (United States General Accounting Office, 2001). However, risks are something that can be unpredictable. A risk that has just arisen may differ from the next risk. Therefore risks should be monitored and viewed as a constantly changeable and evolving process as well as anticipated so that they can be avoided. Changes are the challenging factor for the management to identify risks. For example, when there are changes on organization on operating environment, personnel, information system, technology, rapid growth, new programs, or structural change (Gauthier, 2008).

**Control Environment** is observing how the directors and management are regarding the internal control system in the organization. Important factors here are attitude, awareness, integrity, ethical values and the management philosophy (Hayes et al., 2005). Control environment is the foundation for all other components of internal control and it has a strong connection to the whole atmosphere of the work environment (Gauthier, 2008). It is about the overall attitude, awareness, and actions of directors and management regarding the internal control system and its importance in the entity (Hayes et al., 2005). To reach good environmental control, the organization should have a code of conduct and a code of ethics that are well implemented in the whole organization and very clear to everyone who works there. Internal control is affected by its surrounding and its corporate culture. An organization with an environment that support and open for control can be easier to respond to the different structures of procedures that are implemented. A good control environment is created when the internal control get support by the management. Internal audit has also an impact on the company's creation of sound control environment (Gauthier, 2008).

**Control Activities** is used as a tool to avoid unnecessary risks and to make sure that the organizational procedures will be carried out. It consists of purchasing limits, approvals, security, reconciliations, and specific policies. Control activities occur throughout all levels and in all functions of the organizations. The organization can differ between

preventing controls and detecting controls. Preventing controls are applied before the processing actively occurs while detective controls are more often performed after the processing has been completed. It is important to have a good overview over the whole organization both for different department and for the whole entity. Therefore, it is common to have one general overview and then develops for specific departments. The planning process of all levels in the organization is another important part for good control activities, as well as the evaluation of how well implemented the control activities are in the organization. Components such as approvals, authorizations, verifications, reconciliations, performance reviews, security activities and production of documentation are also involved here. The uses of the control activities can vary a lot between different departments. These are because of the differences of missions, goals, environment, history and culture. It is important to check the properties of each department and extend the internal control based on that (Rezaee, 1995).

**Information and Communication** is about being aware of the importance of the combination of giving relevant information and good communication to people who need it. The quality of information and the financial reporting, among other things, is very important to be reachable for the potential user (Hayes et al., 2005). All of internal and external information, either financial or non-financial, are needed to be able to run and control the business. The information is then communicated among others to the management, who will use it when they are doing the internal control. Good communication with external parties such as customers, suppliers, regulators and shareholders are also very important, especially for decision making and building trust. Besides, good communication with the employees and good channels to share information with them in both directions, from worker to manager and from manager to worker, also help the internal control implementation (Yates, 1993). Communication is the key to link all of the components of internal control (risk assessment, control environment, control activities and monitoring). This is the reason why the information and communication component has been emphasized as an importance factor to internal control implementation and thus building a good control environment in the organization (Gauthier, 2008).

In addition, the board of directors, through audit committee, should also set the meetings with the management, where the management can share about any favorable and unfavorable events in the organization and discuss how to improve the internal control in the company. Internal control is an endless process that needs to be updated and monitored (Gauthier, 2008).

Further, it is very important to have a good **monitoring** system after implementing all of the previous components. Monitoring is a system that is in progress that is helping to achieve good quality of the internal control performance. Internal control needs to be monitored. It covers monthly reviews of performance reports and internal audit functions. The design of control is also including in this component. On a large company, the monitoring function is normally covered by internal auditor. In specifically, the internal auditors, as an outside party from the management, have task to monitor the processes in organization. Besides, the organization is also monitored by several external parties. These are including the government set regulations, employees' feedback and even from customers complain (Hayes et al., 2005). Monitoring activities in an organization include regular management and supervisory activities, comparisons, reconciliations. The boards and management should have adequate understanding about how the effective internal control should be implemented. In addition, they also need to conduct proper reviews in regards with the changes over time, including the changes in technology (The Committee of Sponsoring Organizations of the Treadway Commission, 2009).

### **2.3.2 Different Perspectives of Internal Control**

ISA stands for International Standard on Auditing and works among other with auditor's who are responsible to understand the entity's internal control. The auditors should be aware of the risk of material misstatement that can occur, whether they are related to fraud or other business errors. It is also important that they have a good understanding about the whole entity, the whole hotel-group, and the hotels environment, because the better understanding they have the better control will be done and the risk of negligence will be reduced (International Federation of Accountants (IFAC), 2009).

One important question that the internal auditor should have in mind is if the manager is working in a culturally and honesty area with ethical behavior. The auditor must also be very strict in his control and make sure that his competence is used in proper way and that the internal control is relevant to the audit. Further, when the auditor is doing the risk assessment process of the entity, the auditor shall have an understanding of how it works. If it turns out that he discovers risks, he is responsible to evaluate whether the risk was an underlying kind and he should then have identified by the entity's risk assessment process. The auditor is then also responsible to identify the risk and try to understand why the process did not work out in the right way. Another important factor for the auditor is to understand how the entity communicates financial reporting roles and responsibility. How the communication is between the management and the governance and how the external communications are, especially with the external auditors (International Federation of Accountants (IFAC), 2009).

Research in internal control can be distinguished into these following two different perspectives:

1. Auditing perspective

From an auditing perspective is mainly focuses on the traditional accounting controls to observe how accounting controls affect the reliability of financial reporting. Auditors are here focusing on problems that are related to accounting controls for specific cycles and transactions. They are in the other hand not focusing much at concepts of broad control or at control environment.

2. Organizational perspective

The organizational perspective can also be named as the management control perspective. Internal control is here focusing at the effectiveness of departments and divisions, and it can be divided up into three different controls. The first one is named 'action control' and it is based on the accounting controls that are used for external auditing. The second is 'result control' and is instead based on satisfying groups and individuals for generating good results. The third is 'personnel and cultural controls', and this one is based on a system where the employees control their behaviors, or each other's behaviors (Maijoor, 2000)

The organization perspective focuses more on the quality of the relationship and its three main mechanisms are people, culture and social control (Maijoor, 2000).

Further, internal control can be distinguished into these following concepts:

1. Auditing

Auditing is focusing on lower level controls that are related to specific cycles, processes and transactions in the organization.

2. Management control

Management control focuses on the control problems of departments and divisions in the organization. This control can be described as a middle-level control.

### **2.3.3 Internal Control Principles**

When a company set a new procedures, the word “*what*” is seen to be a very useful word. For example, questions like “*what* is to be done?” can be the foundation to formulate those procedures. Instead, in the process of implementing internal control, the word “*how*” has been considered as more useful. And to evaluate the procedures, it should answer questions like “*how* it is to be done?” (Financial and Grants Management Institute, 2008).

According to Weygandt et al. (2009), to formulate effective internal control procedures, there are six control principles need to be followed.

1. *Establishment of Responsibilities*

It will be controlled more effectively if there is one person who is responsible for one duty. The best example of this principle is for cash handling. It is better if the person who handle cash is always the same person, so that when the error is occur, it will detected at the soonest. And, this has to be supported with proper authorization and approval for any transactions in the respective areas.

2. *Segregation of duties*

An enterprise needs to make separation between persons who do related tasks and ensuring that there is no *duplication of effort* of an employee to avoid any

conflict of interest. Then, there is another person who have different job task acts as a 'controller' to check his/her works. "*When one employee maintains the record of the asset that should be on hand and a different employee has physical custody of the asset, the custodian of the asset is not likely to convert the asset to personal use*" (Weygandt et al., 2009, p. 293).

3. *Documentation procedures*

Documentations related to transactions and events in an enterprise are very important. All of them need to be kept in order to be used for tracking and controlling activities in the enterprise's operation. Further, the documents need to be handed to the accounting department directly. The documents should also have sequence number to be used for any transactions. This is for ensuring that no transaction has been unrecorded or even double recorded.

4. *Physical, Mechanical, and Electronic Controls*

This procedure is important to protect assets and valuable information of an enterprise. The physical controls cover cash deposit boxes, inventory storages, and password restriction for computers. While mechanical and electronic controls comprises the emergency notification to avoid any unauthorized access, security monitoring using CCTV (Closed-circuit television), and clocking machine to monitor employee's attendance.

5. *Independent internal verification*

The independent internal verification is regulated for the purpose of checking whether the assets recorded in the reports are physically existed. This checking has to be done on either regular or surprise basis by independent person, in regards with the respective area, and reported directly to the top level of management for further actions, if needed. This procedure also suggests checking through bank reconciliation. Internal auditors are one of the responsible persons to regulate this procedure in big enterprises.

6. *Other Controls*

The last procedure involves the protection of assets with having proper insurance, employee's job rotation and requirement for all employees to take their vacation.

### **2.3.4 Control System**

Using the four elements of control system described by Anthony and Govindarajan (2007), internal control in an enterprise can be analyzed using the thermostat illustration as follow. The first element is called *detector/sensor* and it is measuring what is actually happening in the enterprise operation and functioning as a detector of the unfavorable activities. The second is called *assessor* and it assesses the current situation “temperature” in the enterprises, in regards with the acceptable standard for how it actually should be. The *effector* that is the third element is synonymous for the feedback and trying to regulate everything so the standards will be followed and complied. The last element, the *communications network*, explains about transmission of information between the detector and the assessor, and then between the assessor and the effector. Referring to this thermostat theory, the role of internal auditors is to both detect and assess. They should ensure that the enterprise correctly follows the existing procedures. Furthermore, the internal auditors can use the data collected by the computer system and also through direct observation. All of the information then should be stored for examination or even for future reference. They then need to compare and see if the information collected by the computer system is truly representing the actual condition. They may have regular activities on checking whether the actual implementation walks along with the procedures. If they find differences, then it is the authority of hotel managers to work as the effector and regulate everything that the auditor pointed out. The manager needs then to inform the changes to the workers and communicate about how the proper implementation of those changes. The management decides what the enterprise should be doing and they can also work as the detector and assessor because of their responsibility to control and coordinate among the units. A big enterprise consists of many separate divisions and management control is a tool to ensure that each part works in harmony with the others (Anthony and Govindarajan, 2007).

### **2.3.5 Regulations on Internal Control Implementation**

The Sarbanes-Oxley Act of 2002 (SOX) is mandatory and contains many regulations according to reach good internal control in the entity, specifically for public listed companies in the US. However, the impacts of SOX have been spread all around the



world. For example, Sweden-based Company, Electrolux, was excluded from NASDAQ American Stock Exchange after SOX was issued. It was because most of the investors believe that SOX is very important on decision making and they saw the SOX compliance as something that can be reliable. (Bisoux, 2005) Thus, it is important for the organization to already in the early phase establish a trustable and detailed security policy. Furthermore, SOX became one of the most influential regulations for internal control all around the world The Sarbanes-Oxley Act consists of the following listed sections, and the sections should among other important information include:

Section 302: *“all significant deficiencies in the design or operation of internal controls which could adversely affect the issuer’s ability to record, process, summarize, and report financial data and have identified for the issuer’s auditors any material weaknesses in internal controls”* (US Securities and Exchange Commission (SEC), 2002).

Section 401: Financial statements need to be published in an accurate and presented way without containing incorrect information. The reports should provide any off-balance sheet liabilities, obligations or transactions (US Securities and Exchange Commission (SEC), 2002).

Section 404: The published information in the annual report shall include the management’s assertion of the key of internal control systems, including the effectiveness of the internal control in the company (Ramos, 2008).

Section 409: The companies are required to present any information on material differences in their financial position or operations. These disclosures should be presented in the clear and understandable (US Securities and Exchange Commission (SEC), 2002).

Section 802: If the auditors do not follow the rules knowingly and willfully violates the requirements they would be fined or imprisoned (US Securities and Exchange Commission (SEC), 2002).

### 2.3.6 Culture

The environment, including the culture, is a variable that affects the accounting. Hofstede (1980) describes culture as “a set of societal values that drives institutional form and practice”. Culture in a country affects the way how a society and its citizens are structured and interacted with others.

The four basic dimensions of culture, described by Hofstede are:

- large versus small power distance (PDI)
  - It describes how the power in institutions and organizations is distributed. Large power distance stands for a hierarchical acceptance where it is very centralized. Everyone knows their place without any further justification.
- individualism versus collectivism (IDV)
  - Individuals take only care about themselves and their immediate families. The individual interests come before the collective.
- masculinity versus femininity (MAS)
  - Masculinity symbolizes achievements, heroism and material success while femininity in the other hand symbolizes relationships, modesty and caring the weak.
- strong versus weak uncertainty avoidance (UAI)
  - Strong uncertainty avoidance stands for strict codes for believes and behaviours.

(Nobes, Parker 2010)

	<b>In general the cultural model of Sweden:</b>	<b>In general the cultural model of Indonesia:</b>
PDI - large (versus small power distance)	a little bit below medium	quite high
IDV - individualism (versus collectivism)	quite high	quite low
MAS - masculinity (versus femininity)	very low	medium
UAI - strong (versus weak uncertainty avoidance)	a little bit below medium	medium

*Geert Hofstede Cultural Dimensions, itim international (Geert Hofstede - itim, 2011)*

From this table, we can see that Sweden has lower point on PDI compared to Indonesia. It is most likely shows that in Sweden, the members of institutions or organizations are rather powerful and has more equality on distribution of wealth. On the other hand, Indonesia is in the opposite way. However, according to this theory, Indonesia has low point of IDV which shows that it possesses integrated group of individuals. It also places group or society's interests before the individual's, more than what it is in Sweden. Further, this table also presents that Sweden has low point on MAS, explaining that this country tends to be modest and caring, while Indonesia is more assertive and competitive. From UAI point, both Sweden and Indonesia are only slightly different. It means that both countries most likely can tolerate the uncertainty and ambiguity. But then, this situation is commonly responded with the establishment of rules or it is rather relied on religion or belief. (Geert Hofstede - itim, 2011) Other environmental influences of accounting are legal systems, corporate financing and tax systems. (Nobes, Parker 2010)

## **2.4 The Hospitality Industry**

### **2.4.1 Introduction to Hospitality Industry**

The market for the hospitality services has a long history. Hospitality industry is one of the service industries who are promoted in many countries. The hotel sector is a part of hospitality industry and has been affected by its situation. The hospitality industry keeps growing year by year and offer very good return for its investors. According to the 2009 U.S. Lodging Report, even the world was facing the economic crisis; surprisingly the hospitality business remains profitable. Especially in the US, the government seemed to provide big support to the infrastructure and access to the tourist attraction places, which also give a good impact for the investment in hospitality sectors (Kane, 2009). The intention to promote the tourism from the government brings a bright future for the hospitality industry. The real example is in the US. According to Ernst & Young's Global Real Estate Center (2011):

*“In 2010, the US Government passed the Travel Promotion Act (TPA), which established the non-profit Corporation for Travel Promotion, to attract more international visitors to the US. The effort is supported by a new US\$14 fee for*

*visitors from 36 countries who are currently able to travel to the US without first obtaining a tourist visa.”*

On the other side, hospitality is also one of the influential industries to the countries' economic condition and employment opportunities. It is showed that big hotels and lodgings need very large number of employees. This condition opens a big employment opportunity for both skilled and unskilled persons, which could help the government on reducing the unemployment rate in the country. The statistic shows that in 2007, at least over than 9 million people employed in the tourism and hospitality sectors in the European Union (Demunter, 2008). And the other study found that tourism gives support the increment of GDP in many countries in the world (Tourism-Review.com, 2011). Recent study also present the fact that in March 2011, there was an additional 37,000 jobs offered by the hospitality industry in the US, which was the second largest job opportunity after health care industry (U.S. Bureau of Labor Statistics, 2011).

A study made in 2009 found that the hotel chain acquires a new location without investing in a brand new hotel from scratch while the local hotel will gain access to a recognized brand name and to the international reservation system from the hotel chain. The local hotel will also be provided by managerial competence by the hotel chain, while the local hotel has all the information about the local market and knowledge. It is an important task that they provide and secure a good service quality via the interaction between the hotel and the customer. A good control of service quality means that the hotel can reach customers' loyalty and it gives ability for the principals to get valid and accurate information about the agent's actions. Corporation between the local hotels and the chains gives also a greater ability to apply current and future knowledge. The hotel culture is related to a long time horizon, which means that they have to build long-term customer relationship (Dahlstrom et al., 2009).

In the post war time the market was product oriented, and then it started continuously to move from production to market orientation. The developed country started then to have overproduction and it became important to adapt the supply to the individual consumer needs. Customer orientation was now in focus. What defines the customer-oriented

company is that it selects a special class of customers and coordinates the production resources required to measure the customer's needs (Nilsson, 2002).

Hospitality industry is about providing services to the customers. With the growth of population as a result of the government regulation in many developed countries, the world deals with the issue of baby-booming. This situation also affects the hospitality industry, as well as in almost all other industries. Later, this population will become prospective customers. In addition, the competition in hospitality industry is also become higher. Thus, customers have freedom to choose where they want to go and to stay. They are also freely to decide what kind of service that they want to get. Therefore, the quality of service cannot be the only factor to keep the businesses' going concern in the future (Harris and Mongiello, 2006).

A study was shown that the company's culture has significant influence to its operation. The culture consists of factors like common beliefs, shared values, norms, and assumptions that are implicitly accepted and explicitly manifested throughout the whole hotel organization. Cultural norms explain why two hotels, with identical formal management control systems, may vary in terms of actual control. Organizational cultural is also strongly influenced by the policies that are implemented (Anthony and Govindarajan, 2007).

#### **2.4.2 Hotel Accounting and Internal Control**

In hotel sector, the Uniform System of Accounts is widely used as a basic chart of accounts that are using worldwide by hotels. The first chart of accounts was published in 1926 by The Hotel Association of New York. Since then this chart of accounts become an established standard for hotel companies worldwide. Nowadays, the American Hotel and Motel Association in the US is the responsible party to regulate this chart of accounts. Most of the big hotel chains have made their own adaptations and translated the chart of accounts of the respective laws in the countries with adoption to their law system and external accounting (Nilsson, 2002).

Likewise any other industries, hotel industry needs an implementation of internal control, which is contained procedures that established by organization. Thus, these procedures are regulated within a hotel that functioning as a protection of the hotels' assets from employee frauds and illegal use. In addition, it is also needed to keep the accounting records remain accurate and reliable. This can be achieved with lowering the risk of mistakes done with either unintentionally or intentionally in reporting (Weygandt et al., 2009). The hotel service has a variety of standards and special rules they need to consider and thereby follow. They also have unwritten rules and standards where the guests expect a certain level from them (Nilsson, 2002). Similar with the general accounting, in hospitality industry, accounting also can be explained as a system where information is registered, processed and reported to facilitate decision-making in economic matters. The reporting section can be divided into an external and an internal part. In the external the purpose is to inform others about the company's business and for the internal it is to follow the cash flows that arise as a consequence of the business transaction in the company. The external auditing is statutory unlike the internal. Requirements from outside has grown through previous market crashes, corporate bankruptcies, and conscious manipulation of information. The internal reporting is similar to management account and addressed to recipients within the organization. It is free from regulation which means that the company can implement self-designed accounting rules. (Nilsson, 2002)

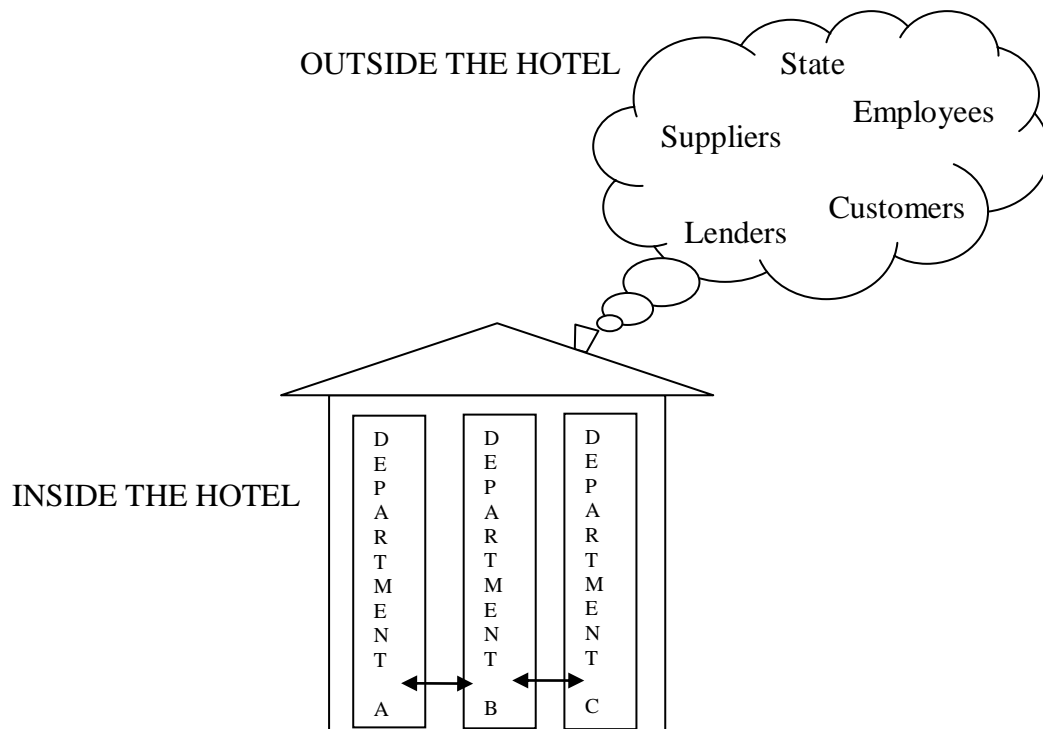


Figure 4. Integration of all factors in a hotel, inside and outside, on implementing effective internal control

*(by: the authors)*

### **3. Research Methodology and Data Collection**

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*In this chapter we describe the data collection and the sources of the empirical basis. We also explain the chosen approach and motivate the research procedures.*

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#### **3.1 Thesis Methodology and Approach**

Bryman and Bell (2005) describes two ways of building knowledge in the form of theory. The framework can be based on a deductive approach, based on hypothesis and ideas, or on an inductive approach that rather seeks an understanding of the relationship between theory and research (Bryman and Bell 2005). We have decided to focus on the first approach, since we would like to examine if the internal control principles that based on COSO and SOX are truly applicable to ensure the effectiveness and efficiency in the enterprise's operation. The deductive method lets the researcher to analyze related theories and perspectives that emerge with the data collection. Thus, theories about related topics were described through the data that are acquired to verify them. (Patton 1990). The focus of the research in this thesis is on the empirical information collected through interviews and literature studies.

#### **3.2 Primary data**

Bryman and Bell (2005) are two of many authors who advocate that interviews are best suited for qualitative methods. It is a type of scientific research that consists of collecting evidence and then analyzing the culturally specific information's, opinions, behaviors and social contexts of particular populations (Patton 1990). Qualitative methods are more flexible than quantitative and give us the opportunity to have open-ended questions, which means that there is a greater spontaneity during the interview, between the researcher and the study participant. This makes it easier for the participant to feel free to respond to the questions in their own words during the interview. In comparison with quantitative studies, where the method is much more structured in order, the qualitative method is helping the researcher to achieve as high reliability and validity as possible for the measurement of components. Moreover, qualitative interviews are also open to letting the respondent to describe what they feel is relevant and important. Our decision to use qualitative method is thereby to focus more on conducting extensive interviews instead of intensive (Bryman and Bell, 2005).



Bryman and Bell also recommend formulating a question framework before the start of the interview, which should serve as a basis for the interview. Then, new questions can always be developed to get more detailed and clear answers (opposed to quantitative interviews where the researcher merely wants to have shorter and more rapid answers). We conducted semi-structured interviews, which were described as a more flexible variant than completely structured interviews. During the interview, the respondents got the opportunity to be free on answering the questions. Further, during the interview process, we had some chances to ask other questions related to the situations and to consider the interviewees' answers, though most of the questions were basically addressed in the original order. We believe that by using this method, we managed to gain more important information from the respondents, than what we would have been able to by using the completely structured method (Bryman and Bell, 2005).

According to Patel and Tebelius (1991) people express and reflect reality through their perceptions and experiences. Therefore, we chose respondents with long-time work experience (at least five years), to make sure that we would get reliable information from them. Patel et.al., further explains that it is the best way of research if the researcher can get a broad view of the observable fact. And thereby, the researcher must ensure that the interview is done in the right time and with the right people. In addition, they should also possess the knowledge that the researcher is keen to receive (Patel and Tebelius, 1991). This was something we took into account and considered carefully when we chose our respondents.

In this thesis, we are focusing on the management perspective, specifically Directors of Finance, as they are the main persons who should be responsible for building and maintaining internal control system in the enterprises. In addition, we also believed that they possess an expertise and experiences of how internal control actually is implemented in their hotels. To acquire good empirical data, our target was to find five Directors of Finance of reputable hotels in the countries they are operating. We chose only experienced Directors of Finance to ensure their fairness on implementing internal control in their hotels. Although several times we had to face the confidentiality

boundaries of the Directors of Finance and their high work load, which resulted in some refusals to our interview request to them, but finally we could meet our target. However, we added two interviews with external auditors from Audit Firms as supporting data on getting clear and objective ideas on internal control implementation as one of the influencing stakeholders in the enterprises.

We studied three hotels in Sweden and two hotels in Indonesia, with different business scales: international and local hotels. We wanted to get an international and broader view and not only represent a country or certain business scale. The reason for why we chose Sweden and Indonesia was because of the consideration that the writers had a strong knowledge about both countries, which is very important to be an initial foundation to do a good research. Moreover, both Sweden and Indonesia are also experiencing tourism growth in recent years that made these countries even more interesting for this research. A statistic in 2010 shows that tourism in Sweden increased compared to 2009 and even helped the country to survive in the economic crisis (Simpson, 2010). The tourism as the fastest growing industry in Sweden also impacted the hotel businesses. Along with the increase in tourism industry, hotel businesses in Sweden have experienced the highest number of overnight stays in Sweden tourism history in 2009 (Invest Sweden, 2010). Further, according to the statistic data from January 2008 until February 2011, Indonesia was also experiencing the increment in tourism (Badan Pusat Statistik, 2011), as well as Sweden.

In this thesis, we are using Hotel A to E to address the specific hotels; instead of disclosing their real names. We keep the hotel' names and Directors of Finance' profiles anonymous to appreciate their preference in order to be participated in this study. In addition, this is also to keep the confidentiality of the hotels, because all of the policies and procedures that are considered as hotels' confidential. Hotel A, D and E are international hotels while hotel B and C are local hotels. Hotel A and B operate their business in Indonesia and hotel C, D and E in Sweden.

We made both telephone and face-to-face interviews. Face-to-face interaction is desirable, because personal contact is a legitimate way to understand human behavior.

The closeness to people and situations give the study another dimension (Patton 1990). Our primary choice was to meet the respondents in person, but two of the interviews were geographically impossible to visit. Hence, we had telephone interviews with the two hotels in Indonesia. However, all of the respondents got the same questions from the same framework. Thus, we have been treating all of the answers equally. We do not think that there is a significant difference between those two methods when doing the interviews. We think that they all are equivalent. Besides, there were language differences in the instructions. Four of the interviews were conducted in English and one of them was in Indonesian. The interview that was conducted in Indonesian involved the same issues as the interviews in English. All of the questions were the same and they were only translated to Indonesian. The reason why this interview was done in Indonesian was that we wanted to appreciate the respondent's preference and tried to avoid any language barriers during the interview process. The respondent's participation in our interview has become a great importance to this study. Later, the author translated the answers of the respondent to English, and ensured that there is no significant change in its meanings.

Further, all of these interviews were recorded with a Dictaphone. According to Bryman and Bell, this is something that is recommended for qualitative interviews to be sure that no material that is of great importance for the whole work will be excluded or misunderstood. They also mention that there is a risk that the interviewer will focus too much on taking notes during the interview and not on the respondent (Bryman and Bell, 2005). Furthermore, we have observed the behaviors of the respondents during the interviews, both when the different questions were asked and when the respondents gave the answers (Patel and Tebelius, 1991).

Further, we found that all of the respondents were very generous when providing time for our interviews, even though they are one of the top management and very busy people. We had time to complete all interviews as scheduled, ask all the questions that we planned to with consistent and clear answers. All respondents were informed before the interview about what the purpose of the survey was. We considered this as important so that they could prepare and thereby give us true and clear information. We

also described how the result will be presented and used. We believe that this was very important because we wanted to make them feel convenient and confident (Patel and Tebelius, 1991).

### **3.3 Secondary data**

Secondary analysis of data is collected by various institutions and organizations as part of their regular activities. This type of data is collected by others writers (Bryman and Bell, 2005). We have used some secondary data to obtain as solid understanding of the subject as possible. Further, we used the knowledge from secondary data as background information and to build up a theoretical framework for our work. In the whole thesis we have used various sources, including articles, books, journals and some sources from the Internet. They are mostly used as supporting sources on our theoretical background. We examined the reliability of these sources before we used them in this thesis.

In addition, we also did interviews with two auditors from Sweden and Indonesia to support the primary data. We sent five questions by email to them, so that they could answer conveniently (appendix annex 3). We did the written interview in English. We did not face any difficulty on delivering this interview in English, due to their multinational experiences.

### **3.4 Weaknesses of the Study**

Validity is a measurement to measure whether the survey gives consistent result (Bryman and Bell, 2005). We are aware of that the choice of respondents and their credibility has an impact on the validity. We wanted to ensure that we interviewed people with specific knowledge in the field of internal control. That is the reason why we chose Director of Finance for the primary data. However, we need to be aware of the fact that there will always be a risk that they might not be objective when they evaluate their own performances, which can have a negative effect on the validity. (Jacobsen 2006) Therefore, to minimize this risk, we also support with the views from external auditors.

Reliability measures how reliable the survey is and the higher level of reliability the better it is. We have been aware of the reliability both for the collected data and the choice of methods. A drawback with personal interviews is that there is always a risk for interviewer effect, that is, the interviewer may influence the answers that the respondent gives just by being present in the room. To prevent this, the interviewer should avoid asking too poignant issues. This is something that we have taken into consideration when we formulated the questions framework. We believe that we have done what we could to counteract the interviewer effect, partly by being aware of its existence and partly by the formulation of questions. (Jacobsen 2006)

We tried to be as critical as possible when we used the sources as our references. Before adding the information from a new source, we always questioned it. "Were the sources good enough to process the material and answer the problem statement with? Were they strong enough to use as evidence and examples?" (Rienecker and Jorgensen 2008: 257). "Where does the information come from? Who collected them? How credible are the sources?" (Jacobsen 2006: 153)

We believe that academic articles are the most reliable sources and that was our primary focus when it comes to secondary data collection. However, there are also articles which we have used from the Internet. Before we decided to include materials from the Internet, we were extra critical toward the reliability, but after doing some researches on the authors and the content of the articles, we feel confident of its reliability. Further, we found that the authors of those articles are having good educational background and experiences in business related field, and they are also academic writers who have been writing books and other academic articles.

However, we are aware of that taking information from one perspective only, in our case is Directors of Finance perspective can be bias. Therefore, with also considering the time constraint, we decided to get five respondents from different country and business background to get the result as fair as possible.

## **4. Empirical Findings**

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*In this chapter, we want to summarize our findings regarding the implementation of internal control more in detail. We chose hotel sector as our case study.*

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We divided this chapter into five parts. In the first part, we wanted to see how the Directors of Finance' opinion about the importance of internal control is, in general. Further, we also tried to see the changes in internal control over the years from their perspective. The second part will examine the importance of internal control in the hospitality industry. In this part, we tried to find an in-depth understanding about how the internal control gives the advantage to the hotels and how the internal control requirements are regulated in hospitality industry, particularly. In addition, we also want to see the challenges on implementing good internal control in this business and also problems resulting from internal control ineffectiveness, from Directors of Finance's view as direct practitioners in the hotel specifically. Continuing with the third part, we acquired information about the real internal control implementation in the hotels. In the fourth part, we tried to see the views of external auditors as outside stakeholders regarding internal control implementation in the enterprises. This is to balance Directors of Finance' perspective as they are the management. In the last part, we described the opinion from both Director of Finance and auditors on internal control development in the future.

### **4.1 Understanding Internal Control**

From the interview that we have done, all of the hotel Directors of Finance realized that having good internal control is very important to every enterprise. Hotel A, D, and E have seen internal control as a tool for safeguarding assets and prevent possible losses that might be happened and as a protection from frauds. On the other hand, Hotel B, C and E's Directors of Finance believe that internal control has been ensured and made everything in track. They ensure that what should happen is truly happening when they follow the standards. Respondent from Hotel B also said that internal control is functioning to prevent wasteful purchases and then help hotel to operate more efficient. Furthermore, we found that two of the respondents, from Hotel A and D, were firstly already inspired about internal control from the school. The other respondents from

Hotel B, C and E dealt with internal control for the first time when they start their job many years ago.

During their long time experience with internal control, all of the respondents also found out that there were many changes on internal control, both in regulations and implementations, over the years. According the Director of Finance of Hotel A, there were some changes made after the publication of COSO Integrated Framework, where the management started to consider on having internal control procedures in their enterprises. In recent years, the changes are mostly impacted from the issuance of Sarbanes Oxley Act in 2002, as pointed by Director of Finance of Hotel A, C, D and E. All of these respondents realized that this Act has been affected so much to internal control regulations and requirements, especially to the hotels in the world-wide chain that have head office in the US. The respondent from Hotel A also mentioned that the hotel is now required to provide the management report on internal control over financial reporting, after the issuance of this Act. Hotel C, D and E felt the impact with there is application of more strict procedures. Nevertheless, according to the respondent from Hotel C, the situation becomes slightly loose and reasonable recently. Furthermore, the advancement of technology is also driven many changes to the internal control implementation, explained by Hotel C's Director of Finance. Along with this development, many people believed that they need to review and update the internal control procedures to make it keep effective, according to the two of the respondents of Hotel A and Hotel D.

#### **4.2 Internal control in hotel sector**

Looking at the implementation of internal control in hospitality industry, three of the interviewees (Hotel A, C and D) believed that it brings a competitive advantage. Hotel A's Director of Finance found that with implementing internal control, it will help the guest to feel secure, for example, to do the transactions in the restaurant and also feel safe to stay in the hotel. Instead, respondents from Hotel C and Hotel D believed that internal control will give competitive advantages in the long run. Continuously, they also believed that it would help guaranteeing the going concern of the businesses in the hospitality industry, as well as the hotel or restaurant's brand. Moreover, according to

them, it would also ensure that the enterprises produce more accurate and reliable reports to the users. Nevertheless, interviewee from Hotel E argued that internal control does not bring any competitive advantage. However, respondent from Hotel B believed that internal control would give competitive advantage, if it is also supported with the good quality services to the customers.

According to all interviewees, internal control would be more effective if it is implemented in all of the areas, mostly in the particular areas who are handling cash and produce revenue, such as Finance Department, Room Department and Food and Beverage Department. Respondents from Hotel B and Hotel C also added Purchasing Department, while Hotel E thought that Food and Beverage Department, as other crucial areas for internal control awareness. Based on all of the Director of Finance's experience since they joined the hospitality businesses, they had found or heard about some cases as a result of lack or ineffective of internal control. For example, Hotel A experienced a problem when the Front Office cashiers tried to make money from the currency exchange with buying the foreign currency from the guest with smaller money he had and then sold it to the money changer afterwards with higher price, so he could keep the money for himself. Another problem also happened in Account Receivable section, where there was too close and long relationship between the staffs. It then caused cash embezzlement, according to Respondent from Hotel B. The Account Receivable staff handed in the collected money from the customers to his Accounting Receivable Supervisor instead of Front Office cashier. *"This was happened because the staff put so much trust to his supervisor, because they had been working together for a long time, so they ignored the internal control procedures"* explained the Director of Finance from Hotel B. The supervisor convinced him that he would record the transaction of collected money first and then handed it in directly by himself to the Front Office cashier, where he never did in actual. Similar problems also happened, based on the interviewees from Hotel C and Hotel D' experience, when there were money and other assets theft by the employees in Front Office cashier and Restaurant cashier. An experience from Hotel E was happened when they coped with casual (hourly basis) employees. Then, it was higher the turnover level in the hotel. Further, these employees had weak understandings of internal control procedures in the hotel,



and as a result of this. Internal control procedures became less effective because they did not follow it

To overcome those problems, according to all of these Directors of Finance, it is very important to have proper internal control procedures. Besides, respondent from Hotel A also believed that it is need to be ensured that all of the staffs comply with those procedures. It could be done with doing the compliance audit in surprise basis regularly, according to three interviewees from Hotel A, D and E. Respondent from Hotel C preferred to reduce cash payments with promoting card payments to the customers, as implemented in this hotel presently. And for newly opened business, Hotel D Director of Finance suggested to discuss with other more experienced hotels or restaurant in the same chain, if they find an internal control issue, and acquired an adequate knowledge from them about the common problems, so they could learn from it and thereby prevent it in the earliest time.

Based on all interviewees' responds, the requirements for having internal control in hospitality industry were only from their corporate office; their external auditors are mostly affected by US' Sarbanes-Oxley Act. For the enterprises that are based in Sweden, they had to follow national requirements and also requirements from the tax authority on internal control. But, there is no specific national regulation for internal control in Indonesia.

#### **4.3 Internal Control in the Specific Hotels**

According to respondents from Hotel A and Hotel D, specifically in their hotels, the main responsibility on implementing effective internal control was on all employees of the hotel. The whole parts of the hotels were very important and all of them need to work together and put the same effort to build an effective internal control system. Nevertheless, according to them, the Director of Finance had to ensure that the procedures are effective and applicable, and then also monitor the implementation of those procedures. The others from Hotel B, C and E argued that the main responsibility is only on the Director of Finance with help of the Vice President/General Manager. Hotel A, D and E's respondents also thought that it is important to give adequate

knowledge about the importance of implementing good internal control procedures in every level from the lowest until the most top level of employment. However, the others believed that it was enough to give adequate knowledge about the importance of internal control only to the employees who handle cash. Further, according to all interviewees, they communicated and implemented the internal control through each employee's job descriptions and Standard Operational Procedures which they have in every department. Four of the respondents, which are Hotel A, B, D and E added job training as another way to communicate how internal control should be implemented. Continue, the employee's direct supervisor was the person who was responsible to give them adequate knowledge about internal control requirements in the hotel.

The respondents from Hotel A also gave examples about the internal control implementation in their hotel as follow. The usage of printed sequence number in the bills would prevent any unrecorded revenue by hotel staffs. The income auditor should run surprise cash count in the crucial areas such as Front Office cashiers and Outlet/Restaurant cashiers. Room vacant control, was also implemented in this hotel, with checking the unsold rooms in the Front Office Report compared to actual. This was aimed to ensure that no rooms are rented without it is inputted as hotel revenue. In another way, Hotel B do this by analyzing the discrepancy report between Front Office report and Housekeeping report about the vacant rooms, every morning, after Housekeeping finished cleaning all of the rooms. As well as room vacant control, Hotel C regulated spot check for the inventory (especially liquors with high cost) and operating equipment in regularly basis. Performing cash count on daily basis in the General Cashier was also one of the internal control implementation in all of the hotel's respondents. In addition, Hotel D Director of Finance added segregation of duties, access restriction with password control and proper approval procedures as other ways to strengthen internal control in the hotel. To minimize the risk with the credit card transactions, according to respondent from Hotel A, Payment Card Industry (PCI) compliance had to be followed by the respective employees. *"This procedure is to protect the customer card's information which is very risky and dangerous if they are known by any irresponsible person"*, the Director of Finance from Hotel A added. All of these hotels also have certain procedures before purchase anything, with certain

approval procedures. The respondents from Hotel A and Hotel B also mentioned that in their hotel, the Purchasing Department was required to find three price quotes before deciding the supplier and doing the purchasing. Further, this department should also do the market survey for several goods the hotel needs to buy. This was to ensure that the supplier is giving the best price for the hotel and minimize any possible fraud that might be done by the Purchasing Department with cooperation with suppliers, according to both of them. In hotel E, the respondent explained that there was computer system to control the purchases. This system was used to ensure that every purchase had been approved by authorized persons. And the person who requested the purchase would also be able to track the authorization progress.

On testing the effectiveness and monitoring the implementation of the internal control procedures, all of the controllers explained that there was compliance audit performed in their hotel regularly which was done by either internal auditor or owner representative (if no internal auditor in the hotel/from their head office). Four of these hotels (Hotel A, B, D and E) mentioned that they also performed self-audit, done by the Director of Finance and Vice President/General Manager at least once in a year. Hotel A's respondent even confirmed that the hotel also acquired some feedback regarding internal control procedures and its implementation from hotel's internal auditors and external auditors. All of the hotels also reviewed the internal control procedures especially if there was an extra ordinary event. However, the implementation of good internal control procedures was not always smooth, based on Director of Finance of Hotel A, B, C, and D's experiences. In the actual situation, they admitted that there was always a problem arise in the hotel. The procedures are quite common to make the customers feel uncomfortable and give complain to the hotel as mentioned by all of the interviewees. In addition, all of the Directors of Finance said that the implementation of internal control in the hotel was become more challenging. But, they tried to solve this problem with giving understanding to the customers and inform the customers about the hotel policies as early as possible.

#### **4.4 Relation between Internal Control and the Auditors**

Hotel A, B, D and E have internal auditors, and Hotel C has owner representative who act similarly like internal auditors. According to the respondents from Hotel A, B and D, internal auditors had a responsibility to check whether internal control procedures are truly followed by everyone in the hotels. Further, they confirmed that internal auditors were also responsible to review and update internal control procedures together with the Director of Finance, if needed. Besides, interviewees from Hotel B, D and E argued that there was no clear relation between internal auditors and external auditors on the internal control implementation. In Hotel A's experience, the internal auditors and external auditors only communicate with each other through their reports. However, according to the respondents from Hotel A and D, both internal auditors and external auditors gave their advices to internal control implementation separately. Further, according to the experiences from Directors of Finance of Hotel A, B and C, with having adequate and effective internal control procedures, would give more confidence to the external auditors and it was possible for them to lower the Control Risk, though they still needed to check it by themselves. Nevertheless, based on Director of Finance of Hotel E, there was no clear relation between good internal control implementation with external auditors' confidence on assessing Control Risk. Thus, there is no direct relation exist between internal and external auditors in a hotel, according to respondent of Hotel A, whilst the others even could not find any relation between them at all.

According to the interview with auditor from Sweden, internal control deals with the company's internal accounting system, which serves to minimize errors in the company's accounts. However, he pointed out that the internal control in smaller companies almost does not exist. They primarily rely on the auditor's control in the annual audit. In larger companies, individual departments are all involved on the internal control implementation. Moreover, it can be an obstacle when he does the audit works if the company internal accounting procedures do not work effectively due to lack of internal control. He said both auditors and financial controllers give influence on internal control, but the most influence would be the financial controller because he/she works closer with the daily internal control procedures in the company. He also believes that internal control had and always will have significant roles in the enterprises'

operation, as internal control is the basis for the risk assessment that the auditor must do. The larger the hotel is the harder it will be.

The auditor from Indonesia reckoned that internal control can nurture an environment that lead the enterprise to the efficiencies to achieve enterprise's goals. In addition, she said that implementation of internal control helps her on doing the audit work. For her as an external auditor, understanding the enterprise's internal control helped her to assess the risk of the enterprise's operation. In her opinion, with this understanding, she could determine suitable audit procedures to evaluate those risks. However, according to her, both Auditors and Financial Controller gave significant influence for internal control implementation in the enterprises with different purposes.

Related to the culture barriers on internal control, she experienced almost nothing when she worked with multinational clients. She explained that it might occur only in smaller enterprises. She believed that internal control is needed, even in the future. Her explanation for this is because internal control may lead the company to operate in more effective and efficient which supporting the company's going concern.

#### **4.5 Internal Control in the Future**

According to all Directors of Finance, the advancement of technology from year to year also has been impacting to development of internal control. With more sophisticated tools and technology would make the internal control become even more important, because it means that there would also be more sophisticated crimes follow it. But, the good side was, there would also be a help from technology on implementing internal control, for example with the computer assisted program for internal control, as explained by all of these Directors of Finance.

## 5. Analysis of Empirical Findings

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*In this chapter, the empirical findings will be analyzed and described in regards of how internal control in hotel sector should be implemented with the help of the five internal control components from COSO Integrated Framework and Sarbanes Oxley Act as our based theory. We also examine our empirical findings to verify the theory.*

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Internal control is not something new to the auditing world. There are lots of enterprises that have found the important role of implementing internal control procedures, apart from the requirements that were issued recently. From our case study, we found the truth of this statement. All of the respondents explained that they have known and have experiences with internal control from many years ago. Some of them have even the understanding of internal control since they were at school, whereas they have left school many years ago and now have long-time experience on working in hotel businesses.

### 5.1 Control Environment

Implementing internal control is important for every enterprise, as well as hotels, like agreed by all of Directors of Finance of our responding hotels. Internal control in hotels can function as a safeguard for its assets, to prevent possible frauds and also to minimize any wasteful purchases. This finding could be a reality for the theory that was explained by The Committee of Sponsoring Organizations of the Treadway Commission (2010). Although internal control can only give *reasonable assurance* on these, but in fact, most of the Directors of Finance found that internal control implementation in their hotels has been giving advantages to make their hotels run more efficiently. Our empirical findings strengthen the assertion in the theory of the importance of internal control in the auditing, economics and organizational perspective described by Maijor (2000). Areas which handle cash and produce revenue are crucially need internal control. Besides, internal control is also important to be implemented in Purchasing Department, where there are transactions with suppliers and warehousing. Furthermore, the other role of internal control has been recognized as guidelines and it

acts like a ‘controller’ to keep the hotel operated effectively, because everything is in track and follows the standards.

From our interviews, we also found that internal control has some changes over the years, especially after the issuance of Sarbanes-Oxley Act in 2002. The Act stimulated even more requirements in regulating internal control for US related companies and also globally like in Sweden and Indonesia. And then, this is also impacted the implementation of internal control all over the world. The standard setters for those hotels, either government or hotels’ head offices, regulated more strict internal control procedures. When their head office is listed in the US or has decided to follow and comply with internal control requirements on Sarbanes-Oxley Act, the hotels are still restricted to follow those requirements, even though they operate their business in other countries that do not have any requirements for that. This situation, of course, not only affected the hotel businesses but also all other businesses in the world. The Sarbanes-Oxley Act has been underlining the needs of internal control on business regulation. Implementation of adequate internal control systems in the hotels, become more crucial. Thus, the owners of the hotels and hoteliers finally admit the usefulness of having good internal control procedures and policies on handling their assets, as long as they comply with that.

We also found that appropriate internal control procedures need to be included on the Standard Operational Procedures and in the respective employees’ job description, like describe by all of the respondents. Including internal control procedures in the Hotel’s Standard Operational Procedures, it means that all of the hoteliers have to implement it in their daily work. Further, this could be an effective way to introduce and implement the internal control procedures in a hotel. The job trainings also help the owner or top management on communicating the internal control procedures. Through the supervisors to their subordinates, internal control will be transferred in the easiest way. But, it sometimes raises some other problems if the supervisors do not give proper trainings and then they do not transfer it as it should, because they are only human and it always have the risk of human error. However, combination of providing clear job descriptions to employees and also proper trainings will result good internal control

implementation. With having this combination, the operation will always be under control and in track. Continuously, it will lead the hotel operation to become more effective and efficient.

Further, we found that international hotels and local hotels have different view about communicating and giving understanding about the importance of internal control in their hotels. Conform to the element of control system by Anthony and Govindarajan, 2007, on world-wide hotels, they believed that all of the employees, regardless their positions or job levels, to have adequate understanding about the importance of internal control. On the contrary, the local hotels believed that only employees in Finance Department (including Purchasing staffs) and other staffs who are handling cash need to have deep understanding about internal control. This shows that there is a gap between this finding and the theory from Dopson and Hayes (2009) about the importance of communicating and giving adequate understanding about internal control to all of employees in the organization. However, we examine that the size and the amount of the employees can be the best explanation for this gap. The world-wide hotels, that are bigger, have more departments and staffs. Therefore, there is a need to give adequate knowledge of internal control to all hotel employees, from the top to the lowest position, because it must be harder for the Directors of Finance to implement internal control procedures in all of departments and staffs of the hotel by themselves. Hence, it will be better if all of the staffs have adequate understanding of internal control, so the Director of Finance and the auditors will only need to control and check whether they implement it in proper way or not. On the other hand, it will be easier for Directors of Finance in smaller hotels to implement the internal control procedures and also control it by them.

Another interesting finding is about the differences of national regulation in Sweden and Indonesia. It is clearly seen that Sweden as part of European Union has put more consideration on creating national requirements regarding internal control. The realization is through the issuance of Swedish Code of Corporate Governance, where this code is also working as an impact of the Sarbanes-Oxley Act. This finding has supported previous research made by Nilsson, 2002 in chapter two that saying that most



of hotel chain will adapt and translate their accounting treatment according to the local law and regulation. On the other hand, in Indonesia, there is no specific national regulation from the government. The companies are only voluntarily establish and implement internal control because of the requirement of their external auditors or only because they want to get the investors trust on post Sarbanes-Oxley. This is can be a fact of the cultural difference between Sweden and Indonesia that has been influenced by the internal control implementation in the world. But, according to Hofstede's theory (Geert Hofstede - itim, 2011) on the chapter three in this thesis, it supposed to be no significant difference between these countries, because both of them are on medium level of UAI. Thus, the participation of Sweden on European Union could be a reason of this gap. As a European Union member, Sweden is required to follow the 8<sup>th</sup> European Union Company Law Directive. Further, beside the different of national governmental regulation, we did not find any other cultural differences on our interview result. This finding shows another gap between our research and the Hofstede's theory (Geert Hofstede - itim, 2011) which shows that it should be some significant cultural differences on PDI, IDV, and MAS between hotels in Sweden and Indonesia. Nevertheless, we believed that this is because we did the case studies in hotel sector, and in only reputable hotels, so that they have to have international environment, and therefore make them all have rather similar culture and way to operate.

## **5.2 Management's Risk Assessment**

As we can see the respond from Hotel A, with having a good internal control system, it can be meant that the hotels provide the feeling of security to their guests, which finally lead the guests to having trust to the hotels. It is very important, because in hospitality industry, guest's trust and comfortable feelings are the business itself. The hotels have implemented stricter internal controls after the Enron scandal and the Sarbanes-Oxley regulations. The ISA also helps the work of internal auditors who are responsible to maintain the internal control structure of the entity. People will keep coming to the hotels if they feel secure and convenient. Definitely, this brings business into the hotels. In addition, a good internal control system will also become an advantage on reducing costs. However, the situation always changes over time. This situation will be the

reason why the internal control procedures need to be kept updated and adapted to the new situations that occur to ensure its effectiveness on assessing any possible risks.

The operations will be more effective and efficient, which was also mentioned by the Director of Finance of Hotel B and Hotel E. As we know, hospitality is a cyclical industry. This means that hospitality industry is very sensitive with the going concern issue; because they do not commonly earn revenue through the year. This is one of the external business risks for this sector. Hence, its owners and hoteliers need to possess a very smart and careful management system to overcome this risk. Furthermore, hotels need to keep updating their internal control procedures in order to be able to balance with the advancement of technology. As we know, there are a lot of criminalities that are using sophisticated technology recently, as another external business risk that enterprises need to aware. Along with that, nowadays, it is also very common to do transactions using internet. This makes internal control even more important. Because an effective internal control procedures will prevent the enterprises from possible fraud. Like mentioned by the respondents, this can be minimized if the hotel has a procedure to follow Payment Card Industry (PCI) compliance, which have certain requirements regarding how to keep the customers' card information safely. Surely, if the hotels follow this, it will give security to the guests and prevent any guest complain or unfavorable situation in the future. Thus, the operation will also be more effective and efficient and will also bring a going concern to the respective hotels.

Hotel, as one of the 'prone to theft' business, should need internal control as a preventive and detective tool for any fraud that might be occurred from inside of the hotel, which are its employees. Hotel, especially the big one, has a lot of high cost inventories and operating equipment, which are very risky to employee thefts. It is even greater the risk if the hotel has a big amount of cash transactions. According to Weygandt et al. (2009), internal control will be implementing effectively if only letting one person to be responsible for one duty, but this becomes problematic for hotel business because it is mostly open all days. Therefore, it is normally to have several people to handle cash in shift basis. Nevertheless, proper internal control procedures are

seen as the best solution, with pressing the risks to minimum level, and then the operation will also be more efficient.

### **5.3 Control Activities**

From the experience of two of our respondent, they found that the whole part of the hotel should take part on the responsibility on maintaining internal control, because internal control will work well only in the integrated departments and when they are all comply with the internal control procedures. For that, an enterprise needs to establish proper internal control procedures. In most of the hotel respondents, the Directors of Finance have a main responsibility to do it with the help of General Manager or Vice President of the hotels. It is also possible that internal auditors and board of directors take part on formulating internal control procedures. Then the top management will include those procedures on the job descriptions of the respective positions. In this way, all of the respective employees should follow the procedures. Further, the internal control procedures are also included in the enterprise's Standard Operational Procedures. This includes authorization policies, segregation of duties and access restrictions to tangible and intangible assets, as described by Weygandt et al. (2009) in chapter 2 of this thesis. From our findings, all of the hotels have authorization policies, especially for cash disbursements. Segregation of duties prevents conflict of interest and ensuring that no one does double role on the related fields. For example, person who records the money collection from the guests has to be different with the person who receives the cash from that collection. Nevertheless, arranging segregation of duties in an enterprise will be costly. The enterprise will need a lot more employees to do different duties; therefore it will also need more funding to cover those expenses. In addition, more involvements of people will higher the possibility of human error. Further, access restriction to tangible assets covers proper keys to access the inventory warehouses and certain procedures and limitations for accessing the customer card's information (in accordance with PCI compliance). And the access restriction for intangible assets will be a password control for accessing enterprise's important information and for each employee's computers.

The other control activities, further, also involve the requirement to keep the documents for certain years for further reference. It is not allowed for an enterprise to destroy their documents until the documents are considered not valid anymore. In addition, the disaster recovery plan has been seen as another important control. Every enterprise should also have a back-up of their important data. This has to be kept in a safe place where it is not accessible to unauthorized persons. The disaster recovery plan also helps the effectiveness and efficiency in an enterprise's operation, especially when the enterprises are really facing a disaster.

Further, from the findings, we can see that most of Weygandt et al. (2009)'s six control principles have been applied in five hotel respondents. The establishment of responsibility is implemented with the implementation of certain proper authorization procedures in those hotels. The Director of Finance and General Manager or representative of the owners, are the responsible persons to decide for the cash disbursements in their hotels. But, this procedure that advises the company to have only one person for one duty can be a problem for hotel business. This is because all of those hotels run 24 hours a day, which means that it has to have more than one person for one duty, especially for cash handling. Guests come and go in whenever time they want. However, proper handover procedures, from one cash handling persons to another after their work shift could be the solution for this matter. Next, the segregation of duties seems to be an important principle for a good internal control implementation. The five hotels' Directors of Finance had set the independent positions and certain job limitation to separate between two or more duties that have conflict of interest. This is to minimize the possibility of too many responsibilities for one person and benefit it themselves. For the documentation, the Directors of Finance also ensure that their financial statements are traceable and reliable, so they should keep the documentations for certain years as advised by the auditors and government. The usage of electronic security systems for physically and non-physically assets of those hotels, like used for their storage (warehouse) access and computer password, are the actualization of the physical, mechanical and electronic control principle. The independent internal verification also has been done by these respondents with doing the surprise cash count in daily basis and stock take on periodically basis. The last principle of other controls has been proved as

an effective principle to strengthen the internal control system. The requirement for the employees to take vacation or manage a job rotation, especially for those who handle cash and income, can minimize the risk of any cash embezzlement and other frauds.

#### **5.4 Information System and Communication**

The advancement of technology recently, brings both positive and negative impacts to the internal control implementation. Beside negative impacts that have been examined before in Management's risk assessment part, the advanced technology will also help internal control implementation to be more effective. In addition, the advancement of computer system assists on regulating internal control procedures in the enterprises. This computer system will minimize any human error and therefore make the internal control implementation more effective. Like mentioned by one of the respondent, computer system can help the authorization procedures to be easier and can always be tracked. With the regulations and advancement of technology, it has been formed an integrated control environment to stimulate implementation of effective internal control procedures.

However, the implementation of internal control in the hotels is challenging and problematic. Hotels are service providers; it means that they have to set careful consideration on maintaining relationship with their customers, because it is their main business. Look into our findings, we found that most of the respondents have ever experienced challenging situation with their guest when implementing good internal control procedures. They should be able to keep guests feel convenient, while sometimes internal control procedures make guests feels uncomfortable and even raise complain to the hotel. To avoid these problems, the hotels need to clearly inform the guests about the internal control procedure, which have relation to guests, at the earliest time. And then, if the hotel still faces these problems, the front-liners of the hotel have to explain the important of internal control procedures to the guest as good as possible. In this situation, it is clear that hotel's front-liners need to have an excellent communication skill to support the effectiveness of internal control.

## **5.5 Monitoring**

Good internal control procedures are not enough if it were not supported with proper monitoring (FERMA & ECIIA, 2010). For example, the problem can still arise even though the hotel has been segregated the duties between related areas. Like explained by one of the respondent, the controllers need to aware with the long-time relationship. This can weaken the internal control implementation. Because of too much trust as a result of long-term relationship, the principle of internal control about segregation of duties can mean nothing and the unfavorable event keeps coming to the hotel. This is correspond to the statement made by Hillison, Pacini, and Sinason, 1999. Therefore, job rotation in regular basis should be suggested to avoid this problem. The requirement for the employees to take their vacation is also help to monitor and ensure that the employees do the appropriate procedures. For example for the General Cashier section, this requirement will help to detect money skimming. It is because when she/he is on vacation, there is another person who will replace her/his job and this person will naturally do the monitoring function and detect the discrepancies. In fact, we could not found any specific theory as an alert to this problem.

Physical controls with cash count and stock take are other ways to monitor the operation. It seems to be appropriate for the employees who handling cash to counting their cash every day or at every end of their shift. It is always easier to find the cash losses on the same day, and then the losses should also not be that big. However, it is also very important that the independent person as representative from Finance Department or internal auditors for doing surprise cash count on each cashiers. Stock take should be done for all inventories, particularly for the high cost inventories, like liquors. But, it will be even better if stock take is also regulated for checking the existence of operating equipment. It is not common in most hotels, due to a large number of operating equipment. But, especially for high cost operating equipment, this stock take become a very crucial monitoring procedure, so then the hotel will remains efficient and the assets are always under control.

We found another gap between the survey from FAR and the IIA Sweden that explaining there should be a communication between internal and external auditor, but

from our findings, we could not find the reality of this theory. Nevertheless, we believed that auditors both internal and external have important roles on monitoring component. The internal auditors usually work together with the Directors of Finance to review the effectiveness of internal control procedures. They will also normally give some advices to Directors of Finance to formulate new procedures, if needed. Internal auditors are also responsible on ensuring that those procedures are correctly and truly implemented by the staffs. The internal auditors will also monitor the work of the Directors of Finance, because there was always a possibility that the Directors of Finance themselves who do not follow the internal control procedures. In addition, external auditors will also function as an independent party to check whether the enterprise has adequate internal control procedures. They will also give suggestions to the Directors of Finance if they find something that they need to be aware of. In smaller enterprises, the owner representative is the person who usually acts similarly like internal auditors.

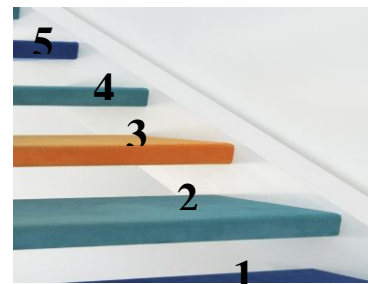
Along with the awareness of internal control in the enterprises recently, it gave the owners of the hotels and also the hoteliers' inspiration to improve the internal control procedures in their hotels. As a result, with having effective internal control, the enterprise will be able to provide more accurate and reliable financial reports.

### 5.6 The internal control implementation as a stair

We can see a pattern how different components depend on each other in order to be able to achieve good internal control in the company.

We resemblance it into a staircase model with five steps.

We can't reach the fifth step without starting on the first step. To get to the fifth step we have to start on the first step and then move upwards. With this illustration we will try to explain how internal control is implemented from the Director of Finance's perspective and how it has effects on entire hotels and actually even on their balance sheets.



In the **first step** we have the laws and regulations which include SOX, COSO and ISA.

By implementing these internal control regulations the hotels can take a step to the second stair.

The **second step** on the stairs is now reached which means that the hotels have reached less fraud and more efficiency in their daily work. Fraud can be very costly for the company, especially uncovered fraud in the entity. What we also found out was that good internal controls in a company lead to advantages as good customer behaviour. The customers feel safer and more secure in the hotels. It is very important, because in hospitality industry, guest's trust and comfortable feelings are the business itself. People will keep coming to the hotels if they feel secure and convenient. In the long term this lead to trustfulness with the customer and the hotelier build up a social security for the customer. The third step is then reached.

The **third step** on the stairs means that the hotels are focusing on improving high quality of financial reporting, through business ethics, effective internal controls and corporate governance. It leads to more trust among the employee. Internal control in hotels can function as a safeguard for its assets, prevent possible frauds and also minimize wasteful purchases. The companies can convince the public that they provide reliable information in their reports and that they are minimizing any possible fraud. The fourth step is then reached.

The **fourth step** head to risen goodwill. As we can see, the factors here depend on each other and stronger goodwill means that the value of the hotels will raise and the hotels have soon been reached the last step on the stairs.

On the **fifth** and the final **step** the values on the hotels rise by risen goodwill. Higher value will then be showed on the balance sheet.

But if the hotels reach the fifths stair it does not mean that once they reach it they will constantly stay there. As we found out, internal control (that is on the first stair) needs to be updated and review. The first step of the stair is the implementation of internal



control. It is the base and if this one is not stable the hotels will not be able to climb any further on the stairs. It is important to keep this in mind.

In the long run, internal control can give competitive advantage. It is about to implement internal control in the daily work to reach the best result of it. But we found out that there have to be regular and strict control to be sure that this rule is followed.

## **6. Conclusion and Suggestions**

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*In this final chapter we give comments on our empirical findings and on the analysis. We summarize the principles that we used as our basis on writing this thesis with our findings. We also give suggestions to future research on this field of study.*

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### **6.1 Conclusion**

We determined that internal control has favorable roles on enterprise's operation. The operation will be effective with the implementation of clear and well-structured procedures that everyone in the entity can understand and follow. The internal control works from the establishment of the procedures, the implementation, and until review and monitoring step. As described in chapter five, there are some gaps between our empirical findings and the theory, as well as there are some differences between the views of internal control in the world-wide hotels compared to the local hotels. The implementation of internal control depends thereby a bit from each other depending on the size of the hotel and its location. From the findings, we see internal control as a tool that can be used in the organization to help the company to achieve its goals and missions. It will help the company to work more efficient and make the mission clearer in the whole organization. The importance is to be aware of the usefulness of internal control and on how it can be implemented in the company. Good internal control is important for the enterprises. However, in line with the organizational theory, to implement an effective internal control system, all elements in the company have to be aware and proactive. Then the Director of Finance has to be consistent on his role to control them and ensure that all internal control procedures really in place. This facts correlate with the former research by Yates, 1993 and Gauthier, 2008 as mentioned in chapter two above.

We found that the theory goes slightly against the efficiency when it comes to reach profitability. We can see the dilemma that can occur by implementing proper internal control procedures. Higher costs and conflicts between workers are two factors that we believe can be the problem on implementing proper internal control by the theory of Weygandt. An important factor according to Weygandt, full effect of internal control

can be obtained with integrating whole department with the internal control system. It says also that it is not the same employer who should follow the cash stream during the whole organization, likewise with our findings. Regarding Standard Operational Procedure, we found that the implementation of efficiency stands contra the profitability. A gap is found where the manager has to decide whether he wants to implement the internal control system. This implementation is rather dilemmatic, because it causes higher costs in terms of employment cost and sometimes higher the risk of conflicts between employees and guests as well. However, in the long term we believe that this will be popular. When we look at the five steps of staircase, we found that higher costs can sometimes be necessary to prevent fraud, create trust among the employers and provide trustfulness amongst the customers, which in the long turn lead to lower costs. Considering COSO framework on preparing Standard Operational Procedure and Budgeting in the organization is a way to anticipate risks of higher costs and conflicts. Good information, communication, control environment and monitoring are important factors to prevent conflicts. Further, to prevent higher costs, it's important to be aware of the risk assessment as well as the other four components of COSO to be calculated on preparing forecasted costs and revenue. We also see that Director of Finance shall work together with internal auditors and board of director on formulating internal control implementation. This will then be more suitable for all stakeholders, since internal control is the management's responsibility.

We can see that internal control will be more developed and important in the future, along with increasingly sophisticated technology. Therefore hotels need to keep in mind that they have to be updated with new technology to keep their internal control procedures in order. But the better understanding the managers have on the different possibilities of risks, the better protection can be constructed.

## **6.2. Internal control regulations and procedures**

The hotels that we have collected empirical data from have their base in the U.S. While the main head office is in the U.S., the hotels branches in other parts of the world need to follow the accounting standards that are set up by the head office, which have influences of the SOX. The result of this is that the SOX regulations will be in the entire

hotel chain worldwide. Thereby we also found that the requirement to have more strict internal control implementation as an impact from SOX had affected not only on enterprises in the U.S., but also all over the world, including Sweden and Indonesia. This is an example on how the control environment in the COSO framework, in this case is location of the company, can make internal control implementation differ from one company to another.

Standard operational procedures in an enterprise function as a guideline for the daily operation. It leads the employees to operate the enterprise to the enterprise's goal. The procedures give clear directions to what the operation should look like. As in the internal control elements from The Committee of Sponsoring Organizations of the Treadway Commission, 2009, it is important to give information and communicate with employees in all levels on how internal control should be implemented correctly. One of the effective ways of communication is through this Standard Operational Procedures which has been distributed to all people in the company. However, the monitoring process also needs to work in line to ensure that everyone read and follow the procedures, and evaluate if there is any challenges on the implementation. Thereby, it will be easier for the Director of Finance and auditors, both internal and external, to detect any misleading actions by the staffs. Many changes have been affected the enterprises' operation. We found out that all of the employees should learn how to deal with unfavorable events when it happens. Therefore, in line with the previous study by VanBaren, 2010, it is important that managers to constantly update the policies and procedures and keep monitoring the implementation, so that they always keep meeting the hotels' needs. It will thereby minimize the chance of business failure and cost overrun.

What we also found out was that internal control and the COSO framework is applicable in every hotel scale all around the world and at all levels. Internal control is then often synonymous with good quality achievement. The Director of Finance is in this case not talking with the workers about strict internal control but instead about good quality. The same is for the COSO framework; it is more indirect implemented, which means that Directors of Finance are not talking directly to the employees about the five

components, but more about good quality standard. Quality is something that most workers have seen as a naturally thing to work towards, and it can thus be seen as something positive and more motivated thing for the workers to achieve than the word control in itself. The word 'control' can give more negative vibes to the workers.

### **6.3 Challenges on implementing internal control in the hotel**

The usefulness of implementing effective internal control procedures in the hotel were also discovered, even if it was not always easy. Written procedures work as a guideline to employees to better understand their role in the company and what they are responsible for. But, we found that regulations and procedures sometimes can also be a problem when it is related to customer satisfaction. In this case, it can be hard to meet between customer satisfaction and good internal control implementation. The hotel needs to find a balance between customer satisfactions at the same time as they need to follow the regulations determined by the government. This is sometimes also impacted on the customers and then affects negatively on the customer's convenience. One solution to overcome this problem is good communication skill to the customers. The regulations are something that the Director of Finance cannot ignore. But in fact, those regulations can affect the customers' behavior toward the enterprises. And in hotels, as service business, it is seen to be appropriate to balance them with good service quality. The manager is then responsible, both legally and professionally, to make sure that the information will be prepared accordingly with the accounting standards.

### **6.4 Final words**

From the Babylonian time until today internal control has been used as a helpful tool to control organizations and improve its efficiency. According to our findings there are no signs of that this is something that will disappear in the future, but it will be even developed and more important.

Our research also shows the involvement of internal auditors on the internal control when they are responsible to check that the procedures are followed by the hotel staff. They also help the Directors of Finance with the establishment of the procedure and checking the effectiveness of the procedures. On the other hand, the external auditor is

looking into the procedures settled by the local government and auditing standards and give advices to the Directors of Finance regarding those requirements to avoid any material misstatement on enterprise's financial statements. We found out that the cooperation between internal and external auditors are not very common.

This led us to the conclusion that with having proper internal control procedures and doing the review of its effectiveness regularly and then supported by auditing its compliance in surprise basis, it is truly lead the enterprise to operate effective and efficiently. In addition, particularly in hotel business, it should be suggested to the hotels to do stock take not only for the inventories but also the operating equipment. Because with the losses of missing operating equipment the efficiency of the hotels' operation will decrease.

Furthermore, we also hope that this thesis will give the owners and management of the enterprises a better understanding of the importance of having a good internal control system in their organizations.

### **6.5 Suggestions for further research**

For further research in this subject it would be interesting to look into the internal control procedures in more detail in the enterprise's Standard Operational Procedures. We also try to give suggestion for future research in this paper, because in our opinion, internal control implementation is an interesting research field with many more aspects to explore. Future related investigations can be based on the information and findings from this thesis. We would propose on conducting a similar study with a longer period, so that the research can also deeply examine other aspects that might influence the internal control implementation. It is also better to include more Directors of Finance from any other countries to make it broader and truly represent the implementation in the whole world. Another suggestion is to do the research to see the real implementation of internal control from another perspective, such as internal auditors or external auditors in an enterprise. With doing this research, it can show whether their perspective is different from Directors of Finance' perspective or not. Another aspect that would be very interesting to be analyzed is to look into other sectors and see if there is any

difference on the implementation of internal control in those sectors compare to hotel sector.

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## **Appendix**

### **Annex 1**

*To give the reader a better overview of our interview questions, they are presented here below:*

#### **Understanding of internal control**

1. In your opinion what is internal control? What was the first that inspired you to think about internal control? When? Has the idea of internal control changed over the years? Do you think the Sarbanes-Oxley Act gives any impacts to the implementation of internal control in general? How?

#### **Internal control in hotel sector**

2. What are the needs of internal control in hotel industry? In what particular areas do you think it is crucial to have good internal control? Why?
  - a. Have you ever experience or do you know any problems as a result of lack of internal control in the hotel?
  - b. How does the hotel solve those problems at that time? How could it be revealed?
3. Do you think that the use of internal control can be a competitive advantage?
4. Are there any legal requirements pertaining to internal control? On regulating internal control system has reference been made to the US requirement (COSO and Sarbanes-Oxley Act)? Is there any specific requirement on a national level? Or from head office?

#### **Internal control of the hotel**

5. Who has the main responsibility for internal control in your hotel? Do you think that it is important to give adequate understanding about internal control to all employees? Why?
6. How is it planned, implemented and communicated? Are there formal procedures? Who are involved?

7. a. Is there any documented Standard Operational Procedure as a guideline for internal control?
  - a. Could you give some examples of the internal control implementation in your hotel?
8. How do you design the internal control system in your hotel? Is there any help from computer assisted program on doing it? How does it work?
9. a. How do you test whether internal control is functioning or not?
  - a. How does the role of internal auditor on maintaining the effectiveness of internal control work?
10. In your opinion, how can the implementation of internal control be monitored?
  - a. Is there any regular self-audit procedure in the hotel? How often?
  - b. Is there any Hotel compliance audit available in your hotel? Who is doing this? How often?
11. How is your hotel doing the hotel compliance audit?
12. What are the challenges of implementing and communicating internal control?

### **Role of internal auditors**

13. Does your company have internal auditors? What is their role in designing and maintaining internal control? (If no, continue to Q15)
14. Are there any meetings between you, as the Controller and the internal auditors about internal control? How often are the meetings?

15. Do internal and external auditors work with each other? In what way do they contribute to making internal control more effective in your hotel? (Continue to Q17)
16. Is there any other person who acts like internal auditor, to check the internal control effectiveness?
17. Based on your experience, how does the relation of having good internal control relates to the level of confidence of the external auditor?

**Future**

18. In your view, how is the development of internal control in the future?



Annex 2

*Summary of our interviews, then we classified based on COSO Integrated Framework:*

COSO Integrated Framework		(A)	(B)	(C)	(D)	(E)
<b>A. Control Environment</b>						
1	Inspiration of IC came from...	school	Work	work	school	work
2	changes of IC over years	yes, because of the advancement of technology, and after COSO framework published and SOX Act issued, the IC become more popular and has been settled as requirement, including the requirement of compliance audit	yes, because of the advancement of technology (nowadays there is computer-assisted program for IC)	yes, especially after SOX, people pay more attention on IC, put the IC into daily work, almost everything must be checked as impact from the US' big scandals, but now it becomes more reasonable	yes, IC become more important	yes, changes in regulation because of SOX
3	impact of Sarbanes-Oxley to IC	yes, company need to provide management assertion on internal control over financial reporting	yes, only in the US or companies who have relation with US	yes, mostly effected to the US or companies who have relation with US	yes, mostly effected to the US or companies who have relation with US	yes, company need to follow many requirements regarding internal control in the US after SOX
4	legal requirement of IC in the hotel	yes, from the head office, refer to US requirement (SOX)	yes, from external auditor (implication from the SOX)	yes, refer to national requirement, no relation with US requirement	yes, from the head office and external auditor	yes, from the head office and external auditor

5	specific requirement in national level	no, only from the corporate office and external auditor	no, only from external auditor	yes, from the accountant profession and tax authority	yes, from the government	yes, from the government
6	main responsibility of IC	Director of Finance, in support from everyone in the hotel	Director of Finance	Director of Finance and Vice President	Director of Finance, in support from everyone in the hotel	Director of Finance
<b>B. Management's Risk Assessment</b>						
1	areas which crucially need IC	all areas need IC, most importantly in areas who has exposure to making money	Rooms, Food&Beverage (particularly in cash handling areas) and Finance (including Purchasing)	in guest safety matters is the most important, but in relation to finance, particularly in cash handling areas including purchasing	Room, Food&Beverage, who produce revenue	Food&Beverage, because in F&B department, there are a lot of inventory, liquor, etc which are highly cost, and prone to theft
2	example problems as a result of lack of IC	Front Office cashier tried to make money from foreign currency, change the foreign currency from the guests with his own money and then he sell it to money changer and keep the profit for himself	hotel embezzlement by account receivable officer => too much trust because long-term relationship weaken the IC	theft of money by Front Office cashier and Restaurant cashier	N/A	not all of the employees really understand the Internal control procedures, because many of them are casual workers (hourly workers)

3	problem solving	proper IC policies and procedures and check it regularly in surprise basis	strengthen the procedures (in this case, on money collection)	do the surprise cash count regularly, limit the transaction with cash (promote the credit card payment more to the guests)	if any, discuss with other hotels in same brand who has more experience	proper IC policies and give more training to employees
<b>C. Accounting Information System and Communication</b>						
1	restricted access with password control	yes	yes	yes	yes	yes
2	using computer program to assist internal control implementation	yes	yes	yes	yes	yes
3	adequate knowledge of IC to all hotel employees	yes, from the lowest until the most top management	No, only Finance staffs and other staffs who are handling cash	No, only Finance staffs and other staffs who are handling cash	yes, from the lowest until the most top management, especially employees in crucial areas	yes, from the lowest until the most top management

4	formal procedures to plan, implement and communicate IC	yes, through job description and job training. To communicate, the hotel provide clear Policies and Procedures about IC that the employees can learn and follow. Particularly for Finance staffs can be specific internal control training	yes, through job descriptions and job training by employees' direct supervisor	yes, through job descriptions	yes, through job descriptions and job training by employees' direct supervisor, brainstorming meeting with the employees	training for Head of Department and they then continue to train their subordinates
<b>D. Control Activities</b>						
1	having Standard Operational Procedures regarding IC	yes	yes	yes	yes	yes

2	examples of IC implementation	using sequence number of the bills, having kitchen printer to pre-punch the food ordered by guests, spot check on buffet restaurant, room vacant control, cash count daily basis for General Cashier, surprise cash count monthly in outlet's cashiers, assess restriction, segregation of duties, operating equipment stock-take, policies for rebates with proper approval, PCI compliance on credit card authorization	daily cash count at General Cashier and monthly surprise cash count at outlet cashier, take 3 quotations before make a decision for purchasing, discrepancy report between housekeeping report versus front office report regarding vacant/unsold rooms control, assess restriction with password control	authorization policies, cash count procedures, equipment stock check, inventory check procedure (especially for liquor) monthly	implementing PCI compliance, spot check	authorization policies for purchases using purchasing matrix, Food & Beverage inventories check procedures monthly, cash count in Front Office and Restaurant's cashier daily basis-surprise basis cash count done by Finance Department staffs, implementing good computer system in rooms check-in, minimizing cash handling
3	challenges of good IC implementation	guest convenience and guest complain	guest convenience and guest complain	guest convenience and guest complain	guest convenience and guest complain	need to have high manning (many employees) to check through the hotel's revenue in daily basis

4	example of challenging situation on implementing good IC	guest complain with the certain internal control procedures in the hotel when the one who deposit money to the hotel is different with the one who want to ask refund, because they are both have authorization in their company, but the hotel can only allow the same person to take the refund for security reason	N/A	if guest pay with different credit card than the one used as guarantee, the bank will reserve a certain amount on the guaranteed credit card, and guest assume that is hotel who charge them twice	on implementing credit card payments systems, different standards required by the national law and brand requirements	on the small hotels, when having low manning, then they can't check through everything in daily basis
5	problem solving	giving understanding to guest regarding hotel policies and procedures in the earliest time	giving understanding to guest regarding hotel policies and procedures in the earliest time	giving understanding to guest regarding hotel policies and procedures in the earliest time	contact credit card support and review the procedures, discuss with other hotels in the same brand who have more experience	strengthen the IC policies and procedures
<b>E. Monitoring</b>						
1	internal auditor in the hotel/ from hotel group (corporate)	yes	yes	no, but having owner representative who will check	yes	yes

2	the role of internal auditor in maintaining the effectiveness of IC	do the surprise hotel compliance audit, and update the IC policies and procedures if needed	do the surprise hotel compliance audit, and update the IC policies and procedures if needed	owner representative will check it in yearly basis	do the surprise hotel compliance audit, and update the IC policies and procedures if needed	do the surprise hotel compliance audit, and update the IC policies and procedures if needed
3	meeting between Director of Finance and Internal Auditor	yes, especially when there is finding to discuss	yes, if there is extra ordinary event	N/A	yes, especially when there is finding to discuss	yes, especially when there is finding to discuss
4	test of IC	with doing self-audit in yearly basis and through hotel compliance audit by the internal auditor	with doing self-audit in yearly basis and through hotel compliance audit by the internal auditor	through hotel compliance checked by owner representative	with doing self-audit in yearly basis and through hotel compliance audit by the internal auditor	with doing self-audit in yearly basis and through hotel compliance audit by the internal auditor
5	review on IC	yes, Director of Finance in consideration of advices and suggestions from internal and external auditors	yes, only if there is any extra ordinary event	yes, only if there is any extra ordinary event	yes, only if there is any extra ordinary event	yes, Director of Finance in consideration of advices and suggestions from internal and external auditors
6	monitoring the IC implementation	through hotel compliance audit by the Hotel Compliance Audit Manager and Director of Finance, and then also by internal auditors	through hotel compliance audit and review by Director of Finance	through review by the Director of Finance and Vice President	through hotel compliance audit by Director of Finance, and then also by internal auditors	through report about who has done the checking and when to the Director of Finance and with internal auditors
7	hotel compliance audit	yes, around once in a year, and with monthly surprise audit	yes, around once in a year, and with monthly surprise audit	N/A	yes, around once in a year, and with monthly surprise audit	yes, around once in a year, and with monthly surprise audit

8	internal auditor and external auditor relationship	yes, only through the report	No	N/A	N/A	No
9	contribution of internal and external auditor to IC	give advices to a more effective internal control	give advices to a more effective internal control	N/A	N/A	give advices to a more effective internal control
10	effect of having good IC in external auditor perspective	external auditor will be more confident, but they still have to check independently	possible to lower the control risk	possible to lower the control risk	N/A	No clear effect is considered



## Annex 3

### *Summary of our interview questions to the external auditors:*

- 1) How do you see the role of internal control?
- 2) Can you see that there is any clear relation between internal auditors and external auditors on the internal control implementation?
- 3) Have you meet any struggle by the internal control?
- 4) Do you co-operate with the internal auditor (sometimes)? If yes, in what way?
- 5) Have you discovered any advantage/disadvantage because of internal control implementation in the enterprises when doing your audit works?
- 6) In your opinion, who will be the most influencing on internal control implementation in the enterprises? Auditors or Financial Controllers? Why?
- 7) How do you see the need of internal control system in the future?