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Assessing and Analyzing Internal Control Practices In The Lodging Industry

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INTRODUCTION

The beginning of the 21st Century brought to public attention a few major scandals that included corporate governance failure involving such large companies as Enron, Tyco, WorldCom, and a few others. Those events influenced in a negative way investors' confidence and questioned the ethics of the top management, professionalism of auditors, as well as effectiveness of existing business regulations. In response to those developments, Congress decided to pass the Sarbanes-Oxley Act (SOX) (Ho and Oddo, 2007). The new document was created specifically for public companies; one of the areas of that extensive document was internal control.

It was not the first attempt of the government to issue such regulations. In 1933, the Securities Exchange Act was passed that prohibited misrepresentations and possible fraud when it came to securities transactions. One year later, the Securities and Exchange Commission was created and given authority and power to regulate many aspects of the securities industry (Jackson, 2006). Later in 1977, the Foreign Corruption Practice Act required companies to establish internal control provisions and execute transactions, with appropriate management authorizations, maintain a proper record of transactions and reflect accurate accountability of assets (Baruch, 1979). SOX was a rational follow-up to the Foreign Corruption Practice Act of 1977 (Stuart, 2012). SOX has 11 sections 302 and 404 specifically focus on internal control matters. Section 302 requires management of a company to evaluate internal control systems within their company and accept responsibility for those controls and financial statements that they are required to certify on a quarterly basis. Section 404 obligates companies to take a much deeper look at their internal control systems so that they have a profound understanding of

internal control system effectiveness. According to Foley and Lardner, the LLP study *The Impact of Sarbanes-Oxley on Private & Nonprofit Companies* (2006), many non-public companies adopt certain provisions from SOX even if that document does not require non-public companies to comply with it.

A strong internal control system can provide reliable information for internal decision-making or external reporting. While internal controls can be implemented to ensure compliance with laws and regulations or improve operational efficiencies, controls related to the preparation of the financial statements are most relevant for a financial statement audit including the audit of internal controls over financial reporting. The internal control can be seen as a process that is designed by management in order to give a reasonable assurance that financial statements prepared by a company meet financial reporting guidelines (Stuart, 2012). According to the American Institute of Certified Public Accountants (AICPA), the four objectives of internal control applicable to diverse businesses are: a) safeguard Assets, b) check accuracy and reliability of accounting data, c) promote operational efficiency and d) encourage adherence to prescribed managerial policies (Schmidgall, 2002).

Many businesses have an internal audit department made-up of employees who are tasked with internal audit. They try to determine possible risks that company may have that may prevent it from achieving its financial objectives and goals. Often, one of the main objectives of the internal audit is to provide assessments of internal control systems within the organization.

Proper internal control and its monitoring require time, money, and financial and labor resources. However, in a long term-run it can have a very positive impact on a company (Hedley and Ben-Chorin, 2011). Companies that do not invest proper amounts of time and resources into

their internal control matters, are often found to become the subjects of control failures (Chan, 2006).

Internal control matters represent a significant importance for a variety of business sectors and lodging is no exception. According to American Hotel & Lodging Association (2011), there are more than 51 thousand hotels in the United States that generate more than 100 billion dollars in sales on an annual basis and the lodging industry without doubt represents a significant segment of this industry's sales. The purpose of effective internal control is to prevent possible mistakes or detect recorded mistakes before they become costly and have the potential to destroy a hotel's good reputation and cause major financial problems. Hotels with a well-established internal control system may have an occasional internal control deficiency. However, a hotel with a poorly established internal control system may, not only have more failures but also have more severe kinds of failures. According to Rezaee et al. 2001, these days a lot of accounting information is kept in an electronic format and accounting journals, account balance, payroll slips can be accessed and monitored in real time that makes access to necessary information much easier. Internal control may be seen as a combination of multiple variables such as policies, procedures, and company reporting hierarchy. Just because a company does have internal control policies and procedures it doesn't mean that it is necessarily working well. People within the company may simply be unaware of them or don't follow them.

When a hotel tries to establish a system of internal control it should tailor the system to its own specific needs. Furthermore, if changes occur as a result of findings made by internal control the hotel should implement new internal control procedures, and install them in a timely fashion. Hotels may have a variety of issues that prevent them from achieving desirable levels of success and profitability. One of these issues is flaws in hotel accounting methods such as when

a hotel simply fails to gather data related to key accounting parameters properly, reflect it accurately in financial reports and correctly interpret it (Payne, 2010).

LITERATURE REVIEW

Several research studies have been done to address issues of internal control in different types of profit and non-profit organizations. However, internal control matters are not well studied in relationship to hotels and specifically to their size, ownership status and longevity of being in business.

Kinney and McDaniel (1998) analyzed errors in quarterly earnings for 73 companies and determined that material errors are higher for small firms and firms that have weaker financial positions. Frankel et al. (2002) analyzed 3074 proxy statements that were filed with Security and Exchange Commission (SEC) over a period of approximately four months and the authors were able to find out a positive relationship between a firm size and non-audit fees. Studies of DeAngelo (1981) and DeFond and Jiambalvo (1991) suggest that smaller businesses have better internal control systems. Doyle, Ge and McWay in their 2006 study examined 779 firms that disclosed internal material weaknesses over a three year period. The authors determined that the size of the business, and the years the company has been in business are main factors that are positively correlated with reporting material weakness. Material weaknesses can occur because of a single significant deficiency by itself or multiple significant deficiencies which may result in the possibility of internal control failing to either prevent or detect the financial misstatements (Arens, Elder and Beasley, 2012).

DeFranco and Wortman (1997) conducted a qualitative study that reviewed casino business regulations and practices. The study underlined the tremendous importance of internal

controls. Mohsin (2006) conducted a study of 34 food service establishments. The study found that despite the fact that almost all owners/operators agreed on the importance of internal control, only a very few were implementing it properly. It was also observed that large restaurants had better internal control systems than small restaurants.

Krizirian, Heinze and Lees (2011) provided an extensive checklist of control objectives' and suggested control activities that could be used by managers and auditors when they conducted audits of gaming establishments.

Karagiorgos, Drogas and Giovanis (2011) conducted a study that intended to measure the effectiveness of internal audits in Greek hotels. The study was based on 52 questionnaires where the respondents were asked to assess the effectiveness through five parameters suggested by the Committee of Sponsoring Organizations (COSO). Based on the results of the study, all elements of internal control system were ranked highly; evaluation of control environment, evaluation of risk assessment, evaluation of control activities, evaluation of information, and evaluation monitoring with the control environment component was ranked as the highest and the monitoring was ranked as the lowest.

Frazer (2012) investigated restaurant managers' perceptions of the internal control systems where he randomly selected 270 restaurants for the survey. Among other findings the study found that managers who were affiliated with small restaurants more often perceived internal control systems to be inadequate. The study found strong positive relationship between protections of assets and verifications of transactions and internal control and negative correlation between segregation of duties and internal control. Sixty six percent reported

inadequate internal controls, 79% reported inadequate segregation of duties, 63% reported protection of assets and 66% reported inadequate verification of transactions.

METHODOLOGY

The purpose of this study is to determine whether there is a significant difference between proxy of internal control between large and small lodging establishments, lodging establishments that have been in business longer and lodging establishments that are either publicly or privately owned. The questionnaire was sent to Hospitality Financial Technology Professional Association (HFTP) members and approximately two hundred HFTP members participated in the survey out of which 33 responses were valid for analysis.

HFTP members were invited to fill in a questionnaire and among other questions to indicate whether their business practiced certain internal control methods or not. Twenty five questions were selected from a Hospitality Internal Control Questionnaire that was developed by a Hotel Accounting Institute primarily for managers and controllers. Controls covering the following relevant accounts/processes were reviewed: cash, accounts receivable, accounts payable, payroll, front office, food and beverage, and balance sheet. According to Arens, Elder, Beasley (2012), usually the most effective way to obtain a combination of assurance for transaction related, balance-related, presentation and disclosure-related audit objectives an effective internal control of a company is to attend to risks that are connected to all relevant assertions for all significant accounts and disclosures in the financial statements. Despite the fact that there is no one correct way to design an internal control, it should be designed in a way it prevents, or detects and corrects, material misstatements in the financial statements. Management is responsible for providing reasonable assurances that financial statements are free of material misstatements, which is one of the main concerns of auditors. According to Arens,

Elder and Beasley (2012), an effective internal control of a company should attend to risks that are connected with all relevant assertions for all significant accounts and disclosures in the financial statements.

Selected balance sheet controls primarily cover the balance-related and presentation related disclosure management assertions. The balance-related assertions are similar, but instead focus on the account period-end balances including, existence, completeness valuation/allocation, cutoff, and rights and obligations. Presentation-related management assertions focus on internal controls over financial reporting including the period-end closing process. Within the other categories, the study selected a sample of controls that covered primarily the transaction-related management assertions. Transaction-related assertions focus on validating individual business transactions and include, occurrence, completeness, accuracy, authorization, cutoff, and classification. (Messier, Glover, Prawitt, 2012)

The questionnaire included questions about the number of room at the establishment, years of operation and ownership of the establishment. The survey was conducted using Qualtrics survey tools and the Statistical Package for the Social Sciences (SPSS) version 21 statistical software was used for data analysis. The following hypothesis were tested: H₁: Larger hotels have better internal control systems, H₂: Hotels that have been longer in business have better internal control systems, and H₃ Hotels under corporate have better internal control systems as opposed to privately owned hotels.

RESULTS

Levene's test was performed in order to determine that Analysis of Variance (ANOVA) would be an appropriate statistical tool for analysis. Levene's test result was .315 and it showed that we could assume that data had equal variance among groups.

No significant difference in internal control proxy was found among hotels of different sizes, $F(2, 21) = .738, p = .49$. Similarly, no significant difference was found among hotels based on years of operation $F(3, 29) = .129, p = .942$. Internal control proxy showed no difference between publically and privately owned hotels $F(2, 30) = .078, p = .783$.

CONCLUSIONS

Despite the fact that there were no significant differences determined between dependent variable (internal control) and independent variables (number of rooms, years of operation, and ownership status), the estimated marginal means based on 25 binary item instrument of internal control analysis demonstrated the expected direction that a larger number of hotel rooms have a higher mean on internal control variable than properties that are smaller. Perhaps larger properties have more financial resources and a larger group of employees and therefore can establish better internal controls. The estimated marginal means of internal control suggested that properties that have been in business longer use a smaller number of internal controls. It may be the result of hotels with more solid and established practices believing that tight internal controls are less necessary. The larger sample size could enhance a quality of this study and analysis of sub-samples for example private and public hotels may be beneficial.

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