

# The Role of Government Internal Control System Quality in Moderating the Relationship of Financial Reports Quality and Local Government Performance

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**ABSTRACT:** Empirical test of the role of the quality of the internal control system in strengthening the relationship between the financial reports quality and the local government's performance in Indonesia used secondary data in the form of the BPK RI audit report and the Appendix's in the 2016 and 2018 of Regional Government Implementation Performance Evaluation Report (EKPPD). The population of 514 regency and city governments in Indonesia. The sampling technique was purposive sampling with a total of 268 regency and city governments using data for 3 years, the total sample was 804. Variable measurement used index, time dimension used panel data. The results showed that the quality of financial reports had a positive and significant effect on the local government performance, then the quality of the government internal control system (SPIP) cannot strengthen the relationship between the quality of financial reports and the performance of local governments. The research results were expected to contribute to the policy that the implementation of the local government internal control system should be the focus of the relevant agencies. The limitation of this research is the large gap score on the key performance indicator in each region EKPPD.

**KEYWORDS:** Financial report Quality, Local Government Performance and Government Internal Control System Quality

## I. INTRODUCTION

The fundamental purpose of New Public Management is to improve public services (Wardhani, Rossieta and Martani, 2017), (D. usanto, Yusuf and Rachmawati, 2014), increase efficiency, responsiveness and increase government accountability and performance (Christensen and Lægheid, 2015). ). NPM can affect public services fairly (Walker and Andrews, 2015), Performance achievements of local government administration including macro performance achievements, (Government of the Republic of Indonesia, 2019). The focus of local governments is to provide public/community services to improve community welfare that is reflected in minimum service standards (Government of the Republic of Indonesia, 2018).

Local Government Financial Reports (LKPD) can be good quality, if they refer and comply with government accounting standards (Government Regulation No. 71 of 2010) and are guided by regional financial management regulations. Regional financial management can run effectively, efficiently, transparently and accountably when carrying out internal control over the implementation of government activities. (Regulation of the Government of the Republic of Indonesia No. 60 of 2008).

The phenomenon of regional financial management in Indonesia includes the number of SPI weaknesses finding, the total problem of audit findings. the number of non-compliance resulting in losses, the increase of potential losses and administrative irregularities from 2014 to 2018, but the

audit opinion of the The Audit Board of Republic of Indonesia (BPKRI) that received an unqualified opinion is increasing, on the other hand, corruption cases involving regional heads and deputy regional head is still high. It indicates that the financial reports quality is not good, and the internal control system has not been implemented optimally so that the contribution to the performance of local governments is still doubt.

The quality of financial reports had a significant effect on non-financial performance (Al-Dmour, Abbod and Al Qadi, 2018), the quality of financial reports affected the quality of public services (Furqan et al., 2020), the implementation of International Public Sector Accounting Standards (IPSAS) can improve accountability and quality of financial reports, (Muraina and Dandago, 2020), furthermore, local government financial reports did not provide the information needed to evaluate local government performance. (Christine Ryan and Christine, 2000), accrual-based financial reports affect the financial performance of local governments (Perwita Sari et al., 2018), local government financial reports that receive a fair opinion with exceptions cannot be used to measure local government performance (Goenawan, 2010). and Bhakti S. Sastranegara, 2012), the difference between this study and previous research lies in the development of research instruments using a questionnaire, this study uses an index or content analysis

The internal control system had a positive effect on fraud prevention (Soleman, 2013), the quality of internal control

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had a positive and significant effect on the follow-up process of findings, the competence of the internal auditor function, and the involvement of the audit committee (Oussii and Boulila Taktak, 2018), the effectiveness of internal control indirectly significantly affects the results of audits of local government financial statements (Nurdiono et al., 2016), this showed that the number of audit findings on SPI and the number of compliance audit findings can influence opinions on LKPD. The number of audit findings on the internal control system had a negative effect on the opinion on LKPD. (M. Munawar, Nadirsya and Abdullah, 2016). Meanwhile, the results of the study (Probohudono, 2015) showed that compliance with laws and regulations affects the audit opinion of local government financial statements.

The implementation of high internal control ensures that financial and accounting SOPs is adhered and implemented to produce reliable financial reports. Government entities that have good internal control will make the accounting process run better. This condition will make the implementation of the budget run more efficiently and effectively so that it will improve government performance. Internal control can create a work culture that runs in accordance with applicable regulations, good internal control can protect organizational assets, so that the potential for fraud is smaller. Good internal government control, good governance, so that it contributes to improve the performance of local governments.

This study aimed to empirically examine the role of the quality of the government internal control system in moderating the relationship between the quality of financial reports and the performance of local governments. The results of the research can contribute science development, especially the development of measurement instruments for the variables studied.

### ANALYSIS OF THE RELEVANT LITERATURE

The implications of stewardship theory and regulatory theory for this research can explain the existence of local government as organizations that is oriented to public services and refer to laws and regulations, so that their duties and functions must be carried out properly and make financial accountability well, so that the goal is to improve the community welfare can be achieved. In relation to this theory, the government issued regulations related to financial statements that is Government Regulation No. 71 of 2010 concerning Government Accounting Standards and Government Regulation of the Republic of Indonesia No. 60 of 2008,

Local government performance measurement refers to local government performance measurement based on the Inputs-Outputs-Outcomes (IOO) model (Walker and Andrews, 2015). Measurement of local government performance sourced in the Regional Government Implementation Performance Evaluation (EKPPD) or minimum service standards (SPM), the MSS indicator is a quantitative and

qualitative achievement benchmark used to describe the amount of targets to be met in achieving MSS, in the form of input, process, outputs, results and/or benefits of basic services. (Government Regulation of the Republic of Indonesia No. 2 of 2018).

Quality local government financial reports show that the regional head is responsible in accordance with the authority delegated in the implementation of the responsibility to manage local government (Government of the Republic of Indonesia, 2010). The measurement of the quality of financial reports is carried out by utilizing the report on the results of the BPK RI examination of the financial statements of local governments by giving a score at intervals according to the conditions, then each dimension is given a weight. The selection of the quality dimensions of financial reports refers to Government Accounting Standards, then the weighting takes into account the information quality hierarchy. Measurement of the quality of local government financial reports with the NICE parameter (Nagara and S. Mulyani, 2016) and this weighting is also based on previous research (Basuki and Aprilia, 2017).

Referring to Government Regulation No. 12 of 2019 concerning Regional Financial Management, it is explained that regional financial management must be carried out economically, effectively, efficiently, transparently, and accountable, then regional heads are obliged to implement an internal control system for the implementation of regional government activities (Government of the Republic of Indonesia, 2019). The measurement of the government internal control system quality refers to the Head of BPKP RI No. 4 of 2016 concerning Guidelines for Assessment of the Maturity Level of the Implementation of SPIP that focuses on 25 statements that are divided into 5 dimensions with : 30% control environment, 20% risk assessment, 25% control activities, accounting, information and communication systems 10% and monitoring 15% (BPKP, 2016).

The application of accrual-based accounting affects the financial reports quality (Hidayah and Zarkasyi, 2017). The application of International Accounting Standards (IAS) or International Financial Reporting Standards (IFRS) in Europe has an effect on the quality of financial reporting (Palea, 2013). The shift from cash to accrual accounting by the government is seen as an aspect of the agenda. better accrual-based financial reports, enabling an assessment of the accountability and performance of government entities (Pina, Torres and Yetano, 2009), (Pinnuck and Potter, 2009). Government financial transparency and accountability have a positive and significant relationship with local government performance. (Agwor, 2017), Follow-up recommendations have a positive relationship in improving the quality of local government financial reports and public services quality, (Furqan et al., 2020), Based on these arguments the

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hypothesis to be tested is: H1. The quality of financial reports has a positive effect on the local governments performance. The internal control system of an organization is weak then there is a tendency for individuals to commit the practice accounting fraud. Conversely, if the internal control system of an organization is strong, the tendency to practice accounting fraud will be smaller. Internal control system is one of the factors that become a predictor of accounting fraud. The internal control system is expected to increase the reliability of financial reports, so that good quality financial reports can then be used to evaluate the performance of local governments. The quality of financial reports affects the performance of local governments through the application of regulations or administrative systems, (Haliah, 2018). The higher the internal control of local government organizations, the lower the practice of accounting fraud. Conversely, when the internal control system is low, accounting fraud will be higher (Lingga, 2017). Based on these arguments, the hypothesis to be tested is: H2. The government internal control system quality can strengthen the relationship between the quality of financial reports and the local governments performance.

### RESEARCH METHODOLOGY

This type of research was quantitative research, associative hypothesis testing was used to test the hypothesis of the influence of local government financial reports quality on the local governments performance and the role of government internal control system quality in moderating the performance of local governments. The time dimension used by panel data was the report on the results of the examination of the The Audit Board of the Republic of Indonesia (BPK RI) on the financial statements of local governments in Indonesia, it was used to measure the quality of financial reports and the Government Internal Control System quality (SPIP) from 2016 to 2018, furthermore report on the results of the Regional Government Implementation Performance Evaluation (EKPPD) from the Ministry of Home Affairs of the Republic of Indonesia.

#### Operationalization and Measurement Variable

1. The Regional Government performance refers to the Government Regulation of the Republic of Indonesia No. 2 of 2018, concerning minimum service standards that include: education, health, public works and spatial planning, public housing and residential areas, public order and social protection, the measurement was carried out with index instruments, by filling in the score on the working paper by another party by looking at the EKPPD report, b). calculate the average of each dimension/affair, c). determine the weight, d). determine the index, it is done by adding up the average of each dimension multiplied by the weight (Appendix 1).

2. The quality of financial reports refers to the Government Regulation of the Republic of Indonesia No. 71 of 2010 that

includes: relevant, reliable, comparable and understandable, the measurement is carried out using the financial report quality index, by: a). prepare working papers, b). fill the scores by other parties based on the references provided, c). determine the weight of each dimension, d). add up and calculate the index by  $\{(Score/Maximum\ Score)*weight\}\%$  (Appendix 2)

3. The quality of the Government's Internal Control System, referring to Government Regulation no. 60 of 2008, which includes: control environment, risk assessment, control activities, information and communication as well as internal control monitoring, measurement is carried out using an index, by: a). prepare working papers, b). fill the scores by other parties based on the references provided, c). determine the weight of each dimension, d). add up and calculate the index by  $\{(Score/Maximum\ Score)*weight\}\%$  (Appendix 3)

4. The control variables used were total regional expenditure, total regional original income and regional status status. The population of this study was the financial reports of regency and city governments throughout Indonesia, as many as 1,542 regencies and cities (514 regencies and cities for 3 years) spread over 34 provincial governments in Indonesia (the provincial government is not the study population). The sampling method was non-probability, the sampling technique that used was purposive sampling, the determination of the sample is carried out as follows:

**Table 1.** Sample Size

Description	Year 2016	Year 2017	Year 2018	Total
Number of Regency/ City Government	514	514	514	1.542
New autonomous region	(13)	(13)	(13)	(39)
Special admin area	(33)	(33)	(33)	(99)
Special Autonomous Region	(42)	(42)	(42)	(126)
Regional heads caught in corruption cases	(36)	(36)	(36)	(108)
No information available	(122)	(122)	(122)	(366)
Number of regency/city governments that cannot be sampled	(246)	(246)	(246)	(738)
<b>Total Sample</b>	<b>268</b>	<b>268</b>	<b>268</b>	<b>804</b>

The analytical method used in this research was quantitative analysis. This study uses panel data in the form of 804 regencies and cities government financial reports (that are divided into 3 years), namely 2016 to 2016. 2018. The analysis used SEM PLS and panel regression.

### ANALYSIS AND RESULTS

Descriptive statistics on the quality of financial reports based on the average of four dimensions, the mean value > standard

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deviation value ( $3.06 > 0.72$ ), the quality of data related to the quality of financial statements was good, then the trend of changes in the average score of the dimensions the quality of financial reports for two years had increased. Local government performance based on 6 dimensions showed the mean value  $>$  standard deviation value ( $(72.66 > 18.42)$ ), so that the data related to local government performance was good, while the trend of changes in the average score during the last three had increased. Quality of internal control system showed an average of 5 dimensions, the mean value  $>$  the standard deviation value ( $3.20 > 0.59$ ), it means that the quality of the internal control system data was good and the trend of changes in the average score showed constant.

### Measurement Model Analysis

The data analysis using SEM-PLS, before testing the hypothesis, the measurement model was first tested using convergent validity and discriminant validity as well as reliability to indicators for each dimension and variable, invalid and reliable indicators are reduced (rule of thumb,

convergent validity was said to be valid if the value of the outer loading indicator  $> 0.708$  and the value of average variance extracted (AVE)  $> 0.50$ , then discriminant validity was valid if the value of the square of the correlation between related constructs  $>$  correlation between latent constructs, meanwhile reliability is measured by composite reliability (CR was be reliable if the CR value  $> 0.708$ ), after undergoing a revision of the measurement model on validity and reliability, the resulting financial report quality variable with 3 dimensions and 4 indicators, local government performance variable with 6 dimensions 14 indicators and quality variable Government internal control system ah with 2 dimensions and 3 indicators.

### Structural Model Analysis

Dimensions and indicators were valid and reliable, the test results were continued with the path coefficient or the relationship between latent variables

**Table 2.** The score of *path coefficients, t-statistics significance, p-value,*

Relation	Original Sample (O)	Sample Mean (M)	Standard Deviation (STDEV)	T Statistics ((O/STDEV)	P Values	Description
KLK -> KPD	0,072	0,073	0,034	2,096	0,037	H1. Accepted
M2 -> KPD	-0,006	-0,006	0,036	0,173	0,862	H2 Rejected

**Source:** Results of Data Processing (2021)

### The Effect of Financial Report Quality on Local Government Performance

Table2 showed that the positive effect of Financial Report Quality (KLK) on Local Government Performance (KPD) was 0.072 (7.2%) and it was statistically significant because the t-count value was 2.096 (greater than 1.96) or p-value 0.037 (less than 5%) so H1 was accepted . This condition indicates that the better the quality of financial reports, the better performance of the local government. Several previous studies with similar results include (Pina, Torres and Yetano, 2009; Pinnuck and Potter, 2009; Aghwor, 2017; Kamran, Ahmed and Alam, 2012; Haliah, 2018; Safkaur and Sagrim, 2019 and Furqan, et al, 2020)

Generally, the trend of changes in the score of the financial report quality increased. In 2016 it was 3.15 and then in 2018 it was 3.23. It means that the quality of financial reports was better, the relevant dimension had the highest average score of 3.67 and the smallest contribution was given a comparable dimension that was 2.21, it means that the number and value of corrections to the change in equity report in 2018 was higher.

The average achievement of each indicator of the financial report quality dimension was 81.20%, it means that each indicator had a high contribution to the KLK dimension, the

use of a chart of accounts in accordance with government accounting standards was 94.40%, the average indicator the relevant dimension that gave the largest contribution that was 88.77% and the smallest dimension that can be compared by 56.68%, it is measured by the amount and value of corrections in the statement of changes in equity from period to period that becomes bigger.

This research is in line with regulatory theory that is a regulation issued by the government to support a harmonious, balanced relationship with the environment, values, norms, culture of the local community to realize sustainable economic development in order to improve the life and environment quality. Government Accounting Standards must be used as a reference in the preparation of local government financial reports to be relevant. It means that financial statements can provide feedback benefits, predictive benefits that are produced on time and complete, it means that the preparation of financial statements has referred to SAP, for example the use of charts of accounts and financial reports equipped with the calculation of financial ratios in order to predict the future, but some regional governments have not done.

Furthermore, the reliability of local government financial reports can be demonstrated by the existence of ownership of



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assets, valid evidence of accountability so that performance can increase. Furthermore, reliable means that local government financial reports are presented honestly, verifiably and neutrally, it means that local government financial reports can be used as a guide in allocating their resources, so that they are easy to trace and when examined by BPK RI that will produce a good opinion, indirectly direct performance of local government that will also increase.

Local government financial reports must also be compared with the financial statements of the previous period or with other local governments, for example, the total correction value between the current year and the previous year, the smaller the correction value, the better quality of the financial statements, thus the performance is better or vice versa. The correction value, the lower the quality of the financial statements. Understandable means that financial statements are prepared using terms that can be understood by users, for example in the notes to financial statements using graphic explanations in the notes to financial statements that are made systematically.

The trend of changes in the score of the regional government performance dimension had increased, in 2016 the average score was 73.90, in 2017 the average score was 75.56 and in 2018 the average score was 78.30, it strengthens the results of research on the quality of financial reports. Local government had a positive and significant effect on the performance of local governments, it shows the greater the quality of financial reports, the greater the performance of local governments.

### **The Role of the Government Internal Control System Quality in Strengthening the Relationship between the Financial Report Quality and the Local Governments Performance**

Referring to table 2, it showed that the quality of the internal control system cannot strengthen the relationship between the financial reports (KLK) quality and local government performance and it was not statistically significant because the t-count value was 0.173 (smaller than 1.96) with a p-value of 0.862 (greater than 5%). This research is not in line with the results of research (Wardhani K and Nugroho P, 2018; Probohudono, 2015; Budiawan and Punomo, 2014) that show the better quality of financial reports due to internal control system runs well, so it can improve the local government performance.

A weak accounting system causes weak internal control and ultimately resulting financial statements that are also less reliable and less relevant for decision making (Budi, 2014). The quality of financial reports affects the quality of public services, but audit findings have a negative impact on the quality of financial reports and the quality of public services, while follow-up audit recommendations have a positive role in improving the quality of financial reports and the quality of public services. (Furqan, 2020). If an organization fails to properly conduct a risk assessment, it will result in not being

identified as possible fraud risks. The more explicit the risk assessment, the more effective the fraud detection (Shonhadji, 2020).

There was no significant relationship between accrual-based earnings management and the quality of internal control. (Salehi, 2019). Internal decision makers consider financial information and budget information that are very useful for decision making, and various types of internal control that can be applied. (Paula, 2016). Completion of audit recommendations had a negative impact on the internal control system and non-compliance with laws and regulations. (Ultimately, Avrian, 2019).

Referring to the average score of variable dimension of the Government Internal Control System Quality, there was no increase in 2017 with 2018 that was 3.34 as well as the control environment indicator score showed 3.25, and risk assessment indicators and accounting, information and communication systems experienced an increase. , this showed that these two indicators were in improving condition, while the average score for the indicators of monitoring and control activities had decreased.

Based on the distribution of each indicator on the SPIP variable, the average achievement of all indicators was 83.35%, and the achievement of the control environment dimension had the lowest average that was 80.01%, then the achievement of the control activity dimension had the highest average that was equal to 89.26%. The results of this study showed that the quality of the government internal control system cannot strengthen the relationship between GGG and KPD because of: 1) the application of government accounting standards was not optimal, 2). Local government financial reports had not been widely used for internal decision making 3). Had coercive power, 4). The local government did not evaluate the SPI element on an ongoing basis, 5). The implementation of the internal control system was not optimal at the level of the Regional Apparatus Work Unit, 6). The number of weaknesses of the SPI and the audit findings did not affect the audit opinion, SPIP was carried out only as a formality.

This study used the main analysis with SEM PLS and additional analysis (to test the hypothesis) using panel regression analysis, it is done to determine the consistency of the results of the second hypothesis test analysis, and it is proven by panel regression analysis that the quality of financial statements had a positive and significant effect on performance. Local government and the quality of the government internal control system were not able to strengthen the relationship between the quality of financial reports and the performance of local governments. Furthermore, the role of the control variables for total regional expenditure, regional original income and regional status in explaining the relationship between financial reporting quality and local government performance can be seen in the following table:

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**Table 3.** The results of Regression of KLK to KPD and Control Variable

Dependent Variable	Local Government Performance		
Independent Variable	Expected Sign	Coefficient	Sign
Constant		59,841	0,000
KLK	+	0,204	0,000
<b>CONTROL VARIABLE</b>			
TBD	+	0,138	0,000
TPAD	+	0,113	0,001
SD	+	0,161	0,000
F. Test Sign		0,000	
Adjusted R Square		0,028	
N		804	

**Source:** Data Processing Results (2021)

Table 3 shows that total regional expenditure had a positive and significant effect on local government performance, it means that the greater the total regional expenditure, the higher and complex quality of financial reporting is required, it will have an impact on local government performance. The control variable for total local revenue also had a positive and significant effect on the local governments performance, local governments with total PAD are required to have high quality financial reports, so that they can be used as decision-making materials in the allocation of funding sources and ultimately have an impact on local government performance. The control variable of regional status had a positive and significant influence on the performance of local governments, it means that local governments with city status have complexity in financial management, so they must have good quality financial reports and can improve local government performance.

### CONCLUSIONS AND SUGGESTIONS

The conclusions of the research are a). The quality of local government financial reports had a positive and significant effect on local government performance, and b). The quality of the government internal control system cannot strengthen the influence of the quality of financial reports on the performance of local governments. The limitation of this research is that the amount of data is not obtained by information, so that it cannot be used as a sample. The large gap in the key performance indicators score in EKPPD resulting in an abnormal distribution of data. Further research is recommended to examine the quality of the government internal control system as an intervening variable and is associated with the power variable coercive considering that the political process in the government is very strong.

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