

The Effect of Internal Audit Function Effectiveness and Implementation of Accrual Based Government Accounting Standard on Financial Reporting Quality

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— *Review of* —
**Integrative
 Business &
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 — *Research* —

ABSTRACT

This study was conducted based on the phenomenon that the internal audit function is still not effective and the low quality of financial reporting. Implementation of the new Indonesian Government Accounting Standards (SAP) based on the accrual basis was applied starting in 2015 so that it was necessary to study the weaknesses and advantages as well as its influence in improving the quality of financial reporting. The purpose of this study was to obtain empirical evidence and review of the (1) effect of the internal audit function effectiveness on the quality of financial reporting, (2) effect of the implementation of accrual based government accounting standards (SAP) on the financial reporting quality. The sample of this study was the Inspectorate at Provincial / District / City in Lampung, Indonesia. This study used primary data with questionnaires as instrument, and analyzed by *SEM PLS* (*Structural Equation Model - Partial Least Square*). The results of this study provided empirical evidence that the effectiveness of the internal audit function had significant effect to the quality of financial reporting, but the implementation of accrual based Government Accounting Standard (SAP) did not support the hypothesis due to the implementation of accrual based SAP recently required to be applied starting in 2015 so there were still a lot of officials who did not understand it. Therefore, it had no significant effect on to the quality of financial reporting. The weaknesses of the effective internal audit function, especially in terms of resource management were coordination, reporting to the leadership, program development and quality control, and follow-up of public complaints. The weaknesses in the implementation of accrual based government accounting standards were in terms of the presentation of the components of financial statements, recognition and measurement, correction and the consolidated financial statements. The local government needed to address the inadequacies in order to improve the quality of local government financial reporting.

Keywords: Effectiveness of Internal Audit Function, accrual based Government Accounting Standards, Quality of Financial Reporting

1. INTRODUCTION

Based on The Indonesian Supreme Audit Agency (BPK RI) (2016), from year 2008 until 2015, only a small number of local governments succeeded in preparing its financial statements. Similar to the Local Government Finance Report (LKPD) for District / City in the province of Lampung, only a small number of districts / cities received unqualified opinion. An unqualified opinion indicates that the financial records have been maintained in accordance with the standards known as Generally Accepted Accounting Principles (GAAP). This is the best type of report a business can receive. But most of them (for Districts / Cities

in the province of Lampung) receive a qualified opinion, and some even receive the adverse opinion (indicates that the firm's financial records do not conform to GAAP), and disclaimer opinion (the firm's financial status could not be determined). The Indonesian Supreme Audit Agency gives the opinion for the fairness of financial statement presented, which is reflected on the financial reporting quality. The Indonesian Supreme Audit Agency stated factors that influence the quality of financial reporting at Local Government which are (1) the presentation of financial statements in conformity with the Indonesian Government Accounting Standard (SAP) and the follow up on The Indonesian Supreme Audit Agency findings and commitment to monitor implementation of Internal Control System (SPI); (2) Internal control which improves the quality of financial statements, (3) Following-up the financial audit result or recommendations by the Indonesian Supreme Audit Agency, to improve the internal control system.

According to the data from The Indonesian Supreme Audit Agency (2016), there is an increase in the number and value in some cases of the Internal Control System weaknesses and noncompliance with laws and regulations from 2008 to 2015. A number of weaknesses of the Internal Control System and the findings of non-compliance with the regulations of local government are possibly associated with the weakness of internal oversight mechanism. Previous studies state that the internal audit function may improve the quality of financial reporting (Schneider and Wilner, 1990; Goodwin and Seow, 2002; Prawitt, et al., 2008; Gramling, et al., 2011). Doyle, *et al.* (2007) suggest that conceptually, the internal control system is the foundation for the creation of quality financial reporting. The purpose of this internal control system can be achieved with the existence of the internal audit function, as guarantor attainment of the objectives of internal control (Sawyer, 2003; Mihret and Yismau, 2007; INTOSAI, 2010). Effective internal audit function can reach the goal of internal audit, which is to increase the efficiency and effectiveness of *internal controls* within an organization (Cangemy and Singleton, 2003; Cohen and Sayag, 2010; Eden and Moriah, 1996).

Preparation of financial statements is a form of transparency as a requirement for accountability in supporting the government's transparency of public resources management activities. *Institute of Internal Auditors* (IIA) (2012) states that the high quality of the internal audit function will improve the quality of financial reporting, and can detect aberrant decision. This statement is supported by Schneider and Wilner (1990) in his research that internal audit can detect irregularities in financial reporting. Similarly, Goodwin and Seow (2002) showed that the existence of the internal audit function affects the quality of financial reporting.

Adequate accounting standards implementation will increase reliability and objectivity of information presented and consistency in financial reporting. Ridwan (2007), Pamungkas (2005) proved that government accounting standard implementation also affects financial reporting quality. However, the formulation of government financial report is based on Governmental Accounting Standard (GAS) that is accrual-based based on Government Regulation No. 71 Year 2010 (PP No. 71 tahun 2010), and is recently mandatorily applied in 2015. Therefore, the researcher is interested in investigating further on how the effect of accrual-based GAS on financial report quality. Based on the phenomenon and previous studies, the identified problems in this research are: (1) How much is the influence of the effectiveness of the internal audit function on the financial reporting quality, (2) How much is the influence of implementation of accrual based governmental accounting standards on the financial reporting quality.

2. LITERATURE REVIEW

2.1 Effectiveness of Internal Audit Function

Cohen and Sayag (2010) stated that the internal audit function will be effective if it can achieve the desired objectives. The purpose of internal audit is to improve the efficiency and effectiveness of the organization (Eden and Moriah, 1996). Cangemy and Singleton (2003) stated that an effective internal audit function is to achieve its objectives. Previous literature stated that the effectiveness of the internal audit is an internal audit capability to plan, implement and communicate the findings objectively (Spraaakman, 1997; Dittenhofer, 2001). Implementation of audit recommendations is crucial for the effectiveness of the internal audit (Van Gansberghe, 2005). Van Gansberghe's findings were also corroborated by Sawyer (2003) whom stated that the internal auditor's work is not completed until the damage has been repaired and corrected. Moeller (2005: 269) and the Institute of Internal Auditors (IIA) (2012) both said that effective internal audit function has the following six dimensions: (1) *planning*, (2) *Communication and approval*, (3) *Management resources*, (4) *Policies and procedures*, (5) *Coordination*, (6) *Reporting to the board and senior management*. Furthermore, the Indonesian Governmental Internal Control Apparatus code of ethics (2008) adds two dimensions for an effective internal audit function, namely (1) *Quality Control and Development Program*; (2) *Public Complaints Follow Up*.

2.2 Implementation of Indonesian Accrual Based Governmental Accounting Standards (SAP)

Establishing accounting standards is an important factor, so there will be accounting standards that are acceptable to the interested parties and beneficial to the development of the government accounting. Indonesia is one of the countries using the *accrual basis accounting* in the financial statements based on International Public Sector Accounting Standard (IPSAS). General purpose of financial statements is intended to meet the common needs of most users report. To achieve this objective, this standard sets the entire consideration in the context of the presentation of financial statements, guidelines for the structure and the contents of financial statements. SAP accrual basis (2010) regulates about financial statement presentation, recognition and measurement, correction and consolidated financial statement. SAP accrual basis (2010) reveals that a government's financial statements will include the components: (1) statement of financial position; (2) statement of financial performance (statement of budget realization, statement of changes in remaining budget, statement of operational; (3) statement of change in net assets / equity; (4) cash flow statement; (5) notes to the financial statement.

2.3 Financial Reporting Quality

Good quality financial reporting is financial reporting which generates useful information for users, i.e. information that meets the quality financial information characteristics (Belkaoui, 2000; Jonas and Blanchet, 2000; McDaniel et al., 2002). Financial Reporting Quality Dimensions according to Beest, et al. (2009) consist of: (1) *Relevant* (4 indicators), (2) *Faithful Representation or Reliability* (5 indicators), (3) *Understandability* (5 indicators), (4) *Comparability* (6 indicators), (5) *Timelines* (1 indicator). Indonesian Governmental Accounting Standards (2010) which is adapted from the *International Public Sector Accounting Standards (IPSAS)* (2010), states that the purpose of governmental financial reporting is to present information that is useful to users in assessing accountability and to make a good decision making of economic, social, and politics. The dimensions of financial reporting quality by the Indonesian Governmental Accounting Standards (SAP) (2010) are as follows: (1) Relevant, (2) Reliable, (3) Comparable, (4) Understandable.

2.4 HYPOTHESIS DEVELOPMENT

2.4.1 The Influence of Internal Audit Function Effectiveness on the Financial Reporting Quality

Internal audit will be effective when it has conducted an audit of internal control and financial statements to achieve the reliability of financial reporting and provide quality assurance and integrity of financial reporting (Arens and Loebbecke, 1997, p. 788). Sawyer (2003) explains that the internal audit is an assessment conducted by internal auditor on the operation and *control* varying within the organization, among others, to determine whether the financial and operating information is accurate and reliable, and whether the risks faced by the company have been identified and minimized. In internal auditing, internal auditors are responsible for evaluating whether the financial statements are fairly presented (qualified financial reporting) (Arens and Loebbecke, 1997, p. 786). Goodwin and Seow (2002) investigated the influence of corporate governance mechanisms (the existence of an internal audit function, the strength of the audit committee, and the strength of the company code of conduct) on the quality of financial reporting. Research results found that three factors affect the quality of financial reporting. Based on the auditor's perception, among the three factors, the internal audit function is the most influential factor on the quality of financial reporting. Schneider and Wilner (1990) supported that internal audit would prevent irregularities in financial reporting. Based on theory and previous studies, the proposed hypothesis is:

Hypothesis 1:

The internal audit function effectiveness affects the financial reporting quality.

2.4.2 The Influence of Accrual based Governmental Accounting Standards Implementation on the Financial Reporting Quality

Indonesian Governmental Accounting Standards (SAP) is a standard to be followed in the financial report of central government agencies and local governments. Users of financial statements will use SAP to understand the information presented in the financial statements. Government Accounting Standards regulate the presentation of general purpose financial statements in order to improve the comparability of the financial statements of both the budget, between periods, and between entities. General purpose financial statements are intended to meet the common needs of most users report. Solikin (2010) has proven that the implementation of governmental accounting standard affects *good governance*. Further research by Ridwan (2007) proved that there was a significant effect of governmental financial accounting implementation to the Local Government performance. Pamungkas (2005) revealed that there were significant effects of governmental financial accounting implementation to the financial reporting quality.

Hypothesis 2:

Implementation of accrual based government accounting standards affects the financial reporting quality.

Based on the framework that has been described, the relationship between research concepts can be described as follows:

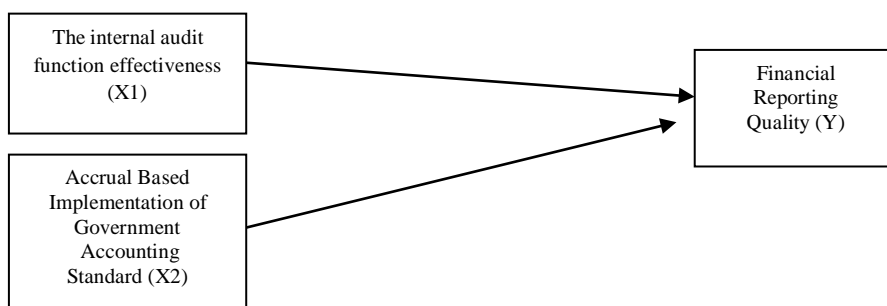


Figure 2.1 Framework

3. RESEARCH METHODE

Variables in this study have some dimensions and indicators to operationalize:

**Table 3.1
Dimensions and Indicators of Variable**

VARIABLE	DIMENSIONS	INDICATORS
Internal audit function effectiveness (X1)	1. Planning internal audit assignments	1.1 Considered activities that have the greatest risk 1.2 Consideration from the leader 1.3 Identify, analyze, evaluate and document sufficient information to achieve the objectives of the assignment. 1.4 Plan audit activities, resources required, vision, mission, goals, strategies, programs and activities of auditors every five years. 1.5 Arrange the plan based on the principles of harmony, alignment, avoiding overlapping and repetitive examination and considering the efficiency and effectiveness of resource use.
	2. Communication and approval	2.1 Communication about audit plan 2.2 Communication about resources
	3. Management of resources	3.1 Manage and utilize its resources economically, efficiently and effectively
	4. Policies and procedures of internal audit	4.1 The contents of the policy and procedures of internal audit 4.2 Review of policies and procedures continuously to be effective.
	5. Coordination	5.1 Coordination of monitoring plans and monitoring results, both with other internal auditors and external auditors.
	6. The internal audit reports to the CEO	6.1 The contents of the report: the outcome of the activities, problems, and obstacles. 6.2 The report submitted periodically to the direct higher up
	7. Development Program and Quality Control	7.1 Developing programs and controlling audit quality covering all aspects of audit activities in the Internal Supervisory Government Apparatus (APIP)
	8. Following-Up the Public Complaints	8.1 Handling complaints with clear mechanisms and procedures, transparent and accountable, based on the rule

Accrual Based Government Accounting Standard Implementation (X2)	I. FINANCIAL STATEMENTS PRESENTATION 1. SAP No. 01 Presentation of Financial Statements 2. SAP No. 02 Statement of Cash based Budget Realization (Laporan realisasi anggaran berbasis kas) 3. SAP No. 03 Cash Flow Statement 4. SAP No. 04 Notes to the financial statements	1.1 Accrual Basis 1.2 Component of Financial Statements 2.1 Presentation of budget realization report 2.2 Cash basis Budget 3. Cash Flows Statements 4. Notes to financial statement compiled systematically
	II. RECOGNITION AND MEASUREMENT 5. SAP No. 05 Accounting Inventories 6. SAP No. 06 Accounting Investments 7. SAP No. 07 Accounting Fixed Asset 8. SAP No. 08 Accounting Construction in progress 9. SAP No. 09 Accounting Obligations	5.1 Recognition of inventories 5.2 Measurement of Inventories 6. Treatment of Investments 7.1 Recognition of fixed assets 7.2 Measurement of fixed assets 8. Recognition of construction in progress 9.1 Classification of liabilities 9.2 Recognition of liability 9.3 Measurement of liabilities
	III. CORRECTION AND CONSOLIDATED FINANCIAL STATEMENTS 10. PSAP No. 10 Error correction, changes in accounting policies, and extraordinary events 11. PSAP No. 11 Consolidated Financial Statements	10.1 The concept of error correction 10.2 The concept of accounting policy changes and extraordinary events 11. Components of the Consolidated Financial Statements
Financial Reporting Quality (Y)	1. Relevant	1.1 Having feedback 1.2 Having predicted value 1.3 On Time 1.4 Detailed Information
	2. Reliable	2.1 Honest presentation 2.2 Can be verified / tested 2.3 Information is neutral
	3. Comparability	3.1 Consistency in accounting policies application 3.2 Comparability between time to time 3.3 Comparability between entities
	4. Understandability	4.1 Utilization 4.2 The form and terms can be understood

Population in this study is Inspectorate at Provincial / District / City in Lampung, Indonesia. This study uses sampling technique of purposive sampling, using specific criteria. The criteria used are: a city that has stood for more than 5 years. Thus obtained samples of the following: (1) Lampung Province, (2) Bandar Lampung City, (3) Metro City, (4) Central Lampung District, (5) East Lampung District, (6) South Lampung District, (7)

Pesawaran District, (8) Way Kanan District, (9) North Lampung District. The respondents are local government inspectorate, such as team leader, team members, technical controllers (regional assistant inspectors), and quality control (inspectors). The instrument used in this study is in the form of a questionnaire Measurement techniques using Likert Scale. *SEM PLS (Structural Equation Model - Partial Least Square)* is used to analyze the model in this study. The model is as follows:

$$\text{FRQ} = a + b_1 \text{IAFE} + b_2 \text{GASI} + e$$

FRQ : Financial Reporting Quality

IAFE : Internal Audit Function Effectiveness

GASI : Accrual Based Governmental Accounting Standards Implementation

e : error

4. RESULTS AND DISCUSSION

4.1 Descriptive Analysis

4.1.1 Internal Audit Function Effectiveness (IAFE)

Table 4.1
Average Score of Internal Audit Function Effectiveness

No.	Dimension	Mean Score	Criteria
1	Plan	4,06	Good
2	Communication and approval	4,24	Good
3	Management of resources	3,95	Moderate
4	Policies and procedures	4.04	Good
5	Coordination	4,00	Good
6	Report to leaders	3,72	Moderate
7	Program development and quality control	3,72	Moderate
8	Follow-up public complaints	3,92	Moderate
Grand Mean		3,90	Moderate

Results of grand mean score about the effectiveness of the internal audit function is 3.90 (in the interval 3-4), meaning that the internal audit function has been quite effective but there are still some weaknesses in the internal audit function, in particular in terms of resource management, coordination, program development and follow-up of complaints, including the following:

1. Most of the inspectorate in planning the audit is still not sure that the resources of internal audit function has been appropriate, adequate, and can be used effectively to achieve the plans that have been approved.
2. Most of the inspectorate did not always allocated resources to activities that have a huge risk.

4.1.2 Accrual Based Governmental Accounting Standards Implementation (GASI)

Table 4.2
Average Score of Accrual Based Governmental Accounting Standards Implementation

No.	Dimension	Mean Score	Criteria
1	Presentation of financial statements components	4, 06	Good
2	Recognition and measurement	3, 85	Moderate
3	Corrections and the consolidated financial statements	3, 98	Moderate
Grand Mean		3, 96	Moderate

Results of *grand mean* score about the implementation of governmental accounting standards amounted to 3.96 (at intervals of 3-4), meaning that governmental accounting standards has been implemented fairly well, but there are still some that have not been applied to the SAP because of their lack of understanding of the new accrual-based SAP (just have been implemented in 2015). The implementation of SAP has been good in terms of presentation of financial statements, budget realization reports, cash flow statement and notes to the financial statement. However, it has weakness in terms of accounting recognition and measurement of inventories, investments, fixed assets, construction in progress, and liabilities, and also still has weakness in terms of error correction, changes in accounting policies and the consolidated financial statements.

4.1.3 Financial Reporting Quality (FRQ)

Table 4.3
Average Score of Financial Reporting Quality

No.	Dimension	Mean Score	Criteria
1	Relevant	4.08	Good
2	Reliability	4.20	Good
3	Comparability	4.08	Good
4	Understandability	4.09	Good
Grand Mean		4.13	Good

Results of *grand mean* score of the financial reporting quality is at the interval 4.13, meaning that financial reporting has been qualified, which means that the financial statements are relevant, reliable, comparable, and understandable. As Government Regulation (PP No. 71 of 2010) concerning the Government Accounting Standards, it mentions that the financial statements must be relevant, reliable, comparable, and understandable. However, based on the results of the questionnaire, there are some quality financial reporting should be improved, among others are:

1. Local Government Financial Statement (LKPD) still has not been used in budgeting decision making by the government and has not always been able to provide the information required by the local government budgeting. This happens because the

human resources that make up LKPD still have some weaknesses in its accounting knowledge and in understanding the SAP.

2. There are still some LKPD who have not been presented on time.
3. There are still LKPD that has not always recorded the transaction based on the actual evidence. For example, the recording of asset scan which can yield misleading information so that the information becomes less reliable.
4. Some local governments, when planning and budgeting, are not in accordance with the income and expenditure budget.

4.2 Measurement Model (validity test)

In this study, exogenous and endogenous variables are:

1. Exogenous variable consists of the effectiveness of the internal audit function and the implementation of accrual based government accounting standards.
2. Endogenous variable consists of the quality of financial reporting.

This study uses *Partial Least Square* as the method of analysis. Based on validity results, all the variables have been valid, as evidenced by the AVE value higher than 0.4. This means that the information contained in all dimensions and indicators have been represented in latent variables. Latent variables have reliability values higher than 0.6 (score recommended) which means that all of the dimensions and indicators have consistency. Based on the PLS analysis, all dimensions have construct *loading factor* greater than 0.55 and significant at alpha 5%, which means that all dimensions have been the right measurement. By using the analytical methods PLS, generating models path diagram is in Figure 1 below.

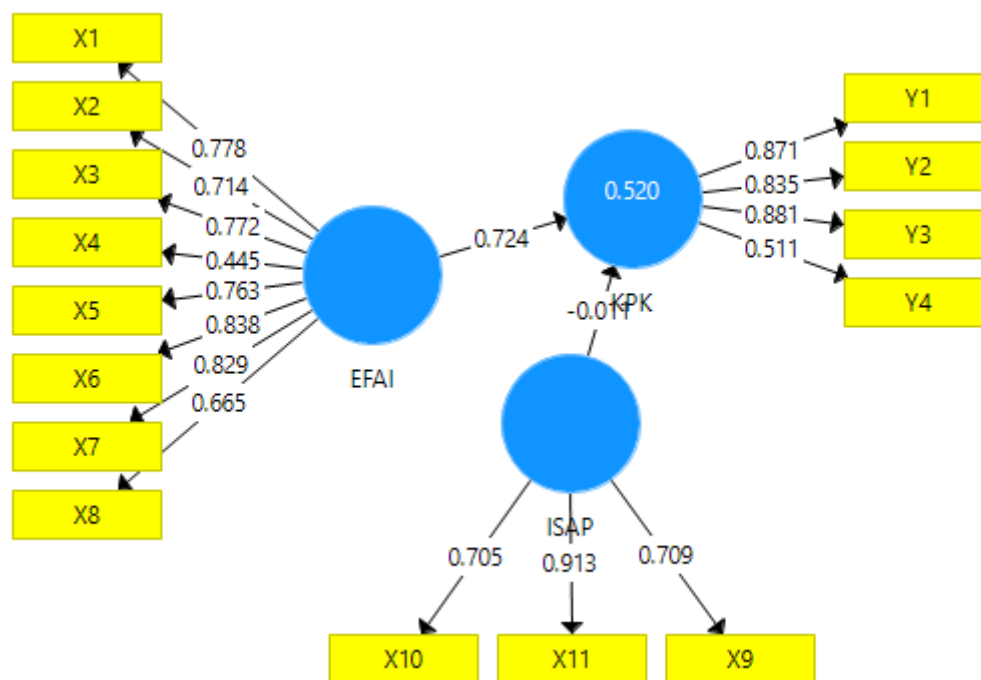


Figure 4.1
Structural Modeling Standards Coefficient

4.3 Structural Model (hypothesis)

Table 4.4

Influence of Effectiveness of Internal Audit Function (EIAF) and the implementation of Government Accounting Standards (GASI) on the Quality of Financial Reporting (FRQ)

Influence	<i>path Coefficient</i>	<i>t value</i>	<i>P Value</i>	Result
EIAF → FRQ	0.724	13.092	0,000 *	Supported
GASI → FRQ	-0.011	.208	0,836	Not supported

* Significant at an alpha level of 5%

R-square model of this study is 0.520 meaning that the effectiveness of the internal audit function and the accrual based implementation of government accounting standards can explain government accounting standards by 52%, the rest is explained by other variables that are not examined in this study. The first hypothesis testing results show that there is a positive and significant influence of the effectiveness of the internal audit function to the financial reporting quality at the significant level of 5%, with a path coefficient of 0.724. The second hypothesis testing results show that there is no significant influence of the implementation of government accounting standards to the financial reporting quality with the path coefficient of 0.011.

4.4 Discussion

4.4.1 The Influence of Internal Audit Function Effectiveness on the Financial Reporting Quality

The first hypothesis testing results show that there is positive and significant effect of the Internal audit function effectiveness (IAFE) to the financial reporting quality (FRQ). Based on this study result, the internal audit function has been effective, as the theory stated that an effective internal audit function consists of planning, communication and approval, resource management, policies and procedures, coordination, reporting to the leader, program development and quality control, and public complaints follow up (Moeller, 2005; Internal Audit Professional Standards, 2004; Standard of internal government audit regulatory authorities, 2008). This result study is consistent with theory stated by Arrens and Loebbecke (1997: 788), which revealed that an effective internal audit function will result in quality financial reporting. Arrens and Loebbecke (1997: 788) also stated that the internal auditor is responsible for evaluating whether the financial statements are presented fairly. Results of this study are consistent with Goodwin and Seow (2002), Schneider and Wilner (1990), Prawitt, *et al.* (2009), and Gramling, *et al.* (2011) which all found that internal audit function effectiveness has effect on the financial reporting quality.

4.4.2 The Influence of the Governmental Accounting Standards Implementation on the Financial Reporting Quality

The second hypothesis testing results indicate that there is no significant effect of governmental accounting standards implementation to the financial reporting quality. Implementation of SAP (2010) is in terms of the presentation of the components of financial statements, recognition and measurement, correction and the consolidated financial statements. Users will use financial statements to understand the information presented in the financial statements. Government Accounting Standards regulate financial statement for general purpose (*general purpose financial statements*) in order to improve comparability of

financial reports on the budget, between periods, or between entities (SAP, 2010). General purpose financial statements are the financial statements intended to meet the common needs of most users report. To achieve this objective, this standard sets the entire consideration in the framework of the presentation of financial statements, guidance on the structure of financial statements and minimum requirements of the contents of the financial statements.

Results of this study prove that there is no significant effect from implementation of government accounting standards to the financial reporting quality. It is not aligning with the results of research conducted by Solikin (2010), Pamungkas (2005), Nugraheni and Subaweh (2008) which prove that governmental accounting standard implementation influences the financial reporting quality. Based on this study result, accrual based government accounting standard implementation cannot affect the quality of local government financial reports (such as relevant, reliable, comparable and understandable) because the new accrual-based SAP just has been implemented on a mandatory in 2015 (just only for a year), so many officials have not yet understood well this accrual-based SAP application.

5. CONCLUSIONS AND IMPLICATION

5.1 Conclusions

Based on the formulation of the problem, formulation of hypotheses and the results of the research, the authors' conclusions are as follows:

1. The effectiveness of the internal audit function has been proven positive and significant to affect the Quality of Financial Reporting. Effective internal audit function can improve the quality of financial reporting. Dimensions that the best reflect the effectiveness of the internal audit function are planning, communication and approval, resource management, policies and procedures, coordination, reporting to the leadership, program development and quality control, and follow-up of public complaints. However, based on questionnaire result, there are still some weaknesses that constrain the internal audit function, especially in terms of resource management, coordination, reporting to the leadership, program development and quality control, and follow-up of public complaints.
2. Indonesian Accrual Based Government Accounting Standards (SAP) implementation has not been proven significantly affects the quality of financial reporting. This implementation since 2015 cannot improve the financial reporting quality. It has not been implemented well because it has been mandatorily applied only in the last one year, the human resources still do not understand well so that many weaknesses are found in their implementation.

5.2 Implication

In the results of this study, the internal audit function effectiveness is a more dominant factor of the financial reporting quality. It provides advice to the local government to improve the internal audit function effectiveness. The local government should improve the policies, procedures, and coordination of the internal audit function in order to achieve qualified financial reporting. The accrual based SAP implementation still has some weaknesses, so the government should improve the human resources competent in implementing accrual based SAP such as improving educational background, skills, with high ethics and moral.

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