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The 3rd IBEA International Conference on Business, Economics and Accounting

15 - 17 April 2015, Ho Chi Minh City - Vietnam



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The Effect of Internal Control Effectiveness on the Quality of Financial Information: A Survey Research of the Local Government

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Abstract

The objective of financial reporting by public sector entities as noted by IPSASB are to provide information about the entity that is useful to users for accountability and decision making purposes. The poor quality of performance accountability is still a major issue for the government of Indonesia. According to The Audit Board of The Republic of Indonesia (BPK-RI), the Government of Indonesia needs to improve the quality of financial reporting, the effectiveness and efficiency of operations, compliance with applicable laws and regulations, and the effectiveness of internal control system.

This research attempts to examine the effect of internal control effectiveness measured by five interrelated elements: control environment, risk assessment, information and communication, control activities, as well as monitoring on the quality of financial information of the local government in Bandung. A survey research design was adopted and data were collected using questionnaires. The research findings revealed that an effective internal control system significantly affects the quality of financial information. Hence, an effective internal control system has a positive impact on the performance accountability of the local government.

Keywords: *internal control effectiveness, quality of financial information*

Introduction

Accounting is basically a system that provide useful information for the interested parties in making decision. In accordance with Law No. 17 year 2003 on State Finance, Government Regulation No. 71 year 2010 on Government Accounting Standards and Regulation of the Minister of Home Affairs No. 59 year 2007 concerning Guidelines on Regional Financial Management, each local government in Indonesia is expected to manage finances economically, efficiently and effectively as well as to provide financial statements as a form of public accountability. Financial reporting should provide information about economic resources, performance of an organization during a period and how an organization obtains and spends cash or other liquid resources, its borrowing and repayment of debt, and other factors that may affect an organization's liquidity (Freeman, et al., 2011). In other words, the quality of financial information is a reflection of performance accountability. The importance of financial reporting is also supported by the results of previous studies (Dechow and Dichev, 2002; Schipper and Vincent, 2003; Botosan, 2004; Daske and Gebhardt, 2006; Beest, 2009). According to the Governmental Accounting Standards Board (GASB) in Concepts Statement 1 concerning the Objective of Financial Reporting, the accountability of public institutions both at the central and local government is a must and also a main objective of the government's financial reporting. Accountability is the foundation of the government financial reporting based on the existence of citizenry has



the right know and receive an explanation of the use of public funds. Performance accountability of government agencies, as noted by the Institute of Public Administration (LAN, 2000) is the embodiment of the obligation of government institutions to responsible for the success of organisational mission in achieving its goals and objectives that have been determined periodically through the system of responsibility. One of the ways to obtain transparency and accountability of financial management is by preparing financial accountability report in accordance with Government Accounting Standards and reporting timely (Jara, et al., 2011).

The Minister of Finance, Sri Mulyani noted that poor quality of financial statements of government agencies due to the lack of internal control effectiveness. Therefore she asked for all head of ministries and agencies, to implement an effective internal control in order to improve the quality of financial reporting (Tempo, 2009). Meanwhile the chairman of audit board, Hadi Poernomo argued that the government has not successfully managed to improve financial reporting quality, effectiveness of programs and activities implementation, compliance with legislation, and effectiveness of internal control (Tempo, 2010). Moreover the vice president, Boediono stated that transparency and accountability of public financial management has not been satisfactory. Over twenty financial statements of ministries and state institutions did not get “unqualified” opinion from the Audit Board (Tempo, 2011). Similarly, the minister of home affairs, Gunawan Fauzi also reported that financial reporting of local governments did not efficient in terms of time and budget (Kompas, 2011). Indonesian President, Susilo Bambang Yudhoyono also stated that he is not satisfied with an examination opinion of the Audit Board concerning performance accountability of government institutions in Indonesia for the year 2011 (Tempo, 2012), while the Minister of Finance, Chatib Basri (2013) stated that the government will should consider how to solve the problem of financial reporting quality regarding transparency and accountability.

The poor quality of government financial reporting is a main problem, because in the public sector, financial reporting is a key element in the accountability of public sector bodies (Henley et al, 1989), and because of its objective for decision making (Engstorm and Copley, 2004). Vice President Boediono asked for all government agencies at the central and local levels to improve the quality of financial statements, due to the target of all ministries and agencies in Indonesia to obtain an “unqualified opinion”. The phenomenon of poor quality of financial statements is associated with the internal control effectiveness as one of the criteria in giving audit opinion in accordance with Law No. 15 year 2004 concerning management audit and state financial responsibility. In other words, the existence of an effective internal control system will affect the quality of the financial statements. The aim of financial audit is to provide reasonable assurance that financial statements are presented fairly in all material respect, in accordance with the principle of generally accepted accounting standards in Indonesia. Financial audit carried out by the Audit Board has a purpose to provide an opinion on the fairness of the financial information (financial statements). Criteria in awarding the opinion is: (a) compliance with Government Accounting Standards, (b) adequate disclosures, (c) compliance with laws and regulations, and (d) effectiveness of the internal control system.

Audit opinion of financial statements conducted by the Audit Board in 2012 showed in the following data:

**Table 1. Opinion based on the examination of Financial Statements
by the Audit Board of Republic of Indonesia For The Year of 2012**

Type of Financial Information	OPINION								
	Unqualified Opinion	%	Qualified Opinion	%	Adverse Opinion	%	Disclaimer of Opinion	%	Total
LKPP	0	0	1	100	0	0	0	0	1
LKKL	68	74	22	24	0	0	2	2	92
LKPD	113	27	267	64	4		31	8	415
LK Badan Lainnya	4	66	1	17	0	0	1	17	6

Source: Summary of Examination Result (IHP) Semester I for the year 2013

Where: LKPP = Financial Statement of Central Government
LKLL = Financial Statement of Ministry and Institutions
LKPD = Financial Statement of Local Government
LK Badan Lainnya = Financial Statement of Others Bodies

Based on Table 1 above we can see that the majority of audit opinion on the financial statements of the central government, ministries, local government, agencies and other bodies are “fair with exception” (qualified opinion), while the government's target is to achieve an “unqualified opinion”. Based on examination results of financial statements of the local government for the year 2012 conducted by the Audit Board, discovered the existence of 4,412 cases of weaknesses in Internal Control System categorized in three groups as described below in table 2:

**Table 2. Findings Group of Internal Control System
Based on Examination Results for the year 2012**

No.	Sub of Group Findings	number of cases
1	Weaknesses in Accounting Control System and Reporting	1.586
2	Weaknesses in Control System of Budget Implementation	1.935
3	Weaknesses in Internal Control Structure	891
	Total	4.412

Literature Review

Quality of Financial Information

Financial reporting aims to produce financial statements as a financial information that serves as a means of accountability and evaluation of financial performance, especially for a public sector organization (Alexander, et al, 2007; Nikolai, et. Al., 2010; Kieso, et al, 2012; Wahlen et. al., 2012). In other words, it can be concluded that financial reporting is a process that encompasses all aspects relating to the preparation and presentation of financial information that will be useful for investors, creditors and other users in making decisions. In order to meet the desired quality of government financial statements, the normative prerequisites is needed. Qualitative characteristics of financial statements is a normative measures to assess the quality of financial statement relating to its purpose.

According Kieso, et al., (2012), the qualitative characteristics of accounting information consists of the fundamental characteristics and enhancing characteristics. fundamental

characteristics is divided into two: (1) relevance which consist of predictive value, confirmatory value, and materiality; and (2) faithful representation which consist of completeness, neutrality, and free from error. Furthermore, in order to improve fundamental qualities include comparability, verifiability, timeliness, and understandability. Beest et al. (2009), stated that the quality of financial reporting can be measured with qualitative characteristics of financial information, namely: relevance, reliability, understandability and comparability. Similarly, Cheung, et al. (2010); and Statement of Government Accounting Standards No. 01 (Government Regulation No. 71 year 2010), stated that the qualitative characteristics of financial statements required by the government in order to meet the desired quality are relevant, reliable, comparable, and understandable. According to Stickney et al. (2010) reliability of financial reporting refers to **faithfulness** with which accounting information represents what it purports to represent and the extent to which the information is both **verifiable** by independent measures and **neutral** with respect to the interest of a particular user group.

Effectiveness of Internal Control System

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 each of the following categories: (a) effectiveness and efficiency of operations; (b) reliability of reporting; (C) compliance with applicable laws and regulations (COSO, 2009; Agami, 2006; Needles, et al, 2008; Narayanaswamy, 2011; Porter and Norton, 2010). Effectiveness of internal control refers to the existence of an adequate system of internal control relevant to the design of policies, rules and procedures (Wittayapoom, et. All., 2011). Effectiveness of internal control can be achieved when managers design a reasonable assurance that the goals and objectives can be achieved. Effective internal control system is supported by five elements, namely: (1) control environment; (2) risk assessment; (3) control activities; (4) information and communication; and (5) monitoring (Needles, et. al., 2008).

The Effect of Internal Control Effectiveness on The Quality of Financial Information

Issues of financial information quality supported by the existence of an effective internal control is the responsibility of management as stated by International Public Sector Accounting Standards Board (IPSASB, 2013). Internal control system is used by management in order to achieve business goals. Thus the success or failure of an organization, depends on the effectiveness of internal control (Wittayapoom, et. All., 2011). The relation between an effective internal control system and financial information quality is supported by theory (Ingram & Albright, 2007; Pfister, 2009; Rezaee & Riley, 2010; Young, 2012; Maher, et al, 2012) and previous research findings (Skaife, et.al, 2007; Wittayapoom & Limsuwan, 2011; Emmanuel et al, 2013).

The importance of internal control effectiveness in order to obtain the good quality of financial information is also supported by Agami (2006), Rittenberg (2007), Michelman (2008), Olach (2009), Elbannan (2009). Based on theory and previous research findings form a premise which shows that relation of internal control effectiveness to the quality of financial information. The hypothesis can be formulated as follow:

H1: The effectiveness of the internal control system affects the quality of financial information.

Research Methodology

In this study there are two variables: Effectiveness of Internal Control as an independent variable where indicators of variable are: 1) control environment, 2) risk assessment, 3) control activity, 4) information and communication, and 5) monitoring and Quality of Financial Information as a dependent variable where indicators of variable are: 1) relevance, 2) reliability, 3) comparability, and 4) understandability. Surveyed design was used in this study, where primary data was obtained through questionnaires which were distributed to selected respondents. The questionnaire was prepared based on indicators that were intended to determine the effect of account representative' service on tax compliance.

The population of this study is the unit of local government (SKPD) at Bandung city, totally 33 SKPD. Target population in this research is apparatus of SKPD who are carrying out daily duties, regarding financial reporting process in order to provide financial information. Questionnaires were distributed to personnel directly related to the financial reporting process such as: the head of finance department, treasurer, budgeting staff and accounting staff. Data collected by using the survey method. A total of 110 questionnaires distributed to 33 SKPD. Of the total 110 questionnaires distributed only 78 questionnaires from 22 SKPD could be collected and analyzed or with a respond rate of 70.9%.

Data was then analyzed using simple regression analysis. Simple regression analysis was intended to measure the influence of independent variable to dependent variable with a significance level 5% ($\alpha = 0,05$). Statistical hypotheses in this study are as follows:

- $H_0: \beta = 0$ means internal control effectiveness does not affect the quality of financial information.
- $H_a: \beta \neq 0$ means internal control effectiveness affects the quality of financial information.

In this study we determine the length of the class interval in order to describe the respondent answers with the following formula:

Length of class interval =	$\frac{\text{Range}}{\text{number of class interval}}$
----------------------------	--

Where: Range = Highest Value - Lowest Value
Number of class interval = 5
Length of Class Interval = $(5 - 1)/5 = 0,8$

Based on the length of the class interval, the average of respondent answers can be classified then into the following categories:

Table 4. Categories of Class Interval

Interval	Description
1,00 - 1,80	Strongly Disagree
1,81-2,61	Disagree
2,62 - 3,42	Neutral
3,43 - 4,23	Agree
4,24 - 5.00	Strongly Agree

In this study, the hypothesis testing is analyzed with simple regression method. The structural regression model in this study can be described as follows:

$$QFI = a + b EIC + e1$$

Where: QFI = Quality of Financial Information
B = Coefficient of Regression
EIC = Effectiveness of Internal Control
e1 = error term

Survey Results

Testing research instruments in this questionnaire study was conducted in two ways, validity and reliability test. Based on the results of the analysis using product moment technique obtained the following results:

Table 5. Validity Test of Variable X

Statement	R (count)	R (table)	conclusion
1	0,632	0,2227	Valid
2	0,600	0,2227	Valid
3	0,527	0,2227	Valid
4	0,498	0,2227	Valid
5	0,697	0,2227	Valid
6	0,769	0,2227	Valid
7	0,580	0,2227	Valid
8	0,620	0,2227	Valid
9	0,616	0,2227	Valid
10	0,711	0,2227	Valid
11	0,687	0,2227	Valid
12	0,647	0,2227	Valid
13	0,665	0,2227	Valid
14	0,595	0,2227	Valid
15	0,650	0,2227	Valid
16	0,705	0,2227	Valid
17	0,694	0,2227	Valid
18	0,635	0,2227	Valid
19	0,564	0,2227	Valid
20	0,570	0,2227	Valid
21	0,658	0,2227	Valid
22	0,617	0,2227	Valid
23	0,714	0,2227	Valid
24	0,646	0,2227	Valid
25	0,213	0,2227	Not Valid
26	0,573	0,2227	Valid
27	0,619	0,2227	Valid
28	0,757	0,2227	Valid

Based on the analysis in Table 5, it is known that all statements other than statements item number 25 has a correlation coefficient (r count) greater than r table (0.05;76), meaning that all items are valid and can be analyzed except for the statement No. 25.

Table 6. Validity Test of Variable Y

Statement	R (count)	R (table)	conclusion
1	0,697	0,2227	Valid
2	0,721	0,2227	Valid
3	0,663	0,2227	Valid
4	0,670	0,2227	Valid
5	0,711	0,2227	Valid
6	0,776	0,2227	Valid
7	0,600	0,2227	Valid
8	0,694	0,2227	Valid
9	0,802	0,2227	Valid
10	0,637	0,2227	Valid
11	0,666	0,2227	Valid
12	0,799	0,2227	Valid
13	0,783	0,2227	Valid
14	0,797	0,2227	Valid

Based on the analysis in Table 6, we can see all items have correlation coefficient (r count) greater than r (table), meaning that all items are valid, therefore all data can be further processed. After validity test, then doing reliability test. Testing reliability of all items using Cronbach Alpha techniques (α) with the help of SPSS.

Table 7. Reliability Test of Variable X

Reliability Statistics

Cronbach's Alpha	N of Items
.943	27

Based on the analysis in Table 7, we can see that Cronbach Alpha value of 0.943 is greater than 0.6, so it can concluded that all items in the statement of independent variable (X) are reliable.

Table 8. Reliability Test of Variable Y

Reliability Statistics

Cronbach's Alpha	N of Items
.924	14

Based on the analysis in Table 8, shows that the Cronbach Alpha value of 0.924 is greater than 0.6, so it can be concluded that all items in the statement of dependent variable (Y) are reliable.

Data analysis to describe respondents are as follow:

Table 9. Demographics of respondents

Description	Number of People	Percentage
Gender:		
• Male	34	43,59 %
• Female	41	52,56 %
• No Answer	3	3,85 %
Age:		
• > 20-30 years	5	6,41 %
• > 30 – 40 years	27	34,61 %
• > 40 – 50 years	25	32,05 %
• > 50 years	8	10,26 %



• No Answer	13	16,67 %
Level of Education:		
• High School	7	8,97 %
• Diploma	3	3,85 %
• Bachelor	49	62,82 %
• Magister/Doctoral	10	12,82 %
• No Answer	9	11,64 %
Educational Background:		
• Accounting	18	23,08 %
• Economics (Non Accounting)	14	17,95 %
• Others (Non Economics)	35	44,87 %
• No Answer	11	14,10 %
Work Experience:		
• < 5 years	29	37,18 %
• 5 – 10 years	16	20,51 %
• 11 – 15 years	7	8,97 %
• > 15 years	10	12,82 %
• No Answer	16	20,51 %

From Table 9 it can be concluded that in general, most of sectors in Bandung city especially in finance department has not been supported by the personnel with adequate competence. This will certainly have an impact on the effectiveness of internal control systems and ultimately on the quality of financial information. Descriptive analysis of both variables are described in the table below:

Table 10. Descriptive Analysis of Internal Control Effectiveness

Variable	Dimension of control environment	Score of respondent answers					average
		5	4	3	2	1	
X1.1	Integrity and ethical value	34	39	4	1	0	4,36
X1.2	Integrity and ethical value	34	40	3	1	0	4,37
X1.3	Commitment to competence	5	48	18	6	1	3,64
X1.4	Commitment to competence	6	55	17	0	0	3,86
X1.5	Leadership Conducive	21	54	3	0	0	4,23
X1.6	Leadership Conducive	21	50	6	1	0	4,17
X1.7	Organizational structure as needed	14	61	2	1	0	4,13
X1.8	Organizational structure as needed	14	57	6	1	0	4,08
X1.9	Delegation of authority and responsibility	8	53	16	1	0	3,87
X1.10	Delegation of authority and responsibility	8	60	9	1	0	3,96
X1.11	Human Resource Development Policy	7	59	11	1	0	3,92
X1.12	Human Resource Development Policy	7	56	14	1	0	3,88
Average							4,04
Variabel	Dimension of risk assessment	Score of respondent answers					average
		5	4	3	2	1	
X1.13	Risk identification	14	57	7	0	0	4,09
X1.14	Risk identification	9	63	2	4	0	3,99
X1.15	Risk analysis	17	55	5	1	0	4,13
X1.16	Risk analysis	14	55	9	0	0	4,06
Average							4,07
Variable	Dimension of control activity	Score of respondent					Average



		answers					
		5	4	3	2	1	
X1.17	Performance review	14	55	8	1	0	4,05
X1.18	Human resource development	13	48	14	3	0	3,91
X1.19	Segregation of function	19	53	5	1	0	4,15
X1.20	Authorisation of transaction and events	12	57	7	2	0	4,01
X1.21	Recording accurate and timely	10	59	6	3	0	3,97
X1.22	Accountability of resources	10	49	16	3	0	3,85
X1.23	Documentation of internal control system	9	57	9	3	0	3,92
Average							3,98
Variabel	Dimension of information and communication	Score of respondent answers					Average
		5	4	3	2	1	
X1.24	Means of communication	10	52	14	2	0	3,90
Average							3,90
Variabel	Dimensi of monitoring	Score of respondent answers					Average
		5	4	3	2	1	
X1.26	Sustainable monitoring	16	60	1	1	0	4,17
X1.27	Separation of evaluation	9	61	7	1	0	4,00
X1.28	Follow-up	12	64	1	1	0	4,12
Average							4,10
Average Score of Internal Control Effectiveness (X)							4.02

From Table 10 above, it appears that the overall average score for the internal control system variable is 4.02, which means the effectiveness of the application included in both categories. It can be concluded that the overall implementation of the internal control system in SKPD in local government at Bandung city has already been effective.

Tabel 11. Descriptive Anaysis of financial information quality

Variable	Dimension of relevance	Score of respondent answers					Average
		5	4	3	2	1	
Y1.1	Benefits of Feedback	13	58	6	1	0	4,06
Y1.2	Benefits of Predictive	16	58	1	2	1	4,10
Y1.3	Timely	12	62	3	1	0	4,09
Y1.4	Completeness	12	58	7	0	1	4,03
Average							4,07
Variable	Dimension of reliability	Score of respondent answers					Average
		5	4	3	2	1	
Y1.5	Penyajian Yang Jujur	12	64	2	0	0	4,13
Y1.6	Dapat Diverifikasi	16	60	1	1	0	4,17
Y1.7	Netralitas	13	52	12	1	0	3,99
Average							4,10
Variable	Dimension of comparability	Score of respondent answers					Average

		5	4	3	2	1	
Y1.8	Consistency in the application of accounting policies	22	56	0	0	0	4,28
Y1.9	Information can be compared with the previous period	13	57	7	1	0	4,05
Y1.10	Information can be compared with other entities	9	55	12	2	0	3,91
Average							4,08
Variable	Dimension of understandability	Score of respondent answers					Average
		5	4	3	2	1	
Y1.11	Using a term that is understood	15	57	5	1	0	4,10
X1.12	Using a format that is understood	19	55	4	0	0	4,19
X1.13	Using classification of the post in accordance with the standards	18	59	1	0	0	4,22
X1.14	Using accounting procedures in accordance with the standards	19	57	2	0	0	4,22
Average							4,18
Average score of information quality (Y)							4,11

Based on the descriptive analysis in Table 11, we can see that the overall mean score for the variable quality of the financial reporting is 4.11 which means that the level of achievement included in the category of good quality. In other words, we can say that in average, the financial information generated by SKPD in Bandung city has a good quality which have characteristics such as: relevant, reliable, comparable and understandable. In order to know the effect of independent variable (X) to the dependent variable (Y), we have done statistical t-test with the following result:

**Table 12. Statistical t-test
Coefficients**

Model	Unstandardized Coefficients		Standardized Coefficients	t	Sig.
	B	Std. Error	Beta		
1 (Constant)	15.302	5.661		2.703	.008
X1	.385	.050	.664	7.737	.000

a. Dependent Variable: Total_Y

Based on the analysis presented in Table 12, the structural regression equation is as follows:

$$QFI = 15,302 + 0,385 EIC + e1$$

Where: QFI = Quality of Financial Information
EIC = Effectiveness of Internal Control
e1 = error term

It is shown that the significance value (0.000) < α (0.05), therefore H0 is rejected and Ha is accepted. It can be concluded that the effectiveness of the internal control system variable has a significant effect on the quality of financial information.

In order to know the ability of the model to explain variation in the dependent variable (X) we have done coefficient of determination test with the following result:

Table 13. Coefficient of Determination Test
Model Summary

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	.664	.441	.433	6.08233

a. Predictors: (Constant), X1

b. Dependent Variable: Total_Y

Based on the analysis, as described in Table 13, it can be seen that the R Square value is 0.441, hence the variation in the quality of financial information as of 44.1% may be explained by variation in the effectiveness of the internal control system, while the remaining 55.9% is explained by other causes from outside of the model. The effectiveness of the internal control system within the government is measured by five dimensions, namely the control environment, risk assessment, control activities, information and communication, as well as monitoring.

Conclusions, Limitations and Recommendations

Conclusions

The result of this research conclude that the effectiveness of internal control system has a positive effect on the quality of financial information. This support the theory which has been stated previously that the effectiveness of internal control system affects the quality of financial information.

Limitations of Research and Recommendations

This research has limitations in variability and size of the sample; hence its findings could only result in the Preliminary Conclusions so far. As variability of SKPD are limited only to Bandung city, the results may not necessarily reflect the situations of SKPD in other provinces in Indonesia. Hence it is recommended that further research could be conducted to examine more SKPD in other provinces in Indonesia.

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