The Zeitgeist of "Financial Reporting Quality" Predictors: An Empirical Study among Local Governments (Districts) in Indonesia

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Abstract The research investigated the relationship among FRQ, ICS, RPM, and COR as moderating variables. The research recommends that local governments should improve in the field of financial management and implement an effective internal control system. Aligning the research problem and objectives, this research adopted the agency theory for local government. This theory includes information asymmetry, where the agent has more information and understands more about the actual financial position than the principal. Modern democracies are based on a series of principal-agent relationships, which may lead to problems in the public sector. In this research, 257 qualified questionnaires were collected from local governments in Indonesia, using self-administered surveys. Furthermore, Partial Least Square-Structural Equation Modelling (PLS-SEM) technique was used for data analysis. The results showed that ICS, COR, and RPM have a positive relationship with FRQ, while the hypothesis that COR strengthens the effect of ICS on FRQ was rejected. High COR does not significantly improve the FRQ without being supported by a good ICS. With a high or low COR, the ICS will continue to be carried out properly by leaders and superiors. Therefore, a good COR does not significantly moderate the effect of the ICS on the FRQ. The quality of financial reports is the result of accounting activities that can provide financial information which can be understood by users and be used for

decision-making in the future.

Keywords Internal Control System and Regulation on Performance Measurement, Commitment to Organization, Financial Reporting Quality

1. Introduction

The consistently low performance of local governments (districts) in Indonesia regarding accountability reports and financial performance for 2015-2019 fell below 25% of the total regional income or was included in the pattern of instructive relationships. This constitutes a problem, as the financial capacity of local governments is still heavily dependent on revenues and loans from the central government [1]. Meanwhile, the performance of local governments is intended to improve accountability, transparency, organizational management, and service improvement to society. Accountability is a significant mediator between quality financial reporting and organizational performance. Local governments in Indonesia have a problem with accounting employees aged 50 years having lower performance than younger employees, different educational backgrounds are not a significant obstacle because training is carried out to have

the same knowledge and abilities. This is especially true for public organizations that aspire to enhance performance using a better-designed accountability system [2], [3]. Furthermore, accurate and precise recording of financial transactions increases performance effectiveness and accountability [4].

Local governments are required to follow the regulation criteria Number 71/ 2010 when drafting financial reports. Regional financial losses occur, alongside lack of revenue, administrative weakness, inefficiency, and ineffectiveness when not following the legislation. In many local governments, the current quality of financial reports does not meet the standards. These include Pematang Siantar, Padang Sidempuan, Medan, Labuhanbatu, North Labuhanbatu, Central Tapanuli, Nias, Padanglawas, Langkat, North Nias, Mandailing Natal, Pakpak Baarat and Karo, Simalungun, West Nias, South Nias, and Tanjungbalai, Karo, Mandailing Natal, and Pakpak Bharat [5]. Many districts with these problems in Indonesia are located in Indonesia; therefore, the financial reporting quality of the Indonesian government is low [6].

In Figure 1, the phenomenon of the gap in financial independence between regions (province, city, and districts) is very high, starting from 2015-2019. The percentage of financial independence shows a very striking difference between province, city, and districts. At the local government level (district) from 2015-2019, it can be seen that the level of regional independence is still very low, which is below 25%, which is included in the instructive relationship pattern, meaning that the district government in Indonesia is unable to carry out regional autonomy financially, it can be seen in the percentage in figure 1, increase or decrease in numbers from 2015-2019. In 2015, the independence ratio was 9.30%, decreased to 8.64% in 2016. Meanwhile, in 2017, this level increased

again to 11.71% but decreased to 10.52% in 2018 and 10.50% in 2019. This indicates that the level of financial reporting on the island is low. In addition, local governments are not able to finance regional activities independently. This shows that the level of financial reporting of local governments (districts) is low compared to provinces and cities. In addition, local governments are not able to finance regional activities independently.

According to the Medan business newspaper (26 June 2019), there are several local governments which did not finance local activities were (e.g., Asahan, North Tapanuli, Toba Samosir, North Padanglawas, Samosir, Batubara, Humbang Hasundutan, South Tapanuli, Serdang Bedagai, Deli Serdang, Dairi and South Labuhanbatu) [7]. The newspaper (Medan, Gatra.com/March 30 2019) also reported that the local governments (district) that had not submitted financial reports to the BPK for auditing, including South Nias, West Nias, Tanjung Balai, Karo district, Mandailing Natal, and Pakpak Bharat [8]. Government financial reports were also weak, namely Pematang Siantar, Padang Sidempuan, Medan, Labuhanbatu, North Labuhanbatu, Central Tapanuli, Nias, Padanglawas, Langkat, North Nias, Mandailing Natal, Pakpak Bharat and Karo [8]. The newspaper "Rakyat Media, November 4, 2019, reported the performance of the Local Government (District) of Anambas to be poor. Several Indonesian local governments generally failed to comply with the law and operations of the financial report due to various points of weakness, which rendered it problematic and inadequate. There were problems such as lack of revenue and administrative irregularities. Therefore, the Audit Board of the Republic of Indonesia instructed the Anambas district government to recover the country's loss.

Figure 1. Independent Level in Local Government of Province, City and Districts 2015-2019 (Audit Board of the Republic of Indonesia, 2020)

The local newspaper in South Bengkulu (district) stated fixed assets worth Rp. 35.48 billion whose whereabouts are unknown. Therefore, it was grouped into other assets, which led to problems in the internal control system and violations of laws and regulations. Furthermore, opinions of the local newspaper's newspaper opinions on South Bengkulu's financial report did not change [9], which constitutes a significant problem for local governments. The weaknesses in the accounting and financial reporting system include the lack of orderly preparation and application following government financial accountability report principles, such as the Government Accounting Standard No. 71/ 2010. This standard was established based on regulations [10], where local governments can administer their financial management [11].

Deviations and leaks are still found in the finance report, which shows that the quality of financial reporting is not yet standard [12]. There is a problem of lack of revenue and irregularities in the administration of state finance, which is a weakness of the local governments in Indonesia [13], [14]. The financial reports have decreased due to many errors in reporting from District Governments in Indonesia [15], [16]. Based on Law No. 15/ 2004 concerning the Audit of State Financial Management and Accountability in Indonesia, providing audit opinions to produce financial reporting quality are based on general criteria. These include the effectiveness of the internal control system, compliance with applicable laws and regulations, and compliance with Government Accounting Standards No. 71/ 2010 [17].

The contribution of this research is contributing to examine examining issues related to the financial reporting quality assessment in local governments. The results are expected to give input and feedback to prepare and evaluate accounting standards in developing, improving, and selecting the financial reporting quality policies in a local government. Furthermore, this research can also be used to evaluate the local government financial reporting quality and give provide motivation to the government related to using public funds and other entrusted assets. This is because it provides an overview of the consolidated state of affairs and resources and improves the characteristics of accountability, decision making, understanding, comparability, verification, and timeliness. It is an important element of financial reporting information, which enhances significant decisions.

2. Literature Review

The agency theory explains the agreement (contract) between the principal and agent, where the principal permits the agent to make decisions on their behalf [18]. Therefore, agency theory is the relationship between the principal and the agent [19]. This theory is used to

ascertain how an individual delegates responsibility to others [20]. According to this theory, someone who delegates a job to which they are responsible is called principal, and individuals who accept jobs are called agents [21]. Furthermore, Indonesia's current local government believes that the courts have been convicted for misusing local revenue and spending budgets. This is likely due to a large legislative role in budgeting, especially at the planning or formulation stages of budget policy and approval. Allegedly, there was a budget allocation and estimation because of the personal interest of some politicians [22].

The internal control system is important in every organization because it directly affects the financial report quality issued to users. The managers in insurance companies should regularly review the internal control system and hire qualified staff for the internal audit department [23].

Hypothesis 1: ICS positively affects FRQ

Irrespective of organizational commitment, the internal control system may be carried out properly by the leadership and superiors. Therefore, good organizational commitment may not necessarily be able to moderate the influence of internal control on the quality of financial reporting [24]. Organizations without an existing internal control system are generally considered to be open to risk and may bring down an institution in a short time. This also brings the possibility of fraud and loss of organizational funds by staff, thereby damaging financial reports [25]. Meanwhile, internal control over the quality of financial reporting expresses a positive objective, especially when all parties in the organization involved comply with their duties. It enables the quality of financial reporting to be comparable, understandable, relevant, and reliable [26]. In addition, a good internal control system helps organizations prevent fraud, errors and minimize waste [27].

Furthermore, it is impossible to eliminate regulations that are impossible to stop, as they exist to improve the financial reporting quality [28]. Law enforcement is important because it enhances and guarantees financial reporting quality [29]. A country's legal and regulatory system significantly affects financial reporting quality but is yet to be explored in accounting literature. The country's regulations determine the quality of the annual reports [30].

Hypothesis 2: ICS significantly influences FRQ with COR as a moderator.

The commitment to goals is crucial for manager productivity to determine whether the organization can achieve its goals [31]. High-performing organizations choose the best strategies for integrating their components, activities, core processes, and resources to support the achievement of the mission [32]. Commitment shows the

employee's loyalty to the company reflected through continuous participation in decision-making, attention to members, and the prosperity of successful organizations [33]. Therefore, commitment to the organization is seen as employee loyalty to their employer [34]. Individuals' identification and involvement with a particular organization are more significant than perceived loyalty [35]. Commitment to the organization is significant when employees are more interested in maintaining work relationships [36].

Local government financial reports are an essential component for Indonesia to realize public financial management accountability [37]. Therefore, increasing demand for the implementation of public accountability has implications for management in government institutions to provide information to the public, which includes information about financial reports [38]. The function of information in financial reports will not have benefits if the presentation and delivery of financial information are unreliable and not timely [39].

Hypothesis 3: COR positively affects FRQ

Regarding the compliance with the regulation for financial reporting quality, the results are consistent with the reason that the financial reporting quality must be improved by an implemented regulation [40]. Regulations are impossible to eliminate, as they exist to improve the quality of financial reporting [28]. Law enforcement helps to increase and guarantee financial reporting quality [29]. One of the important factors that affect financial reporting quality that is yet to be explored in accounting literature is the country's legal and regulatory system. There are limited studies on the environmental laws and effects of regulation on quality financial reporting. This is because a country's laws play a very important role in establishing the quality of the company's annual report [30].

Hypothesis 4: RPM positively affects FRQ

In this research, based on agency theory, the relationship between ICS, RPM, COR, and FRQ in a theoretical model is shown in Figure 2.

3. Data and Methodology

The respondents amounted to 257 people from various positions such as head of accounting, senior and junior accounting which constitute the financial management in local governments (Districts) in Indonesia. Furthermore, data were collected through questionnaires delivered to the respondent's workplaces. This approach tends to have a higher response rate than sending a questionnaire by mail or post [41].

Table 1. Demographic Characteristics of the Respondents

Demographic	Category	n	%
Gender	Male	102	39.7
	Female	155	60.3
Age	<25	40	15.57
	25-37	62	24.12
	38-50	121	47.09
	>50	34	13.22
Education	Bachelor Degree	165	64.20
	Master Degree or Above	92	35.80
Position	Head of Accounting	87	33.85
	Senior Accounting	92	35.80
	Junior Accounting	78	30.35

Figure 2. Theoretical Framework

The demographic characteristics of the respondents in this study are the profiles of the 257 respondents who filled out this questionnaire. The characteristics of these respondents include gender, age, education, and position in local government in Indonesia. Male respondents were 102 (39.7%), while female respondents were 155 (60.3%). As for age, 40 (15.57%) respondents were <25 years, 62 (24.12%) were 25-37 years, 121 (47.09%) were 38-50 years and 34 (13.22%) were >50 years. People who got a Bachelor's Degree were as many as 165 (64.20%) and Master's Degree or Above 92 (35.80%). Positions in the Head of Accounting category were 87 (33.85%), Senior Accounting 92 (35.80%), and Junior Accounting 78 (30.35%). The demographic characteristics of the respondents are given in Table 1.

The technique of data collection in this research is known as snowball sampling. First, 15 employees from several local governments in Indonesia who were willing to participate in the survey were identified. They, in turn, asked other groups and communities if they would like to be involved in this online survey and received 257 positive responses. The measurement items in the questionnaire were seven-point Likert scales and adapted from ICS 26 items [42]; RPM 5 items [43]; COR 15 item [44]; FRQ 4 items [45].

The Partial Least Square (PLS) with Structural Equation Modeling (SEM) was used to analyze data and test the validity of statistical conclusions [46]. Specifically, SmartPLS was used, one of the most common software with favorable terms, methodological options, and ease of use [47].

4. Results

The first stage of PLS-SEM evaluation was the model measurement. The model validity was established before conducting the hypothesis test and ensuring the efficiency

of the instrument. The composite reliability was tested first because it is related to validity. The ideal composite reliability value should be above 0.7 [48]. Table 2 shows that the composite reliability value of COR, FRQ, ICS, RPM are above 0.7 and meet the convergent validity criteria.

Table 2. The result of Composite Reliability

Model Construct	Item	Composite Reliability
COR	15	0.927
FRQ	4	0.900
ICS	26	0.990
RPM	5	0.933

Meanwhile, the convergent validity of this model should be tested by researchers. According to the guidelines [48], regarding the measurement of an element of convergent validity, for an acceptable convergent validity, the factor loading requires > 0.70 . The average variance extracted (AVE) has to be > 0.50 . Table 3 displays the convergent validity of the 4 variables. Based on table 2, the factor loading of COR, FRQ, ICS, RPM is greater than 0.7 with AVE above 0.5; hence, the convergent validity is met. Based on the tests carried out, it was observed that five indicators were declared invalid, with the value of outer loading ≥ 0.40 but < 0.70 . Therefore, these indicators must be removed to review the results of the outer loading generated to ensure continuation with the next step [48]. With the removal of the invalid indicator, the test results obtained are shown in Table 3.

The discriminant validity falls under construct validity. Table 3 shows that the square root of the model constructs AVE was greater than the squared correlations. Therefore, the discriminant validity of the variable is met and recognized.

Table 3. The result of Convergent Validity

Model Construct	Measurement Items	Loading	AVE
COR	COR 1	0.842	0.759
	COR 2	0.981	
	COR 3	0.210	
	COR 4	0.881	
	COR 5	0.828	
	COR 6	0.834	
	COR 7	0.372	
	COR 8	0.877	
	COR 9	0.384	
	COR 10	0.840	
	COR 11	0.325	
	COR 12	0.424	
	COR 13	0.894	
	COR 14	0.806	
	COR 15	0.308	
FRQ	FRQ 1	0.769	0.694
	FRQ 2	0.829	
	FRQ 3	0.800	
	FRQ 4	0.926	
ICS	ICS 1	0.921	0.796
	ICS 2	0.942	
	ICS 3	0.878	
	ICS 4	0.869	
	ICS 5	0.898	
	ICS 6	0.953	
	ICS 7	0.836	
	ICS 8	0.929	
	ICS 9	0.877	
	ICS 10	0.862	
	ICS 11	0.915	
	ICS 12	0.926	
	ICS 13	0.894	
	ICS 14	0.917	
	ICS 15	0.960	
	ICS 16	0.841	
	ICS 17	0.814	
	ICS 18	0.861	
	ICS 19	0.833	
	ICS 20	0.850	
	ICS 21	0.899	
	ICS 22	0.994	
	ICS 23	0.835	
	ICS 24	0.880	
	ICS 25	0.938	
	ICS 26	0.845	
RPM	RPM 1	0.782	0.737
	RPM 2	0.869	
	RPM 3	0.955	
	RPM 4	0.843	
	RPM 5	0.835	

Table 4. Discriminant Validity of Constructs

Constructs	COR	FRQ	ICS	RPM
COR	0.705			
FRQ	0.661	0.833		
ICS	0.611	0.710	0.892	
RPM	0.307	0.503	0.246	0.859

The R2 values show the quality of the variable reflected by the structural model specifications. The approved value of R2 is between 0 and 1[48].

The communality and redundancy value can be explored as additional structural model specification pillars. The ideal structural model value of communality should be greater than 0.4 and lower than 0.10 for redundancy. Table 4 displays the values of the structural model specification variables.

As shown in Table 4, all constructs have met the criteria for communality validity. The redundancy validity was approved even though the FRQ value was higher than 0.1 concerning R2 value and communality. Therefore, all

constructs met the structural model validity criteria.

Table 5. Structural Model Specification

Constructs	R2	Communality	Redundancy
COR	Predictor	0.759	Predictor
FRQ	0.672	0.694	0.466
ICS	Predictor	0.796	Predictor
RPM	Predictor	0.737	Predictor

Hypothesis testing is also referred to as bootstrapping technology. Figure 4 shows the PLS Bootstrapping for the research model.

This study has four hypotheses, which were tested using Partial Least Square (PLS). As shown in the Hypothesis Testing in Table 6, ICS has a statistically positive effect on the FRQ (H1), ICS has a statistically positive effect on the FRQ, COR strengthens the effect of ICS on FRQ is rejected (H2), COR has a statistically positive effect on the FRQ (H3) and RPM has a statistically positive effect on the FRQ (H4).

Figure 3. The Structural Model for Individual Latent Variables**Table 6.** Hypothesis Testing

Hypothesis	Relationship	Original Sample	Standard Deviation	T Statistics	P Values	Supported
H1	ICS → FRQ	0.457	0.049	9.340	0.000	Yes
H2	COR X ICS → FRQ	-0.039	0.040	0.956	0.339	No
H3	COR → FRQ	0.245	0.080	3.070	0.002	Yes
H4	RPM → FRQ	0.303	0.056	5.432	0.000	Yes

4.1. Relationship between Internal Control System (ICS) and Financial Reporting Quality (FRQ)

The effect of ICS on FRQ had a statistical value of 9,340 and a p-value of 0.000. The P-value was lesser than $\alpha = 0.05$; therefore, it has a statistically positive effect on the FRQ. The research (H1) is true that good ICS improves the FRQ, and ICS plays an important role in meeting the objectives of managing public finances, the state economy, making informed decisions, and minimizing corruption [26]. The implementation of the ICS was able to improve the reliability and objectivity of information, prevent inconsistencies, and facilitate the process of auditing financial reports to create FRQ because ICS is the basis of the entire process of securing and managing state assets, and every government institution must encourage the availability of all state financial managers who have a strong awareness of the importance of internal system enforcement [49]. An effective internal control system will assure that the preparation of FRQ is consistent with recognized accounting principles and standards [50]. It is intended to give adequate assurance to achieve effective and efficient management based on Government Regulation No. 60/2008, among others: control environment, risk assessment, control activities, information and communication, and monitoring. This means that the better the implementation of the ICS implementation element, the better the quality of the local government financial reports produced. The implementation of the ICS can improve the reliability and objectivity of information, prevent inconsistencies, and facilitate the process of auditing financial statements to create FRQ [49], [51]. This research is in line with [52],[23].

4.2. Internal Control System (ICS) effect on Financial Reporting Quality (FRQ) to be moderated Commitment to Organization (COR)

The effect of ICS on FRQ using COR as a moderator had a statistical value of 0.956 and a p-value of 0.339. The P-value was greater than $\alpha = 0.05$; statistically, COR does not moderate the effect of ICS on FRQ. Therefore, the hypothesis (H2), which states that COR strengthens the effect of ICS on FRQ, is rejected. High COR is not enough to improve the FRQ without being supported by a good ICS. The COR failed to moderate the effect of ICS on the FRQ. Whether high or low COR, the ICS will continue to be carried out properly by leaders and superiors; therefore, a good COR may not necessarily moderate the effect of system COR and ICS on the FRQ [24]. To minimize fraud, employees need to consider the quality of Internal Control and perceived fairness of organizational rules and policies, most of which are sourced from controlled finance or the chief accountant of an organization to achieve FRQ [53].

In an organization, the roles and policies taken by top

management are very decisive because every work done by subordinates only follows what is ordered by the superior or pleases the boss. Therefore, if they are not in line with the policies taken by the leadership, good SPI and COR will certainly not improve the FRQ produced. Local governments must also always motivate employees in the finance department so that competent human resources have high COR because they can improve the financial performance of local governments in preparing FRQ. Employees or subordinates who have a high commitment to their organization will use the budget to assist leaders in achieving organizational goals. Employees will tend to avoid and minimize the occurrence of budget slack because subordinates who have high COR will seek to develop the organization in a better direction. Subordinates with low COR will use budget planning and implementation to achieve personal interests, creating budget slack. The level of COR, the internal control system, will still be carried out properly by the leadership and superiors, so that good COR may not necessarily be able to moderate the influence of the COR, ICS on the FRQ. This research is in line with [24].

4.3. Commitment to Organization (COR) and Financial Reporting Quality (FRQ)

The influence of COR on FRQ had a statistical value of 3.070 and a p-value of 0.002. The P-value was smaller than $\alpha = 0.05$; therefore, it affects the FRQ statistically. The hypothesis (H3), which states that COR positively affects FRQ, is accepted. These results prove that when an employee is highly committed to achieving organizational goals, the output will be better, and vice versa, related to financial reports produced by regional work units. The Local government's commitment to financial management will improve the quality of the report as per the regulatory standards. This commitment involves job attitudes or beliefs that reflect the relative strength of partisanship and involvement of individuals in organizations in particular [54]. Commitment shows the enthusiasm to work hard, utilize energy and time on a job or activity. Therefore, it involves more than passive loyalty and includes active relationships and aspiration to contribute to the organization effectively [55]. Contribution in the management of state finances is to producing financial reports quality for the presentation, disclosure of all financial transactions, and control of all assets to get a good opinion from the auditor.

4.4. Relationship between Regulation on Performance Measurement (RPM) and Financial Reporting Quality (FRQ)

The influence of RPM on FRQ had a statistical value of 5.432 and a p-value of 0.000. The P-value was smaller than $\alpha = 0.05$ and had a statistically positive effect on the FRQ. Therefore, hypothesis (H4), which states that RPM

positively affects the FRQ, is accepted. The results are consistent with why the FRQ must be improved by implementing regulations [40]. Regulations are impossible to eliminate and exist to improve the FRQ [28]. Law enforcement is important because it enhances and guarantees FRQ [29]. There is no need to be afraid of stricter regulations such as laws, and this is related to transparency; it can allow the company/organization to be high-performing to show its performance, increasing its competitive advantage [56]. It does not matter whether it is against other relevant laws and regulations. This transparency allows promoting access to information, and thereby increasing citizens' trust [57]. Transparency has become the main instrument of regulation. Legislators require public institutions to disclose information about their activities that affect public welfare. Transparency in the laws and regulations is required when governing accounting services to these citizens [58]. The need for financial transparency was first mentioned in Law 17/2003 concerning State Finance, confirmed as a significant factor in the state finances accountability. Government transparency in the state finances management and accountability is important. The public disclosure of financial reports shows "transparency" and "accountability" of state financial management. The regulation explains several reasons that require public bodies to be transparent in terms of information to citizens, guarantee citizens' rights, know plans for making public policies, public policy programs, and public decision-making processes, as well as the reasons for making a public decision. This research is in line with [57], [59].

5. Conclusions and Suggestions

Overall, this research investigated the relationship between FRQ, ICS, RPM, and COR as moderating variables. From the results, the proposed model provided insight and understanding of the relationship between each variable that affects financial reporting quality. Furthermore, the model showed a moderating effect of COR on the relationship between ICS and FRQ. This research recommends that local governments should improve in the field of financial management and implement an effective internal control system. This provides sufficient confidence for stakeholders that local government financial management was carried out in a transparent and accountable manner. Furthermore, commitment to the organization becomes an important part because it plays a role in change, implementation, and decision-making. It can increase discipline in accountability and challenges for local governments to improve the quality of financial reports. The public still pays attention to or demands financial reporting quality, which is used as a service and community need. Thus, to realize the performance required by the community

requires financial quality and accounting management. Local governments must be committed to encouraging their human resources to comply with regulations and perform to produce quality financial reports. This study also found that the local government in Indonesia had problems with accounting employees aged ≥ 50 years having lower performance compared to younger employees. Different educational backgrounds are not a significant obstacle because training is carried out to have the same knowledge and abilities.

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