
The Follow Up of Auditing Results, Accountability of Financial Reporting and Mediating Effect of Financial Loss Rate: An Empirical Study in Indonesian Local Governments

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Abstract:

This study aimed to analyze the effect of the follow-up of financial investigation results on the financial reporting accountability and to examine the influence of follow-up of financial investigation on the level of financial losses.

This research was conducted in all the municipalities and cities in Indonesia by purposive sampling method from the period of 2011-2014, with the number of observations as much as in 1152.

Data analysis was performed with the Structural Equation Model (SEM) with Warp-PLS Program 5.0 and Sobel test method to test the mediating variable. The results showed that follow-up of financial investigation reduces the level of financial losses, thereby increasing the accountability of local government financial reporting.

Keywords: *follow-up of auditing results, financial loss, financial reporting accountability.*

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1. Introduction

Accountability along with transparency is a key issue for the organizers of an administration. Based on the law number 17 of 2003 on State finances, the realization of accountability and transparency is reflected in the preparation of the financial statements. Setyaningrum *et al.* (2015) states that the financial report is a monitoring tool that is used to reduce the information asymmetry in the concept of an agency relationship. Therefore, the role of the auditor is needed in mitigating the agency relationship as an independent party assessing the fairness of the government's financial report.

In Indonesia, based on the law no. 15 of 2006 on the Supreme Audit Board (*Badan Pemeriksa Keuangan/BPK*, hereinafter referred to as the board, or in its Indonesian abbreviation, BPK) strengthen the position of the board as a state institution that is free and independent in checking the management and financial responsibility of the State. Thus, the BPK acts as an independent examiner assigned to evaluate the accountability of government financial reporting which aims to provide information to the public on the government's financial management processes. BPK's auditing results include audit opinion, audit findings and recommendation of inspection result.

Based on the results of the 2015's BPK summaries on Local Government Financial Report (*Laporan Keuangan Pemerintah Daerah/LKPD*, referred to as the report or LKPD) shows that the BPK provide unqualified opinions for 252 LKPD or 47 per cent of the total 539 LKPD in 2014. Development of opinion on 539 LKPD in 2014 compared to the previous year (2013) has increased considerably. The amount of LKPD obtained unqualified opinions has increased from 156 LKPD to 252 LKPD or increases by 18 per cent. However, the opinion still showed an increase accountability of local government financial reporting remains low as seen unqualified opinion that is still less than 50 per cent. Lack of financial accountability due to the less performant local government in performing the duty of follow up on the auditing results of BPK as a form of state finance manager obligations as stipulated in the law no. 15 of 2004. The BPK's summaries show that until 2014 the percentage of recommendations that has been followed up based on the recommendation amounted to 54.13 per cent. In addition, the number of loss findings in 2014 as many as 2,630 findings or decreased from 2013 by 2,818 findings.

Based on this phenomenon, this study aimed to analyze the effect of the follow-up of auditing results on the financial reporting accountability of local governments through financial loss rate. Some empirical research related to follow-up the results of financial investigation on the financial accountability state that the auditee efforts in following up the results is a factor that can increase financial accountability (Kennedy, 1993; Gendron, Cooper & Townley, 2001). In addition, Liu and Lin (2012), Reinikka & Svensson, (2005) stated that following up on recommendations

can reduce the level of corruption. It is also in line with research of Setyaningrum *et al.* (2015) finding that the follow-up of auditing results can reduce audit findings that can improve the financial accountability or similarly increase the results of the audit opinion. This study is different from the research done by Setyaningrum *et al.* (2015). The differences in this study look at the magnitude of the effect of the level of financial losses as part of the findings of the compliance of legislation. In addition, the research is also done at the regional administration level of districts / municipalities in Indonesia from 2011 to 2014. Therefore, these differences become the originality of this study compared with previous studies.

2. Literature Review and Hypothesis Development

In the context of this study, the accountability of financial reporting of local government that proxied by the audit opinion on LKPD assumed to serve as the basis of legitimacy provided by the parties interested in the local government, especially the local community. Local governments provide information to reduce information asymmetry between entities and external parties. In fulfilling the legitimacy, local governments signal to external parties that the obligation to follow up on the results of financial investigation will increase accountability and reduce the level of financial losses (Deis Jr, & Giroux, 1992; Giroux & Shields, 1993).

2.1 Legitimacy Theory

The basic assumption of the theory of legitimacy as stated by Suchman (1995) is that the legitimacy of the organization will be formed when there are conditions of organizational behaviour in line with the expectations of the parties around the organization running its activities. When the legitimacy of the organization becomes diminished, it will have consequences for the reduced flow of resources received and the adverse impact on the achievement of organizational goals. Therefore, it is important for organizations to design and manage organizational institutions to protect or maintain legitimacy (Gabrini, 2013; Deegan, 2002; Setyawati *et al.*, 2017; Hapsoro and Suryanto, 2017). This is also in line with Power's (2003) statement which states that with increasing demands on current organizational transparency and accountability the audit plays an important role in producing legitimacy.

In the context of this study, by considering the needs of local governments on the legitimacy from the community and the government to support the implementation and finance the regional development programs, the local governments will always strive to improve its credibility, especially in relation to the financial management marked by the remarkable achievement of the audit opinion (Fontanella & Rossietta, 2014).

2.2 Government Audit

Auditing is functioned as to provide assurance on the fairness of presentation of financial statements in describing the actual economic activity (Dye, 2007; DeAngelo, 1981; Vovchenko *et al.*, 2017). Based on the law no. 15 of 2004

concerning the Management and Accountability of State Finance, BPK acts as external auditors of government, which have the freedom and independence in the third stage of financial investigation, i.e planning, execution, and reporting of investigation results (Adebayo, 2011). To perform its functions, the BPK has the authority to obtain the data, documents and information from the parties under investigation, the opportunity to physically examine any assets that are within the management of officials that were investigated, including sealed to secure money, goods, and / or of the state financial management at the time of the investigation (Setyaningrum, 2012).

Audits conducted by BPK can be in the form of a financial audit, performance inspection and examination with a specific purpose, for example for investigative purposes. The financial audit carried out to giving opinions about the level of fairness of the information presented in the financial statements of the government. The opinion is a professional statement of the auditor regarding the fairness of financial information presented in the government financial statements. The opinion given by the examiner as the result of financial investigation consists of 4 (four) types, namely:

1. *Unqualified opinion:*
Unqualified opinion, stating that the government's financial statements are presented materially in accordance with Government Accounting Standards.
2. *Qualified opinion:*
Fair opinion with the exception, stating that the government financial statements are fairly presented in all material matters under Government Accounting Standards, except for the impact of matters relating to the excluded.
3. *Adverse opinion:*
Opinion is not fair, stating that the government's financial statements are not presented fairly on the financial position in accordance with Government Accounting Standards.
4. *Disclaimer:*
Opinion not express an opinion, stating that the government's financial statements cannot be believed to be reasonable or not in all material respects in accordance with the Government Accounting Standards.

The opinion setting by BPK is based on the following criteria:

1. Compatibility with Government Accounting Standards.
2. Sufficiency of disclosure (adequate disclosures).
3. Compliance with laws and regulations.
4. Effectiveness of Government Internal Control System.

In addition to those criteria, based on research results of Adzani and Martani (2014), audit opinion generated by BPK on local government financial report is also influenced by several factors, namely human development that gives positive influence. In contrast, the political dynasties and the period of elections of heads of regions negatively affect the audit opinion (Ferraz & Finan, 2008). Therefore, the

accuracy of audit opinion in measuring the performance of government, becomes the most important thing to maintain the legitimacy provided by the community.

2.3 Financial losses

The act of corruption is a misuse of public office in the form of a policy of self-interest which is done through extortion against other parties (Dzhumashev, 2014; DiRienzo, *et al*, 2007; Dye, 2007; Olken, 2009; Malagueño, *et al.*, 2010; Everett, Neu & Rahaman, 2007; Olken, 2007; Pellegrini, & Gerlagh, 2007), bribes in government procurement and embezzlement of government funds (Svensson, 2005) and includes illegal cash payments, misuse of assets and other illegal economic transactions (Treisman, 2000).

From the perspective of law in Indonesia as stated in the law no. 31 of 1999 jo. the law no. 20 of 2001 on eradication of corruption crime then the criminal act of corruption can basically be grouped as follows, (1) state losses, (2) bribes, (3) embezzlement in office, (4) extortion, (5) fraud, (6) conflict of interest in procurement, and (7) gratuities. In addition, other types of criminal offenses related to criminal acts of corruption include (1) blocking corruption cases, (2) the suspect did not give any information or give any untrue information about his or her wealth, (3) banks that do not provide account information of the suspect, (4) witnesses or experts who do not provide information or give false information, (5) the person holding the secret of office does not give any information or give false information, and (6) witnesses who open the identity of the complainant. Based on the definition of corruption or the grouping of this research focuses on the loss of local government as part of a form of corruption. This loss under the law no. 1 of 2004 on State Treasury Article 1 (22) is defined as "losses experienced by countries / local administration is lack of money, securities, and goods, real and definite amount because of an unlawful act, either intentionally or negligent".

3. The Effect of Follow-up of Auditing Results on Accountability for Local Financial Reporting

Based on the law no. 1 of 2004 and the law no. 15 of 2004, it is stated that the stipulation of opinion by BPK is based on the following criteria, namely compliance with government standards, adequate disclosures, compliance with laws and effectiveness of government internal control system. In this case, the follow-up of financial investigation is one representation of the assessment of the effectiveness of the government's internal control system (Roussy, 2013). Setyaningrum *et al.* (2015) finds that the follow-up of audit findings positively affects the audit opinion. The greater the level of follow up of recommendation of the results of financial investigation, the more the the accountability of financial reporting of local government that is indicated by the positive outlook of audit opinion. Based on this argument, the hypothesis to be tested is:

H₁: the follow-up of audit findings positively impacts on the audit opinion.

4. Effect of Follow-Up Audit of Financial Loss Rate

Liu and Lin (2012) argue that audit institutions play a role in the follow-up process of financial investigation results by directly sanctioning, delegating cases to other responsible parties, providing suggestions to correct the weaknesses found and monitoring the recommendations of financial investigation results. In Indonesia, BPK's recommendations are followed by rescue of money / assets to the State / region / company and / or administrative measures. Rescue of money / assets can be done by depositing money to the State / region / company, returning or delivering assets to the state / region / company or done by administrative action in the form of warning, reprimand or sanction to the responsible person of the activity. Accordingly, the greater the level of follow-up of the financial investigation results, the less the level of financial losses. Based on this argument, the hypothesis to be tested are:

H₂: Follow-up Audit Findings negative effect on the level of financial losses.

5. Effect of Financial losses on the Audit Opinion

Liu and Lin (2012) found that the audit findings presented by the auditor positively effect on the level of corruption in China, which the amelioration of the post-audit findings can reduce the level of corruption. In Indonesia, BPK in giving opinion has four criteria, namely compliance with government accounting standards, adequacy of disclosure, compliance with legislation and internal control effectiveness. Compliance with laws and regulations results in the loss of the state or the region. Financial losses experienced by local governments will impact on the financial misstatements that may affect the audit opinion. Thus, the more the level of loss, the more it may affect the audit opinion. Based on this argument, the hypothesis to be tested are:

H₃: Financial loss rate negatively affects audit opinion.

Furthermore, the control variables on the dependent variable used in this study consisted of human development index and the size of local government proxied by the total assets.

6. Methodology

6.1 Sampling Method

The data source of this research is the data of Inspection Report (LHP) from BPK on LKPD obtained from the BPK of the Republic of Indonesia and the data of human development index (HDI) from the Central Bureau of Statistics (BPS) of the Republic of Indonesia. Research period was conducted in period of 2011-2014, based on the implementation of evaluation of roadmap bureaucracy reform 2010-2014 started in 2011. The number of local government in Indonesia in 2014 is 539 local governments. The sampling selection was done by purposive sampling method by using following criteria:

1. Not the provincial government as provincial local government has the different characteristics of governments with the district/city.
2. Having complete data regarding all the variables studied, which have data follow up on results of examination, regional loss rate, the audit opinion, total assets, and the human development index data.

Furthermore, an overview of the sampling and description of the sample are presented in Table 1 below:

Table 1. Overview of Research Sample

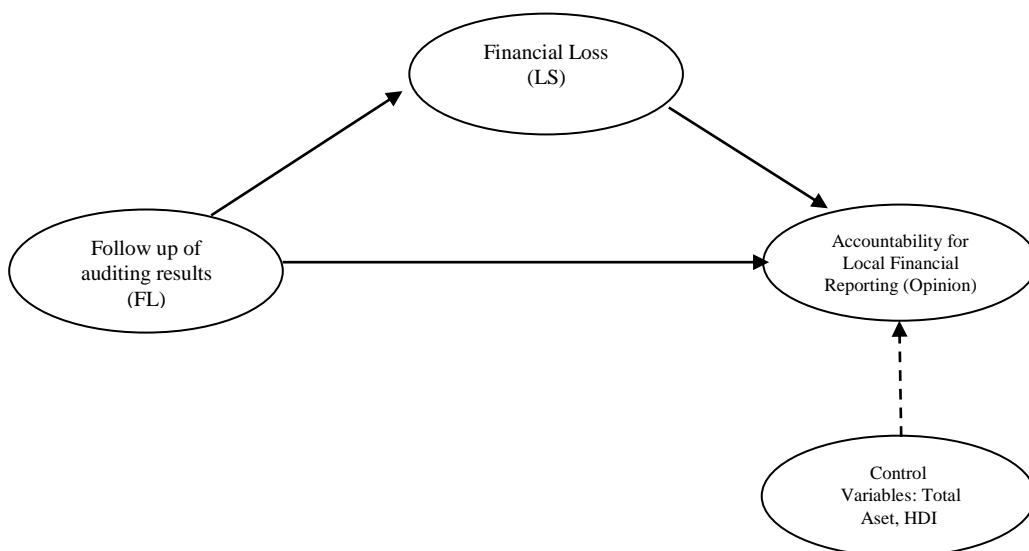
Sample Criteria	Observation
Number of Local Government in Indonesia (2014)	539
Provincial Government	(34)
Having no complete financial report data	(217)
Number of Final Samples	288
Number of Final Samples based on observations	
288 local governments x 4 years (2011-2014)	1152

Source: Secondary data processed, 2017

6.2 Empirical Model and Measurement of Variables

The analytical method used to test the hypothesis is path analysis using analytical tools Partial Least Square (PLS) with warpPLS software version 5.0 (Ghozali & Latan, 2014). Following empirical research models in the following path diagrams:

Figure 1. Research Model



The equation for the model can be written follows:

Direct Model:

$$\text{Opinion} = \beta_1 \text{FL} + \beta_2 \text{HDI} + \beta_3 \text{TA} + \varepsilon \quad (1)$$

Indirect Model:

$$\text{Opinion} = \beta_1 \text{FL} + \beta_2 \text{LS} + \beta_3 \text{HDI} + \beta_4 \text{TA} + \varepsilon \quad (2)$$

$$\text{LS} = \beta_1 \text{FL} + \varepsilon \quad (3)$$

In which:

- Opinion (OP) is the audit opinion which is set by the BPK is based on the results of the LKPD t , as measured by categorical, i.e 5 for an unqualified opinion, 4 for an unqualified opinion with paragraph modifier, '3' for qualified opinion, '2' for adverse opinion, and '1' for disclaimer.
- Financial losses (LS) the loss rate measured by ratio between the loss incurred in the management of local government finances its budget (Ziegenfuss, 2001).
- Follow up (FL) is a follow-up to the result of financial investigation which is the value of the recommendations completed following the total value of the recommendation as used by Setyaningrum *et al.* (2014).
- Lastly, as a control variable in this study consists of: asset is the total assets owned by a district or municipality, as measured by the natural logarithm of the absolute value of the total assets of the region in the year of t , HDI, is the Human Development Index, which is measured by the human development index score of a district/municipality in t .

In addition, to path analysis methods used to test the hypothesis, this study also tests the effect of mediating variable with Sobel test conducted with a two-step method (Baron & Kenny, 1986; Kock, 2011; Solihin & Ratmono, 2013), namely to estimate the magnitude of the effect of direct and indirect influence on the empirical model presented above.

7. Results

7.1 Descriptive Statistics

The descriptive statistics of variables in this study can be seen in Table 2.

Table 2. Statistic Description of Variables

Panel A: Overall Samples = 1152 observations (2011-2014)				
Information	Mean	Standard Deviation	Min	Max
OPINION	3.3383	0.9580	1	5
LS	0.0017	0.0049	0.0000	0.1231
FL	0.5961	0.2081	0.0030	1.0000
TA (in million Rp)	2,797	3,356	10,585	38,6050
HDI	66.78	5.9369	36.61	82.22

Panel B: The comparison among the sample of districts and municipalities			
Informati	Sample of	Sample of Districts	t-test for

on	Municipalities Government 248 observations (2011- 2014)		Government 904 observations (2011-2014)		Equality of Means	
	Mean	St. Dev	Mean	St.Dev	T-stat	Sig
LS	0.0017	0.0041	0.0017	0.0051	0.006	0.995
FL	0.6109	0.1986	0.5921	0.2105	1.308	0.192
HDI	73.6364	4.7569	64.9005	4.7213	25.660	0.000

OPINION, is the audit opinion on LKPD *t*, as measured by categorical i.e '5' for an unqualified opinion, '4' for an unqualified opinion with paragraph modifier, '3' for qualified opinion, '2' for adverse opinion, and '1' for disclaimer; *LS* is the level of financial loss experienced by a district/municipality measured by the ratio of financial losses incurred in the management of local government finances with regional spending; *FL* is a follow-up of financial investigation which is the value of the finished actionable recommendations divided by the total value of the recommendation; *TA* is the total assets of local government, as measured with absolute value of total asset of a region in the time of *t*, *HDI* is Human Development Index, as measured with score of human development index in *t*.

Source: Secondary data processed, SPSS output (2017).

In Table 2 Panel A illustrates the descriptive statistics of variables for the sample, while in Panel B illustrates the descriptive statistics of variables for the sample based on the municipality (as much as 248 observations) and sampled by the regency government (as much as 904 observations). For the sample, average follow-up of financial investigation results 59.21% to the average level of local financial loss of 0.17%. The average opinion to be in the category of a qualified opinion (mean of 3.338). Panel B shows there is no significant difference between the municipality and the district government whether viewed from the level of financial loss or follow-up of auditing results. Thus, both the municipality and the district governments strive to continue improving the local financial management by following up the recommendations of financial investigation results, especially related to the reduction of the level of financial losses.

7.2 Hypothesis Testing

In this study, H_1 predicts that the follow-up of auditing results has direct and positive effect on audit opinion, while H_2 predicts that the follow-up of auditing results has negative effect on the level of financial losses. Moreover, H_3 predicts that the financial loss rate negatively affects the audit opinion. The testing results of hypotheses is presented in Table 3.

Table 3. Hypothesis Testing Results

Variable	Sign	Model Direct Effect (Opinion)	Model Indirect Effect		
			Sign	LS	Sign Opinion

FL	+	0.227 (0.001)	-	-0.205 (0.001)	+	0.184 (0.001)
LS	n/a	n/a	n/a	n/a	-	-0.200 (0.001)
TA	+	0.096 (0.001)		n/a	+	0.079 (0.004)
HDI	+	0.107 (0.001)		n/a	+	0.0075 (0.005)
Number. Observation		1152				1152
R²		0.089		0.042		0.125
Adjusted R²		0.086		0.041		0.122
APC		0.143		n/a		0.149
ARS		0.089		n/a		0.083
AARS		0.086		n/a		0.082
AVIF		1,049		n/a		1085
AFVIF		1,079		n/a		1090

OPINION, is the audit opinion on LKPD *t*, as measured by categorical i.e '5' for an unqualified opinion, '4' for an unqualified opinion with paragraph modifier, '3' for qualified opinion, '2' for adverse opinion, and '1' for disclaimer; *LS* is the level of financial loss experienced by local governments, as measured by the ratio of financial losses incurred in the management of local government finances with regional spending; *FL* is a follow-up of financial investigation which is the value of the finished actionable recommendations divided by the total value of the recommendation; *TA* is the total assets of local government, as measured with absolute value of total asset of a region in the time of *t*, *HDI* is Human Development Index, as measured with score of human development index in *t*.

Source: Secondary data, warp PLS output 5.0 (Processed, 2017).

Table 3 presents the results of testing on the H1, H2 and H3. These results indicate that the models used to test the direct effects of the follow-up of auditing results on the audit opinion by 8.6 percent and significant at the 1 percent level. In this model test results that are directly visible from the significant effect of follow-up of auditing results on the audit opinion with a coefficient of 0.227 at a significance level of 1 percent. This result indicates that a follow-up of financial investigation results is more likely to affect the audit opinion.

Moreover, the indirect model shows that follow-up has significant effect on audit opinion so that both direct and indirect models of test results show consistent results. Nonetheless, the indirect model coefficients turn out to be 0.184 or smaller compared with the direct model. This indicates that the variable of financial loss rate is only positioned as partial mediation variable between follow up of auditing result and audit opinion. In addition, based on the testing result of mediating variable with Sobel test, it is resulted in the coefficient value of the variable of financial loss by 0.0366 with significance level less than 0.001. The indirect model as represented by H2 stating that the negative influence follow-up of auditing results on the financial losses level indicates that the follow up negatively affects the rate of financial loss with a coefficient of -0.21 with R-square of 4.2 per cent. The indirect model also examines the H3 presenting the effect of financial losses on the audit opinion. The

results of this study indicate that the level of loss negatively and significantly affects the audit opinion with coefficient -0.200 . This means that the smaller the level of loss of receivables, the better the opinion obtained by the local governments. The indirect model also shows that R-square is 12.5 per cent. This may mean that the testing results of financial investigation, the level of financial losses, the size of local government and Human Development Index can explain 12.5 per cent of the variable of audit opinion.

The results of this study support the results of previous research conducted by Liu and Lin (2012) and Setyaningrum *et al.* (2015) which state that if the recommendation of the audit result is completed by the higher auditee, the findings related to the previous period's loss will be expected to be not repeated diminishing and the opportunity of local government to get unqualified opinion is also higher.

8. Conclusion

This study aims to analyze the effect of follow-up of auditing results on accountability of local financial reporting by trying to reduce the level of financial losses to gain legitimacy of the parties around the organization in the management of local finance. This study uses data from 288 district / city governments during 2011-2014. In general, the results of this study indicate that follow-up of financial investigation has positive significant effect on audit opinion. Furthermore, the follow up of financial investigation results also have a significant and negative effect on the level of financial loss experienced by a regional administration and the level of financial losses has a significant negative effect on audit opinion.

However, the loss rate variable only becomes a partial mediator between the follow-up of auditing results and the audit opinion as a form of accountability of financial reporting. Thus, the implication of this research is one form of strategy in obtaining legitimacy from the external auditors in order to increase the accountability of regional finances through increased efforts and further the results of financial investigation. This is expected to decrease the level of financial losses, so that local governments get legitimacy to obtain a reasonable opinion without exception. This study also has the limitations. This study did not analyse some differences of local governments attributes such as the provincial governments level and leader characteristics. Therefore, the further studies are expected to add the variable of characteristics of local leaders as one of the variables that can affect the audit opinion.

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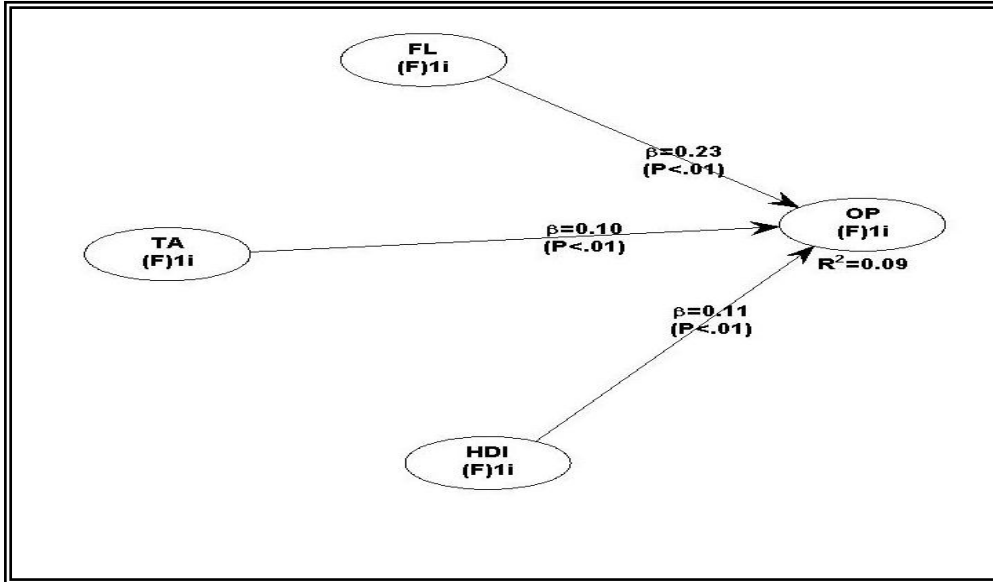
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Appendix 1: Output Warp Pls 5.0.

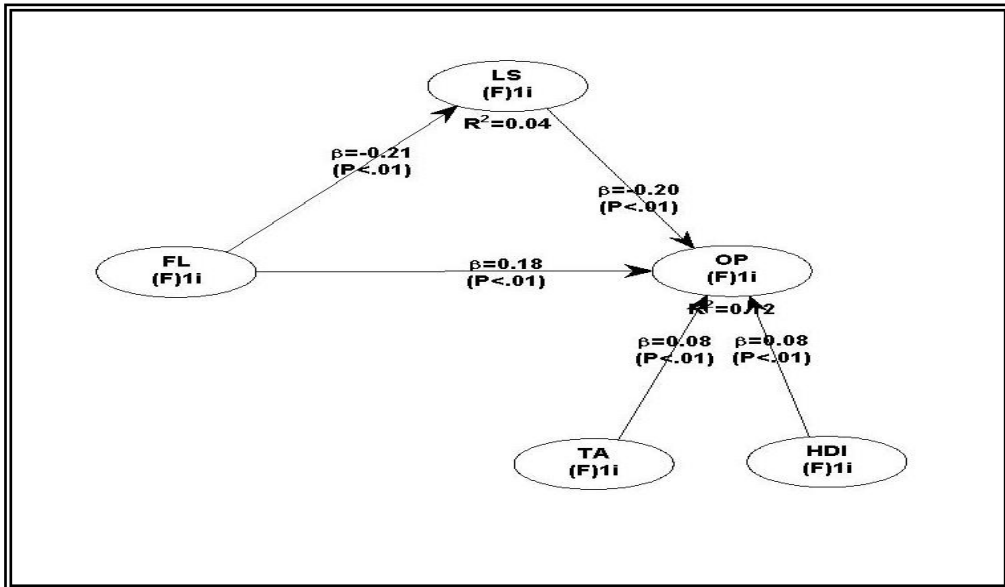
Model Direct Effect:



Model fit and quality indices

-
- Average path coefficient (APC)=0.143, $P < 0.001$
- Average R-squared (ARS)=0.089, $P < 0.001$
- Average adjusted R-squared (AARS)=0.086, $P < 0.001$
- Average block VIF (AVIF)=1.049, acceptable if ≤ 5 , ideally ≤ 3.3
- Average full collinearity VIF (AFVIF)=1.079, acceptable if ≤ 5 , ideally ≤ 3.3
- Tenenhaus GoF (GoF)=0.298, small ≥ 0.1 , medium ≥ 0.25 , large ≥ 0.36
- Sympson's paradox ratio (SPR)=1.000, acceptable if ≥ 0.7 , ideally = 1
- R-squared contribution ratio (RSCR)=1.000, acceptable if ≥ 0.9 , ideally = 1
- Statistical suppression ratio (SSR)=1.000, acceptable if ≥ 0.7
- Nonlinear bivariate causality direction ratio (NLBCDR)=1.000, acceptable if ≥ 0.7

Model Indirect Effect:



Model fit and quality indices

-
- Average path coefficient (APC)=0.149, $P < 0.001$
 - Average R-squared (ARS)=0.083, $P = 0.001$
 - Average adjusted R-squared (AARS)=0.082, $P = 0.001$
 - Average block VIF (AVIF)=1.085, acceptable if ≤ 5 , ideally ≤ 3.3
 - Average full collinearity VIF (AFVIF)=1.090, acceptable if ≤ 5 , ideally ≤ 3.3
 - Tenenhaus GoF (GoF)=0.289, small ≥ 0.1 , medium ≥ 0.25 , large ≥ 0.36
 - Sympson's paradox ratio (SPR)=1.000, acceptable if ≥ 0.7 , ideally = 1
 - R-squared contribution ratio (RSCR)=1.000, acceptable if ≥ 0.9 , ideally = 1
 - Statistical suppression ratio (SSR)=1.000, acceptable if ≥ 0.7
 - Nonlinear bivariate causality direction ratio (NLBCDR)=1.000, acceptable if ≥ 0.7

Sobel Test for Mediating Effect:

1 **Assessing a mediating effect: Change the values in the yellow cells to obtain the values in the green cells**

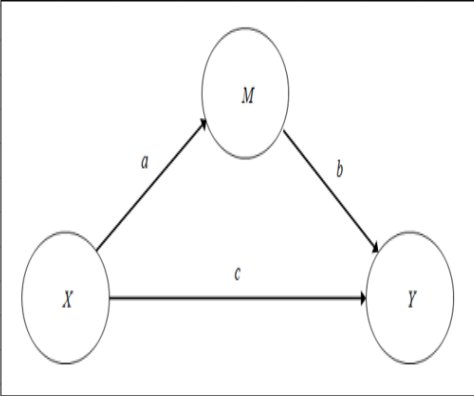
2

3 This spreadsheet implements the mediating effects tests discussed in the following publication using coefficients generated by WarpPLS:

4 - Kock (2013). *Advanced mediating effects tests, multi-group analyses, and measurement model assessments in PLS-based SEM*. Laredo, Texas: ScriptWarp Systems.

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```

graph LR
    X((X)) -- a --> M((M))
    M -- b --> Y((Y))
    X -- c --> Y
            
```

Inputs

N 1152 (Sample size)

a -0.2080 (Path coefficient calculated by WarpPLS)

b -0.1760 (Path coefficient calculated by WarpPLS)

Sa 0.0280 (Standard error calculated by WarpPLS)

Sb 0.0280 (Standard error calculated by WarpPLS)

Outputs

Sab 0.0077 (Sobel's standard error for mediating effect)

ab 0.0366 (Product path coefficient for mediating effect)

Tab 4.7733 (T value for mediating effect)

Pab 0.0000 (P value for mediating effect, one-tailed)

Pab' 0.0000 (P value for mediating effect, two-tailed)

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