

# FACTORS INFLUENCING THE WEAKNESSES OF INTERNAL CONTROL OF LOCAL GOVERNMENTS IN INDONESIA

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## FACTORS INFLUENCING THE WEAKNESSES OF INTERNAL CONTROL OF LOCAL GOVERNMENTS IN INDONESIA

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### Abstract

**Purpose of the study:** This paper aims to examine the factors influencing local government internal control weakness, includes leverage, locally generated revenue, capital expenditure, complexity, previous year's internal control weaknesses findings

**Methodology:** The population of this research is the audit report of the Audit Board of the Republic of Indonesia (BPK) in the Regency/City of West Indonesia with a total of 263 financial statements. The purposive sampling method is used, resulting in 186 financial statements as samples. Hypotheses are tested using multiple linear regression using SPSS V.21.

**Main Findings:** The results of the study show that locally generated income, capital expenditure, and previous year's internal control weaknesses findings positively affect the weaknesses of local government control. Meanwhile, leverage and regional complexity do not affect the weaknesses of local government internal controls. Lack of supervision among revenues and expenditures causes a decrease in local government internal control system quality.

**Applications of this study:** This study can be useful for local governments to minimize the internal control weakness in the organization.

**Novelty/Originality of this study:** Leverage and previous year's finding on internal control weaknesses variables are included in this study because there have been only a few studies that use those variables. This research uses a different proxy than the previous ones with the aim of getting more accurate results.

**Keywords:** Complexity, Capital Expenditure, Internal Control Weakness, Leverage, Local Government, Locally Generated Revenue.

### INTRODUCTION

After the financial crisis, the United States, the European Union and almost all countries in the world created some new regulations to improve the internal control of an organization. The internal control system represents all policies and procedures that are approved and used by the management to achieve its effectiveness. The control system includes internal control and internal procedures (Mihaela & Iulian, 2012).

Not only private organizations, but also local governments need certain policies that can encourage organizational accountability. Society as the key stakeholders of local governments needs an assurance that the government is run well. This is demonstrated by effective internal control of local governments. Internal control is an important factor in increasing the effectiveness of local government performance (Badara & Saidin, 2013).

The development of regional government autonomy in Indonesia requires adequate mechanisms in preventing fraud. 28% of fraud is caused by internal control weaknesses (KPMG, 2012). Based on this explanation, the implementation of internal control is significantly important. The Internal Control System provides adequate procedures to improve the effectiveness and efficiency of accounting records and improve the quality of financial statements. Any institutions will not run well without good internal controls (Afiah & Azwari, 2015).

Based on the Overview of Semester 1 Examination Results in 2017, financial losses incurred due to weak internal control reached Rp 27,397 trillion caused by 14,997 problems of SPI weaknesses. BPK (Financial Supervisory Agency) audited 645 financial statements, 9 performance reports, and 33 reports with specific objectives during the first semester of 2017. The audit resulted in 9,729 findings with 14,997 problems included as SPI weaknesses, non-compliance with statutory provisions, as well as inefficiency (Tempo, 3 October 2017).

Some studies related to the factors that cause weaknesses in internal control have been carried out previously. Research by Petrovits et al. (2010) found the influence of organizational size, auditor, growth, company age, and organizational risk towards the weaknesses within the internal control process. Another study was conducted by Kristanto (2009) who found that there was a relationship between organizational size, Original Local Government Revenue (PAD), and capital expenditure and the weaknesses of internal control. The results of other research were shown by Putri & Mahmud (2015) who concluded that economic growth, Original Local Government Revenue, organizational size, and complexity affect the weaknesses of internal control in the local government. Yamin & Sutaryo (2014) examined the relationship between the number of Regional Work Units, population, findings of the weakness of the previous year's internal control system, e-Government ranking, and the level of completion of the follow-up recommendations of the audit on the weaknesses of internal control.



This research aims to examine the influence of leverage, Original Local Government Revenue, capital expenditure, regional complexity and findings of previous year internal control weaknesses towards the weaknesses of current regional government internal control. The researchers include the leverage variable and the finding of internal control weaknesses in the previous year because there have been only a few studies in Indonesia that use those variables. This research uses a different proxy than the previous ones with the aim of getting more accurate results. This research uses a sample of LHP from western Indonesia because the local governments there are more complex with a higher number of districts/cities than other regions in Indonesia. In addition, capital expenditure in western Indonesia is higher than others seen from more advanced infrastructure.

## LITERATURE REVIEW

The theory as the basis of this research is stewardship theory. The stewardship theory explains that leaders should not be driven by individual goals but rather lead to organizational interests. Steward (Government) is driven to behave in line with the needs of the principal (people/society). Besides, the steward (government) will not leave the organization because the steward is trying to achieve organizational goals. This theory explains that the leaders (stewards) within the organization are servants of people so that they are encouraged to behave in the best ways for their [principle \(Donaldson & Davis, 1991\)](#).

Leverage is a factor that influences the weaknesses in the internal control of the local governments. Sources of funding for operations and investments that come from outside of the company surely use leverage ([Pinnuck & Potter, 2009](#)). The leverage indicates the composition of an organization's funding origin by comparing debt and equity. The local governments that have greater leverage will spend a greater amount of fixed assets. Debt realization is possible for the procurement of regional fixed assets to support the welfare of the community.

[Schneider & Church \(2008\)](#) have shown that the weaknesses in internal control reduce lenders' trust in the quality of financial statements. According to [Costello & Wittenbreg-Moerman \(2011\)](#), the lenders are more likely to return loans to companies that have better internal control reports than those who don't.

This shows that they need collateral to compensate for the reduction in the number of financial agreements. The greater the leverage, the greater the supervision conducted by the party providing the loan. This encourages the local governments to provide better information to the lenders to improve their trust and reduce information asymmetry. This motivates the local governments to improve the quality of their internal control systems. It can be concluded that the leverage has a negative effect on the weaknesses of the internal control of local governments

### **H1: Leverage negatively influences the weaknesses of internal control of the local governments.**

Based on Law Number 33 of 2004, Original Regional Government Revenue is one of the regional revenues obtained by processing the resources owned by the region. Collection of local taxes, regional levies, results of the management of separated regional assets, and income from other legitimate sources are some sources of Original Local Government Revenue. The size of the Original Local Government Revenue can illustrate the ability of a local government to exploit its potential. Problems related to the internal control will increase if the amount of revenue that is contained in the original regional revenue is also higher ([Petrovits et al., 2010](#)).

The Original Local Government Revenue is a source of fraud. Local governments with higher total revenues are more difficult to protect their income. The use of regional funds that are not in accordance with applicable regulations, corruption, and embezzlement are some examples of frauds that occur related to the original income.

The Original Local Government Revenue has a positive influence on the weaknesses of internal control of the local governments ([Petrovits et al., 2010](#) and [Susiarini & Kiswanto, 2016](#)). [Kwanbo \(2010\)](#) found that proper authorization of regional revenue and expenditure would improve the internal control system of local governments.

### **H2: Original Local Government Revenue positively influences the weaknesses of internal control of the local governments.**

Capital expenditure is a state outcome used for work unit operations by providing services and welfare for the community. The provision of fixed assets is very closely related to capital expenditure. If the allocation of assets to a region is higher, the capital expenditure will also increase. The process of providing fixed assets in the local governments is carried out through auctions. In the auction process, the company that wins the fixed asset procurement project is the company that meets the requirements and provides the best offer. In this case, fraud often occurs by irresponsible parties that can harm the government. The more fixed assets owned by local governments, the more opportunity for doing fraud in local governments ([Saputro, 2015](#)).

The research conducted by [Kim et al. \(2011\)](#) and [Ashbaugh-skaife et al. \(2009\)](#) found that capital expenditure increases the weaknesses in internal control. [Beneish et al. \(2008\)](#) explained that capital expenditure increases the disclosure of internal control weaknesses. [Kwanbo \(2010\)](#) found that proper regional revenue and expenditure authorization would improve the internal control system of the local governments.

### **H3: Capital expenditure positively influences the weaknesses of internal control of the local governments.**

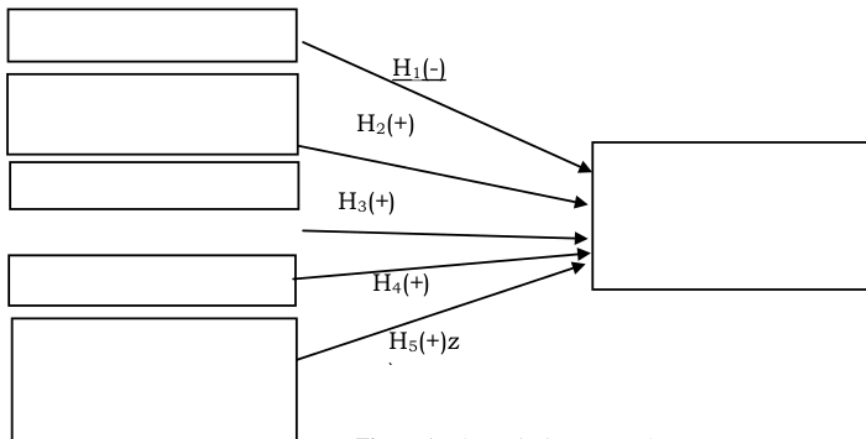
Total Regional Work Units, total sub-districts, and the total population in an area are some aspects of regional complexity. According to [Susiarini & Kiswanto \(2016\)](#), complexity is a layer within an organization, including the specialization layer of task separation, the total layer in the institutional hierarchy, and the size of the extent to which organizational units are spread widely in the region in order to achieve the objectives of implementing internal control. Complexity is related to the consolidation of financial statements at the time of delivery of local governments' financial reports. The more complex a region is, the implementation of objectives in the context of internal control will also be more difficult ([Putri & Mahmud, 2015](#)), [Putri & Mahmud \(2015\)](#) and [Mascha et al. \(2010\)](#) stated that complexity influences the disclosure of internal control weaknesses.

**H4: Regional complexity positively influences the weaknesses of internal control of the local governments.**

The findings of the previous year's internal control system weaknesses are closely connected with the findings of the following year. The absence of corrections to the implementation of policies and responsibilities, especially in the local government accounting process, has the potential to increase the weaknesses of the internal control system in the following year. The finding of weaknesses in the previous year's internal control system can be used as a reference by the investigators regarding the state of the internal control system of the audited fiscal year. The lack of internal control in the previous year may cause misstatements of accounting records in the following year, both on the application of SAP and compliance with legislation ([Mulyani & Suryawati, 2011](#)). Research [Keane et al. \(2013\)](#) stated the audit findings of the previous year positively and significantly influence the same findings in the audit year. [Yamin & Sutaryo \(2014\)](#) stated that the findings of internal control weaknesses in the previous year positively affect the weaknesses of internal control of local governments

**H5: Findings of the weakness of internal control in the previous year positively influences the weaknesses of internal control of the local governments.**

The research framework can be described through the following figure 1.



**Figure 1:** Theoretical Framework

Source: Author

**METHODOLOGY**

This research used a quantitative approach with secondary data. Multiple regressions were performed using SPSS V.21. The population of this study is the local government (regencies/cities) in western Indonesia, which amounted to 263 local government. The samples were taken using a purposive sampling technique that generated 186 samples. The sample selection criteria could be seen in table 1.

**Table 1:** Criteria of sample selection

No.	Criteria	Qualify
1.	Total regencies/cities in the western part of Indonesia	263
2.	Regencies / Cities that do not have complete data on the Inspection Results Report	(43)
3.	Local governments equal with provincial level	(1)
4.	Outlier data on the research year	(33)
Total samples for the one-year study period		186

Source: secondary processed data using SPSS v21, 2018

Table 1 showed that of the 263 financial statements obtained, 43 regional governments had incomplete data such as missing number of subdistricts and internal control findings were only a brief explanation. One sample was the Special Region of Jakarta. Jakarta had one administrative district and five administrative cities but there was only one financial statement, not one report for each district/city. There were 33 outlier data eliminated in the sample selection. The outlier data were determined by transforming the data values into standardized numbers (z-scores). The data were declared as an outlier if their values were between -2.5 and 2.5.

“Weaknesses of internal control” was the dependent variable in this research. This variable was measured by the total findings of internal control system cases contained in the local government's financial report that had been published by the Audit Board of Indonesia. There were five independent variables in this research, namely leverage, original local government revenue, capital expenditure, regional complexity and the findings of internal control weaknesses of the previous year. The operational description and scale of each variable were explained in Table 2.

**Table 2:** Operational Descriptions of Research Variables

No.	Variable	Definition	Measurement
1.	Weaknesses of Internal Control (Y)	Weaknesses which results are far from the actual situation that cannot be reduced or found before (Saputro, 2015).	Number of SPI weaknesses findings published by the Audit Board of Indonesia in 2016 (Saputro, 2015)
2.	Leverage (X1)	Leverage is the origin of funding for operations that come from external parties. (Pinnuck & Potter, 2009).	<i>totalliability</i> <i>totalequity</i> (Pinnuck & Potter, 2009)
3.	Original Local Government Revenue (X2)	Original local government revenue is the regional revenue that is obtained by processing and utilizing potential it has (Regulation Number 33 Year 2004).	Total original local government revenue owned by the local government (Saputro, 2015)
4.	Capital expenditure (X3)	Capital expenditure is the state expenditure to provide capital or supply of fixed assets in order to provide services and prosper the community (Kristanto, 2009).	Number of Capital expenditure owned by the local government (Kristanto, 2009)
5.	Regional complexity (X4)	layers of differences within the local government that cause problems in the context of achieving prosperity (Susiari & Kiswanto, 2016)	A number of sub-districts owned by the local government. (Susiari & Kiswanto, 2016)
6.	Findings of Weaknesses of Internal Control in the Previous Year (X5)	Findings of irregularities/violations of SPI by BPK in the previous period or the previous year (Yamin & Sutaryo, 2014)	Number of SPI weaknesses findings published by BPK in the previous year, i.e. 2015 (Yamin & Sutaryo, 2014)

**Source:** Processed secondary data, 2018

This research used documentation techniques. The researchers collected the data from the audit report presented by the Supreme Audit Board obtained from [www.bpk.go.id](http://www.bpk.go.id) (Audit Board of Indonesia, 2018). Descriptive statistical analysis and inferential statistical analysis were the analytical techniques used in this research with multiple regression models using SPSS software version 21. This research used a 95% confidence level or  $\alpha = 0.05$ .

#### DISCUSSION / ANALYSIS

The value of significance probability in the normality test (Kolmogorov-Smirnov test) results in 0.383. This figure shows that the model is normally distributed because it is higher than  $\alpha = 0.05$ . The autocorrelation test generates a value of 0.883 means that the model is free from autocorrelation. VIF value is lower than 10 which is 1.074 for the leverage, 1.992 in original local government revenue, 1,840 for capital expenditure, 1,322 for regional complexity, and 1.073 in the finding of internal control weaknesses in the previous year, which shows that there is no multicollinearity in each variable. Heteroscedasticity test is seen from the absolute value of residuals in the Glejser test with the value of leverage 0.493, original local government revenue 0.415, capital expenditure 0.831, and regional complexity 0.275, which means the model is free from the heteroscedasticity.



The adjusted R2 value in the determination coefficient test of this study is 0.183, where 18.3% of variations in local government internal control weaknesses are explained by the variations of the leverage, original local government revenue, capital expenditure, regional complexity, and findings of previous year's internal control weaknesses. The weakness of the local government internal control variable is influenced by other variables did not use in this research amounted to 81.7%. The hypotheses test results are shown in Table 3.

**Table 3:** Summary of Hypotheses Testing

No	Hypothesis	Sig.	Regression Coefficient	Result
H1	Leverage negatively influences the weaknesses of internal control of local governments	0.492	2,473	Rejected
H2	Original local government revenue positively influences the weaknesses of internal control of local governments	0.023	0,192	Accepted
H3	Capital expenditure positively influences the weaknesses of internal control of local governments	0.000	0,585	Accepted
H4	Regional complexity positively influences the weaknesses of internal control of local governments	0.150	-0,108	Rejected
H5	Findings of internal control weaknesses in previous year positively influences the weaknesses of internal control of local governments	0.034	0,143	Accepted

**Source:** Secondary data processed using SPSS V.21, 2018

The equation generated in the multiple regression analysis is based on the results of the hypothesis testing as follows

$$Y = -20,477 + 2,473 X1 + 0,192 X2 + 0,585 X3 - 0,108 X4 + 0,143 \quad (1)$$

#### **Influence of Leverage towards the weaknesses of internal control of local governments**

The leverage does not affect the weaknesses of local governments' internal control. The results of this research indicate that the level of leverage does not influence the weaknesses of the internal control of the local governments. According to Law No. 33 of 2004, funding in local governments consist of Original Local Government Revenue, Balancing Funds, Regional Loans, and other legal income. The funding will be used for operational activities every day so that the leverage position is different from the situation of a business unit. The amount of debt in the local governments is quite low because it has been ruled in the Regulation Government of the Republic of Indonesia No. 30 of 2011. The results are consistent with the Stewardship theory which explains that the stewards will be motivated to act in the best ways for the principle. The leverage does not affect the weaknesses of the internal control of the local government, which shows that the governments do not rely on debt as their main source of funding, which in turn will burden them in paying it off. This indicates that the local governments can act responsibly in the public interest by not relying on external debt (Kusumawardani, 2012).

This research is also supported by Ittonen (2016) and Gao et al. (2018) who stated the disclosure of internal control weaknesses does not always improve the lenders' confidence. The companies that either disclose or do not disclose the weaknesses in their internal control show the same tendency related to equity and debt financing.

#### **Influence of Original Local Government Revenue towards the weaknesses of internal control of local governments**

The original local revenue influences the local governments' internal control weaknesses positively and significantly. The results of this research show that the higher the amount of original local revenue, the higher the internal control weaknesses will be. The research conducted by Kwanbo (2010) and Kristanto (2009) proved that there is a positive and significant influence of the local revenue positively on the weaknesses of internal control. Research by Petrovits et al. (2010) found that the original revenue of an organization increases the problems of internal control. Regional levies, natural resource management, and local taxes are some sources of local revenue. The value of each source of original local government revenue is not too high on average, but the number of regional revenue positions makes it difficult to monitor the revenue, causing the internal control weaknesses to increase.

The results of this research are accepted because it is supported by the results of descriptive statistics which show that there are 50.71% of the local governments in western Indonesia have had moderate to very high original regional revenue. This means that most local governments in western Indonesia have low to very high levels of local revenue,



resulting in weak internal control. This is because the local government could not supervise and prevent fraud in managing their large amount of local revenue.

#### **Influence of capital expenditure towards the weaknesses of internal control of local governments**

The results show that capital expenditure affects the weaknesses of the internal control of the regional governments in a positive direction. Ups and downs of the capital expenditure on the local governments cause changes in the findings of the weaknesses of internal control. The local governments that have high capital expenditure will automatically make purchases of large-scale regional fixed assets. This large capital expenditure allocation is very vulnerable to corruption in the procurement process of the fixed assets. A large amount of capital expenditure is very prone to fraud. It will cause a lot of possible causes of internal control weaknesses (Saputro, 2015).

The research from Kim et al. (2011) and Ashbaugh-Scaife et al. (2009) found that capital expenditure increases the weaknesses of internal control. Research by Huefner (2011) stated that the local governments, especially those which are on the lower level than the regencies/municipalities such as sub-districts and villages, are vulnerable to fraud. Many local governments are quite small and have fewer professional financial employees. A supervision personnel is provided by an elected board where the officials do not have good managerial insight and control orientation, which results in a weak control environment.

#### **Influence of regional complexity towards the weaknesses of internal control of local governments**

Regional complexity does not affect the weaknesses of the internal control of the regional governments. The decrease or increase in regional complexity does not influence the weaknesses of the internal control of the local governments. The results of this research are supported by Susiarini & Kiswanto (2016) and Saputro (2015) who found no influence of regional complexity on the weaknesses of internal control of local governments. Complexity cannot be determined by the number of sub-districts. The total number of smaller sub-districts does not necessarily reflect better conditions or vice versa. This is because every sub-district has the same duties and functions

In addition, the scope of work in the sub-district is very simple. The large number of sub-districts does not make the existing administration in the regencies/cities more complicated. The complexity of an area does not influence the weaknesses of the internal control of the local government because the sub-districts in each regency/city have relatively the same duties and responsibilities. Although each sub-district has different backgrounds, its main task is almost the same and not complex, i.e. providing the best services for the welfare of the community (Susiarini&Kiswanto, 2015);

The results of this research indicate that the internal control system in managing complexity has been good enough. The local governments have played their roles according to the stewardship theory. They have done all the tasks assigned to achieve common interests. The stewards (governments) have managed to regulate and carry out protection against regional complexity in an orderly manner in accordance with the expectations of the principals (community) even though the number of sub-districts owned in a regency/city is quite high. The governments (stewards) have also worked as best as possible to carry out their duties accountably, transparently, effectively and efficiently for the community (principals).

#### **Influence of findings of internal control weaknesses in the previous year towards the internal control weaknesses of the local governments**

The findings of the previous year's internal control weaknesses positively affect the weaknesses of the governments' internal controls. The results of this research have proved that the ups and downs of the findings of the previous year's control weaknesses in local governments cause changes in the findings of the weaknesses of the internal control of local governments. The results of this research are supported by Yamin & Sutaryo (2014) who stated that the findings of the weaknesses of internal control in the previous year positively influence the weaknesses of internal control of the local governments. This shows that governments still do not learn from their previous experience and do not correct the mistakes made in the past.

Mulyani & Suryawati (2011) explained that the weak internal control system in the previous year could cause misstatements of accounting records for the following year both on the application of Government Accounting Standards and compliance with legislation. Fatimah al. (2014) found that the findings on the previous year are related to the following year's findings. This is because the problems have not been resolved yet. This is also because the previous year's figures are restated in the next accounting period. Research by Keane et al. (2013) showed that the company will reveal the same material weaknesses in the previous and current years.

The results of this research are also supported by descriptive statistical results which show that the variable of the findings of internal control weaknesses in the previous year is in moderate to very bad category (26.88%), while in the research year of the findings of the weaknesses of internal control of the regional governments, the value can be classified as moderate to bad category by 39.24%. This shows a decrease in the quality of government internal control compared to the previous year. The local governments in the regencies/cities in western Indonesia are still unable to manage their finances and are still stuck in the programs or policies from the previous year.



## CONCLUSION

It can be concluded that the original local revenue, capital expenditure, the findings of the previous year's internal control weaknesses positively influence the weaknesses of the regional government's internal control. The leverage and regional complexity do not affect the weaknesses of internal control of the local governments.

The local governments can minimize the factors driving the weaknesses of the internal control in the environment, such as local revenue, capital expenditure, and findings of weaknesses in the previous year's internal control. Improved design and implementation of controls related to regional revenue and capital expenditures are needed to improve the effectiveness and efficiency of regional governments' Internal Control System. The findings of the Internal Control System weaknesses in the previous year should be followed up seriously and monitored by the Audit Board of Indonesia to reduce Internal Control System weaknesses in the current and subsequent years.

The Regional Work Units are expected to be able to increase their regional internal control policies by establishing procedures for the distribution of tasks and functions in each of the existing positions, especially implementing officers and the Local Government Budget Team, implementing reward and punishment mechanisms, and conducting deeper risk analysis to the occurrence of fraud from the internal control system.

## LIMITATION AND STUDY FORWARD

The limitation of this study is the proxy for the complexity measurement variable. Future studies should use more precise indicators of regional complexity measurement such as the number of Regional Work Units. The more Regional Work Units, the more information and communication channels needed, thus increasing the complexity of internal control.

## IMPLICATIONS

This research has implications for the implementation of internal control of local governments. The local governments can minimize the factors that have been proven to cause weaknesses in their internal control. The next section will explain the theoretical framework, development of hypotheses, research methods, results and discussions, and conclusions and suggestions for further research.

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