GOVERNANCE OF FINANCIAL MANAGEMENT AND REGULATION-BASED FISCAL ACCOUNTABILITY

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Abstract

This study aims to analyze financial accountability based on the regulation as a moderating effect of fiscal decentralization on fraud rates in local government financial management. Regulatory accountability consists of financial reporting accountability, accountability of the government internal control system, accountability compliance with legislation and accountability follow-up to audit results. This research is an empirical research with a purposive sampling technique in collecting data. The data used in this study is secondary data with a sample of 412 regency and city governments in Indonesia, during 2011–2014. Data processing used WarpPLS statistic software. The results show empirical evidence that fiscal decentralization has a positive effect on fraud rates in regional financial management. Accountability, financial reporting and accountability compliance with legislation are empirically proven as moderating the effects of fiscal decentralization on fraud rates in regional financial management. In addition, the results of this study also show that the low level of accountability of the internal control system and accountability does not continue the results of the examination so it cannot moderate the effect of fiscal decentralization on fraud rates in regional financial management. The results of this study have implications for strengthening agency theory, institutional theory, economic regulation theory and fraud triangle theory. The results of this study also have practical implications for the role of accountability through the formulation of regulations related to sanctions and rewards for local governments to carry out good governance through increasing their financial accountability. In addition, the regional government is expected to pay attention to audit recommendations so that it can reduce fraud rates in regional financial management.

Keywords: Fiscal Decentralization, Local Governance, Financial Accountability, Regulation, Fraud Triangle, Financial Management

1. INTRODUCTION

Financial reform and regional autonomy began since the enactment of Law No. 22 of 1999, then Law No. 32 of 2004 and finally perfected with the issuance of Law No. 23 of 2014 concerning regional governance, which changed governance from centralized to decentralized. The implementation of regional autonomy, where the central government gives authority to the regional government in managing their own governmental affairs under their authority. This means that local governments are given power in exercising authority, one of which is the authority in the management of regional finances. In the implementation of financial management in local governments in Indonesia a lot of fraud occurred. One form of fraud that occurs in Indonesia is corruption.

Based on Law No. 31 of 1999 in conjunction with Law No. 20 of 2001 concerning eradication of corruption, classifying corruption into seven types, namely detrimental to state finances (enriching oneself or abusing authority so as to harm state finances), bribery, gratification, embezzlement in office, extortion, fraud, and conflict of interest. Corruption in Indonesia has the potential to occur to regional governments as indicated by regional financial losses. Some of the causes of corruption in local governments are the application of fiscal decentralization which is not in line with the concept of decentralization (Sasana, 2009). There are practices of abuse of power by some regional elites such as legislative, executive and business people, zig-zag or discontinuous rules of the game and have not increased the fiscal power of districts and cities (Jaya, 2010). Corruption practices are supported by differences in regulations by the central and regional governments, the lack of cooperation between the legislative and executive institutions, and the lack of public supervision (Rinaldi, Purnomo, & Damayanti, 2007; Furqan & Din, 2019).

Corruption is a symptom of government failure due to weak management quality, accountability, legal framework and transparency (Shah, 2006). Klitgaard (1998) states that the cause of corruption is spearheaded by the monopoly of power, both goods and services and balanced with the freedom of actors to act with discretion without the support of accountability. Therefore, this study aims to analyze the effect of fiscal decentralization on the level of fraud in local government financial management with regulation based financial accountability as a moderating variable. Financial accountability based on regulations in this study is related to the accountability of local governments in implementing financial reporting, internal control systems and compliance with legislation and follow-up on audit results that are regulated based on regulations established by the central government.

The structure of the paper is as follows: Section 2 is devoted literature review and hypotheses development; Section 3 presents the methodology of the research; Section 4 highlights the results of the study; Section 5 concludes the paper.

2. LITERATURE REVIEW AND HYPOTHESES DEVELOPMENT

This research uses agency theory, institutional theory, economic regulatory theory, and fraud triangle theory. In the implementation of fiscal decentralization in several countries, the results of the study show that most fiscal decentralization has a positive impact on the level of corruption which means fiscal decentralization can reduce the occurrence of corruption (Shah & Huther, 1999; Fisman & Gatti, 2002; Arikan, 2004; Tumennasan, 2005; Shah, 2006; Freille, Haque, & Kneller, 2007; Fan, Lin, & Treisman, 2009; Lessman & Markwardt, 2010). However, there are some studies that suggest otherwise, decentralization has a negative impact on the level of corruption, which means that decentralization can increase corruption. Treisman (2000) and Wu (2005) found that federal states have a high level of corruption, meaning that the more decentralized the power, the higher the level of corruption. The results of the study were also supported by Rinaldi et al. (2007), Keong (2020), Suprayitno (2011), Saputra (2012) and Turseno (2012) who stated that fiscal decentralization in Indonesia tends to increase corruption in the regions. However, Hartanto and Probohudono (2013) found that fiscal decentralization did not affect perceptions of corruption.

Based on agency theory, the relationship between the central government and the delegation of authority to regional governments in managing and managing their own activities in the regional government in order to provide services to the community. From these relationships, it can lead to a moral hazard and adverse selection. The moral hazard is caused by the actions of the local government which cannot be observed by the central government so that the local government will maximize its personal interests which in reality are not always in line with the interests of the central government. Adverse selection arises because local governments have information that cannot be observed by the central government due to the weakness of monitoring from the central government, so opportunistic behavior in local governments can develop so as to increase corruption. In addition, the existence of authority given to local governments is an opportunity for corruption. As explained in the fraud triangle theory, there is an opportunity for fraud. Opportunities are created due to weaknesses in internal control, ineffective management supervision, or abuse of position or authority.

H1: Fiscal decentralization has a positive impact on the level of fraud in regional financial management. The higher the level of fiscal decentralization, the higher the level of regional financial loss.

Previous studies on fiscal decentralization against corruption have inconsistent results, so this study aims to obtain empirical evidence related to the inconsistency of previous research by developing research on fiscal decentralization of the level of fraud in regional financial management that includes financial accountability variables based on regulation as moderating variables. This is based on

the concept of Klitgaard (1998) which states that the cause of corruption is spearheaded by the monopoly of power, both goods and services and balanced with the freedom of actors to act with discretion without the support of accountability.

Based on the previous concept, this study will also conduct a study based on the opinion of Bardhan (2002), which states that the implementation of decentralization in developing countries has weaknesses, namely accounting information systems and public monitoring mechanisms so it can lead to high levels of corruption. Furthermore, Bardhan and Mookherjee (2006) stated that there is a tendency for local governments to provide excessive services to the local political elite compared to public services so this will reduce the monitoring system of the political elite.

In addition, Wu (2005) argues that transparency and the provision of accounting information can help reduce the level of corruption by increasing the possibility of detecting bribery. Better accounting practices with financial reporting help to reduce the information asymmetry between the principal and agent so as to enable the principal to more effectively monitor the behavior of the agent (Fakhimuddin, Khasanah, & Trimiyati, 2021). Based on this concept, this research will develop research related to fiscal decentralization and the level of fraud in regional financial management by including accountability which is based on regulations as a moderating variable. The accountability variable based on regulation is developed from the theory of new institutional economics which states that there is an imbalance of information in the institution so it makes the principal spend transaction costs to create good governance (Reza & Ullah, 2019). Governance is established based on regulation as a form of government intervention to overcome the imbalance of information in the implementation of delegation of authority (Posner, 2006). Therefore, financial accountability based on regulations in this study is the responsibility of the local government in the form of financial reporting that has been audited by The Audit Board of the Republic of Indonesia (*Badan Pemeriksa Keuangan*, BPK) which consists of conformity of financial reporting with government accounting standards as proxied by BPK's audit opinion on local government financial reports (*Laporan Keuangan Pemerintah Daerah*, LKPD) as a form of financial reporting accountability. The effectiveness of SPIP is based on BPK's audit criteria related to government internal control system (SPIP) in regional financial management which is proxied by social progress index (SPI) findings, where the more SPI findings the lower the level of accountability of the government's internal control system. Compliance with laws and regulations is proxied by findings of compliance with laws and regulations, which means that the more findings of compliance with laws and regulations, the lower the level of accountability of district/city government compliance with applicable laws and regulations (Masdar, Furqan, Masruddin, & Meldawaty, 2021). Follow-up of audit results is based on the results of the BPK follow-up monitoring report included in the BPK audit report, proxied by the ratio between the number of BPK recommendations that are followed up according to the recommendations and the total recommendations (Furqan, Wardhani, Martani, & Setyaningrum, 2020).

Financial reporting accountability is the conformity of financial reporting with government accounting standards that are reflected in audit opinions. Setyowati, Isthika, and Pratiwi (2016) state that the quality of local government financial management can be known from the audit opinion, so the regional government audit opinion is used as a consideration by the central government in assessing the performance of local governments. Masyitoh, Wardhani, and Setyaningrum (2015) found that audit opinion has a negative effect on perceptions of corruption, where the better the audit opinion obtained, the regional government has a lower perception of corruption. In addition, this study also found that local governments that received statements not giving opinions from auditors had significantly higher perceptions of corruption than local governments that received fair opinions. This proves that the better the audit opinion obtained by the local government shows a good performance evaluation of the local government.

H2a: The higher the level of accountability in financial reporting, the greater the negative effect of the level of fiscal decentralization on the level of fraud in regional financial management.

Huefner (2011) states that the main way to prevent fraud is to have a strong internal control system. Petrovits, Shakespeare, and Shih (2011) examine non-profit organizations that use funds from public donors, where the results of their research prove that donors react to information about internal control both directly and indirectly. This gives the conclusion that the internal control system is a very important aspect in the management of organizations including government organizations. Hendriani and Firman (2013) states that the application of SPIP can prevent fraud, this study is based on auditor perceptions. In addition, Masyitoh et al. (2015) suggested the weakness of the accounting and reporting control system has a significant influence on the perception of corruption. In addition, based on fraud triangle theory, the weakness of internal control, the ineffectiveness of management supervision, or abuse of position or authority increases the chances of fraud.

H2b: The higher the level of accountability of government internal control systems, the greater the negative influence of the level of fiscal decentralization on the level of fraud in regional financial management.

Disclosure of non-compliance with regulations and legislation in the administration of regional government is needed to ensure that the process of implementing local government is in line with applicable laws and regulations. Similarly, Nosworthy (1999) argues that one of the objectives of the examination is to review compliance with laws and regulations. Raman and Wilson (1994) also state that audits in government agencies contribute to ensuring compliance with laws and regulations and minimizing wasteful, fraudulent and corrupt acts.

Meanwhile, Dwiputrianti (2008) argues that examinations regarding compliance with the legal

basis support anti-corruption programs in several countries, one of which is Indonesia. Compliance with applicable laws and regulations (compliance with laws and regulations) is one of the criteria that shows the quality of the report on the results of examinations of government agencies. In addition, Mustikarini and Fitriasari (2012) and Arifianti, Payamta, and Sutaryo (2013) have empirically proven that local government non-compliance with regulations and legislation has a negative and significant impact on performance appraisal. With a violation of the regulations that have been set shows poor governance in the area.

In addition, the BPK also stated that non-compliance with regulations and legislation could cause regional losses as well as potential losses to the region, in the form of a lack of revenue, thereby reducing regional revenue, inefficiency, inefficiency and ineffectiveness. Masyitoh et al. (2015) examining the effect of compliance with laws and regulations on perceptions of corruption shows that non-compliance which results in regional losses and potential regional losses has a significant positive effect on perceived levels of corruption in local government (Munawarah, Din, Zainuddin, & Muharam, 2017). This shows that corruption occurs in violations of laws and regulations that result in losses in regional finances, both those that occur in real terms and those that are still potential.

H2c: The higher the level of accountability for compliance with laws and regulations, the greater the negative effect of the level of fiscal decentralization on the level of fraud in regional financial management.

Based on Article 20 of Law No. 15 of 2004 concerning the audit of state financial management and responsibility, stating that when the results of the BPK report are issued, the party examined must respond no more than 60 days from the time the report was published. After the audit process is carried out, the next process is the monitoring phase as a result of the follow-up or recommendation from the auditor, so that in the future it can be implemented by the local government to improve the current report. Dwiputrianti (2008) argues that the existence of a follow-up report on the findings and recommendations in the inspection report shows the quality of an examination report and this report will be more effective if the recommendation is implemented by the organization that has been examined. In addition, Umar (2012) argues that with the input from auditors, decision-makers can stop and prevent the recurrence of mistakes, irregularities, misappropriations, and waste. By implementing what has been recommended by the auditor, the regional government has tried to correct mistakes in the accountability of state administration.

The same thing is stated in Liu and Lin (2012), that improvements after an audit can increase the effectiveness of the audit process, and this process is more important than detecting the audit findings themselves. For the sake of creating accountability, improvement after an audit is a must and responsibility of the regional government for errors in making regional financial reports (Sibghatullah, 2018). On the contrary, it will be a waste if the audit process is not followed up by the authorities. Masyitoh et al. (2015) state that the follow-up on the audit results negatively affects

the perception of corruption, where more and more auditor recommendations that are followed up by local governments show a lower perception of corruption. The higher the level of accountability for the follow-up of the audit results, the greater the negative effect of the level of fiscal decentralization on the level of fraud in regional financial management.

H2d: The higher the level of accountability for the follow-up results of the audit, the greater the negative effect of the level of fiscal decentralization on the level of fraud in the management of regional finances.

3. METHOD

In addition to the research variables above, there are also control variables in this study conducted to control variables that can affect the level of fraud in local financial management, namely the type of local government, the age of the local government, human development index (HDI), the size of the local government, and the total population. The population of this study is all provincial, district and city local governments in Indonesia from 2011–2014. The reason for choosing local government is based on Law No. 32 of 2004 as amended lastly into Law No. 23 of 2014 concerning local government, which explains that in the context of the implementation of decentralization the central government delegates authority to the regional government to carry out governmental tasks which are its authority in the regions.

The selection of the observation period which began in 2011 is chosen based on the implementation of bureaucratic reforms in government based on the Republic of Indonesia Presidential Regulation No. 81 of 2010 concerning the grand design of the 2010–2025 bureaucracy reform which took effect in 2011. The selection of samples is based on purposive sampling with some criteria determined.

First, based on the types of the regional government, it is divided into regency government and city government. The reason for the exclusion of the provincial government in this study is that based on Article 4 of Law No. 23 of 2014, the provincial area in addition to being a regional territory is also an administrative region which is a working area for the governor as the representative of the central government and a working area for the governor in carrying out general government affairs in the region. provincial area.

Secondly, they prepared LKPD and be audited by BPK in the form of LHP for 2011–2014, and have complete data related to opinions, audit findings, and follow-up of provincial/district/city inspection results throughout Indonesia from the 2011–2014 period listed in the BPK audit results summary (*Ikhtisar Hasil Pemeriksaan Semester*, IHPS), and complete data related to HDI, population number and administrative age of the regional government from 2011–2014.

The number of samples in this study was 412 regency/city governments in Indonesia with an observation period from 2011 to 2014. In this study, hypotheses were tested by using structural equation modeling (SEM) analysis tools and data were processed by using the WarpPLS application version 6.0.

4. RESULTS

The results showed that the data fulfilled model fit (Table 1). The results showed that fiscal decentralization has a positive effect on the level of fraud in regional financial management. This indicates that the higher the level of fiscal decentralization, the higher the level of fraud in regional financial management (Table 2; Figure 1). The results of this study confirm the perspective of information asymmetry which is one of the assumptions of the agency theory about the imbalance of information obtained between the central government (principal) and local government (agent). This imbalance of information makes agents enjoy abuse of the authority given (abuse of power) so as to cause fraud in the management of regional finances. The results of this study support the research by Wu (2005), Rinaldi et al. (2007), Sasana (2009), Saputra (2012), and Fan et al. (2009). Therefore, the ability to reduce fraud in the management of regional finances, a monitoring system is required which can reduce information asymmetry and then it can reduce fraud in regional financial management.

Table 1. Model fit and quality indices

Parameter	Value	p-value	Limitation	Conclusion
APC	0.055	0.0004	$p < 0.05$	Model fit
ARS	0.094	0.0001	$p < 0.05$	Model fit
AARS	0.087	0.0001	$p < 0.05$	Model fit
AVIF	1.655		Acceptable if <= 5, ideally <= 3.3	Model fit
AFVIF	1.682		Acceptable if <= 5, ideally <= 3.3	Model fit
GoF	0.307		small >= 0.1, medium >= 0.25, large >= 0.36	Medium fit

The statistical testing also showed that the higher the level of accountability in financial reporting, the greater the negative effect of the level of fiscal decentralization on the level of fraud in regional financial management. The results of this study confirm the institutional theory in which the principal-agent model, the central government seeks to oversee the implementation of decentralization in local governments, through the formulation of good governance in local government by means of formulating good regulations and monitoring aimed at avoiding opportunistic behavior by the government area. The monitoring mechanism is carried out through an external audit process to evaluate the governance carried out by the local government. The audit mechanism is carried out to evaluate the actions taken by the local government. The results of audits conducted by an external examiner (BPK) produce an audit opinion. The results of the examination are a form of accountability of local government financial reporting on the authority granted by the central government. Thus, accountability is a control tool carried out by the central government to local governments to overcome the problem of information asymmetry that causes fraud in regional financial management. The results of this study support research from Klitgaard (1998), Bardhan (2002), Wu (2005), Lessman and Markwardt (2010), Masyitoh et al. (2015), which state that with accountability the application of fiscal decentralization can reduce the level of fraud in regional financial management.

Moreover, the testing showed that *H2b* is rejected, which means that it is not in accordance with the proposed hypothesis that the higher the level of accountability of government internal control systems, the greater the negative influence of the level of fiscal decentralization on the level of fraud in regional financial management. This is due to the low accountability of the internal control system of the local government and the finding of weaknesses in the internal control system (SPI) which are repeated from the previous fiscal year. The results of this study are in accordance with the fraud triangle theory that the occurrence of fraud in the management of regional finances is due to the weakness of the government's internal control system. The results of this study are also in line with Huefner (2011) stating that the main way to prevent fraud is the presence of a strong internal control system. Thus, it can be concluded that a weak internal control system can lead to fraud in the management of regional finances.

Table 2. Path coefficients, p-value, R-squared, adjusted R-squared, Q-squared and full collin variance inflation factor (VIF)

Variable	Sign	Coefficient	p-value	Full collin VIF
FD	+	0.030	0.099	3.957
FRA	-	(0.228)	0.001	1.188
ICSA	-	0.013	0.289	1.036
LCA	-	(0.042)	0.033	1.070
ARFA	-	(0.060)	0.005	1.189
FD × FRA	-	(0.034)	0.069	1.705
FD × ICSA	-	(0.019)	0.205	1.338
FD × LCA	-	(0.050)	0.015	1.495
FD × ARFA	-	0.004	0.424	1.564
Type	+/-	(0.006)	0.399	1.636
Age	-	(0.062)	0.004	1.312
HDI	-	(0.089)	0.001	1.811
Asset	+	0.121	0.001	2.677
Population	-	(0.013)	0.291	2.196
R-squared		0.094		
Adjusted R-squared		0.087		
Q-squared		0.096		
Dependent variable: RLR				

Notes: RLR = regional loss rate; FD = fiscal decentralization; FRA = finance report accountability; ICSA = internal control system accountability; LCA = legal compliance accountability; ARFA = audit result follow-up accountability; HDI = human development index.

Furthermore, the hypothesis testing showed that the higher the level of accountability for compliance with laws and regulations, the greater the negative effect of the level of fiscal decentralization on the level of fraud in regional financial management. The results of this study confirm the institutional theory in which the principal-agent model, the central government seeks to oversee the implementation of decentralization in local governments by formulating good governance in local government through the formulation of effective regulation and monitoring, with the aim of avoiding opportunistic behavior by local government. In addition, the results of this study also confirm the theory of economic regulation that in the context of the delegation of authority to local governments, the government intervenes in the form of regulations to regulate such authority so that the form of accountability in government in the form of inter-institutional accountability, inter-community accountability and regional government institutions can be achieved (Mullins, 2007). Furthermore, Posner (2006) states that institutional accountability is related to the fulfillment of standards and expectations by agents set by the principal. Results of this study supports the results of research by Raman and Wilson (1994), Mustikarini and Fitriasari (2012), Arifianti et al. (2013) and Masyitoh et al. (2015).

Figure 1. Output WarpPLS 6.0-full model
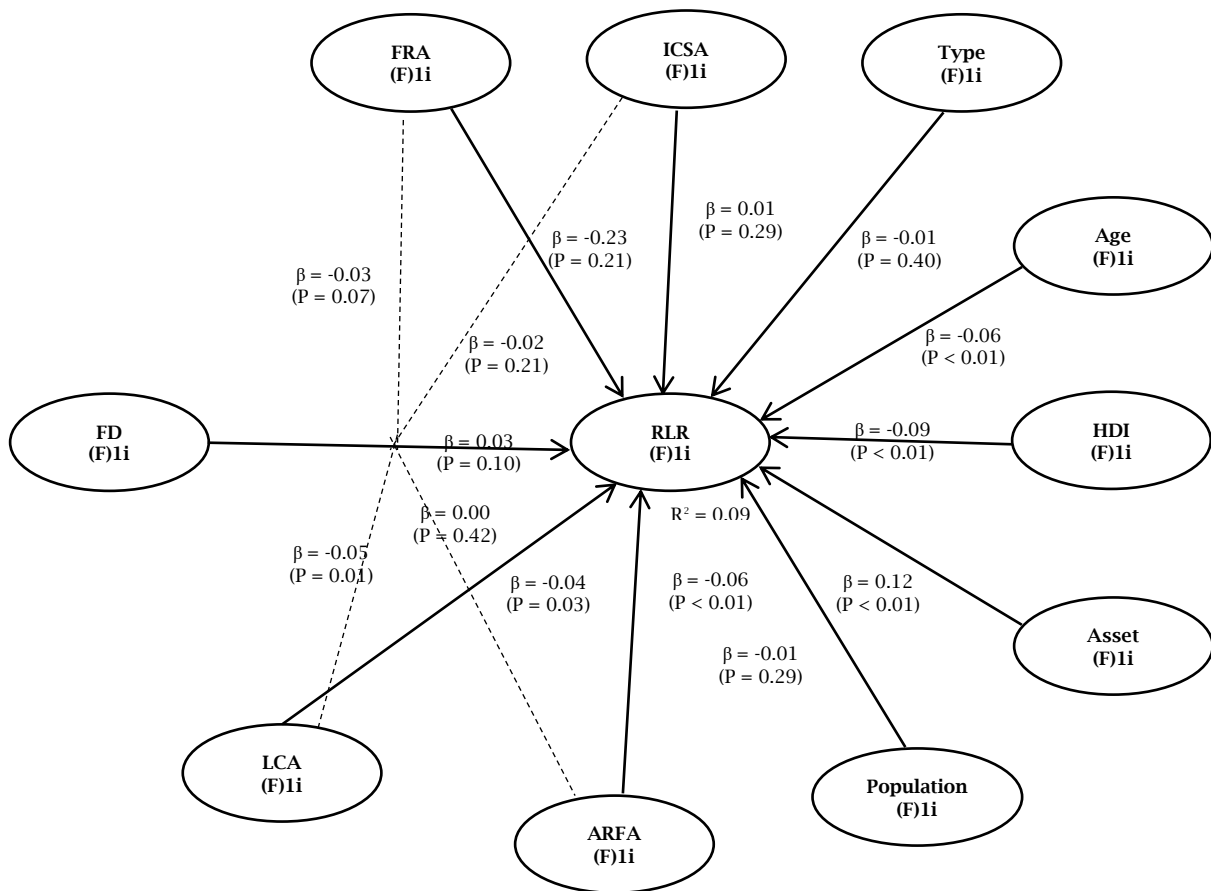
Notes: RLR = regional loss rate; FD = fiscal decentralization; FRA = finance report accountability; ICSA = internal control system accountability; LCA = legal compliance accountability; ARFA = audit result follow-up accountability; HDI = human development index.

However, the results showed that *H2d* is rejected, which means that it is not in accordance with the proposed hypothesis that the higher the level of accountability for the follow-up results of the audit, the greater the negative effect of the level of fiscal decentralization on the level of fraud in regional financial management. This is due to the lack of accountability for the follow-up results of regional government examinations. However, the level of accountability for the follow-up of the audit results has a negative and significant effect on the level of fraud in regional financial management. The results of this study are in line with research by Masyitoh et al. (2015). This is also consistent with previous findings demonstrating that some regulations are directly related to accounting aspects in a company, such as accounting reporting standards (Walker, 1987).

5. CONCLUSION

Fiscal decentralization has a positive effect on fraud rates in regional financial management. Accountability variables financial reporting and accountability compliance with legislation are also empirically proven as moderating the effects of fiscal decentralization on fraud rates in regional financial management. In addition, the results of this study also show that the low level of accountability of the internal control system and accountability does not continue the results of the examination so it cannot moderate the effect of fiscal decentralization on fraud rates in regional financial management.

The results of this study have implications for strengthening agency theory, institutional theory,

economic regulation theory and fraud triangle theory. The results of this study also have practical implications for the role of accountability through the formulation of regulations related to sanctions and rewards for local governments to carry out good governance through increasing their financial accountability. In addition, the regional government is expected to pay attention to audit recommendations so that it can reduce fraud rates in regional financial management.

This research has limitations that can be minimized in future studies, namely:

1. The study was conducted at the local government in Indonesia in the period 2011–2014, so this research applies to the situation and regulations during the research period.

2. The low coefficient of determination reflects the small variability of the effect of the independent variable on the dependent variable because most of the influence is explained by other variables not explained by the model in this study.

3. Accountability related to the internal control system and compliance with statutory regulations using data obtained from a summary of audit results that are grouped into findings related to weaknesses in internal control and non-compliance with laws and regulations.

4. Recommendations on examination results in this study are only based on those in accordance with recommendations without considering recommendations that are still in the process of being resolved.

Future research agendas that are needed for improvement in a number of ways include:

1. Develop existing measurement models by considering other measurements such as the level of regional loss based on cases that have been submitted to the court.

2. Accountability is measured based on continuous improvement from year to year by the regional government in detail from BPK's findings so that things are known to be repeated year after year.

3. Comparing the period before and after changes in government accounting standards so that it can further refine the results of this study.

4. The role of supervision, both the Regional People's Representative Assembly (*Dewan Perwakilan Rakyat Daerah*, DPRD) and the government's internal supervisory apparatus, should be added to reduce the occurrence of fraud related to regional financial management.

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