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Implementation of Audit Strategy to Improve Audit Quality in First Year of Local Government Implementing Accrual-based Accounting

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Abstract: The purpose of this study is to determine audit strategy in relation with audit quality as a response of the change of auditees' situation. This study is a case study of the Supreme Audit Institution of Indonesia, an Pemeriksa Keuangan (BPK), in planning the audit of local government financial statements (LKPD) year 2015, which is the first year of accrual accounting-based financial reporting implementation as required by the government regulation. Using analytical and descriptive approach based on secondary data and interview, the result of this study indicates that audit quality is well maintained through performance audits during the transition period in 2013-2015, including enhancement of auditor competence and independence. Performance audit findings assist auditor in focusing on high potential risks area of material misstatements and the recommendations from the performance audit results assist auditees in improving financial reporting quality. An increase of 7% of LKPD year 2015 that received unqualified opinion indicates that the change of accounting-based financial reporting can be overcome by the change of audit strategy. However, an increase of unqualified opinion of LKPD year 2014 from 51% to 58% on LKPD 2015 compared to all of 542 LKPD of all local government in Indonesia, the increase is not optimal yet. The main problem are the recommendations from auditor have not been done optimally by the local government and the intensity of audit activities does not match with the number of competent auditor. The limitations of this study are descriptive so that the results of the study are not intended to provide empirical conclusions or generalizations, but audit strategy, auditor competence and independence as a dominant of audit quality are expected to be the purpose of further discussion and research. The originality of this study is the study of audit quality in relation to the audit strategy is the first study in the audit literature.

Keywords: Public sector, audit strategy, performance audit, competence, independence, audit quality, financial reporting quality

I. INTRODUCTION

Accrual-based financial reporting over the past few decades that has dominantly applied as a basis for financial reporting in the corporate of private sector. However, in recent years it has been widely implemented

in public sector entities (Cavanagh, 2016: 1; Buhr, 2010: 11; PwC, 2013: 1). The changes of accounting basis is triggered by the assumptions and consideration that the accrual-based financial statements is better able to provide information and reports more transparent and comprehensive of public sector entities' accountability (IFAC, 2002 in Provost, 2015: 26). With accrual basis, government activities and programs, asset management, and liabilities such as reserves for pensions are disclosed and informed comprehensively, so that users of financial statements can be easier in evaluating the effectiveness of asset and capital management for decision-making considerations (World Bank 2007; Buhr,2010: 11). In addition, accrual-based financial statements can prevent unexpected expenditure of funds, which ultimately help to increase public confidence in resource management by public sector entity managers, as financial statements more reliable (IFAC, 2002 in Provost, 2015: 26).

However, the transition of financial reporting from the cash basis to the accrual basis is generally not easy and time consuming, as it requires the commitment of government officials, regulatory changes, financial reporting conceptual frameworks, changes in standards and accounting policies, and causing additional expenses of human resources training, infrastructure investment and application systems. Overall, it is recognized that changes of accrual based financial reporting will revolutionize the management system and culture of public sector entities (EY, 2012: 47-48; Biraud,2010: 9). Therefore, the transition period is often considered frightening as considered potentially will degrade the quality of the financial statements and audit opinion (Biraud, 2010: 9; BPK, 2013: 16).

In Indonesia, the adoption of the accrual-based accounting is first suggested on Article 36 (1) of Law Number 17/2003 on State Finance that explicitly specified that accrual-based financial reporting shall be applied no later than five years later, in 2008. However, due to various obstacles, for bridging, the Government issued Regulation Number 24/2005 on the financial reporting standard of cash-basis towards accrual (CTA) that give an option to record of revenues, expenditures and financing on a cash or accrual but for assets, liabilities and equity must be recorded in accrual basis. Until the year 2008 most entities still have not been able to present accrual basis financial statements, finally the Government issued a Regulation Number 71/2010 which is mandatory for all public entities to implement accrual-based financial reporting standards on local government financial statements (LKPD) year 2015 (Cindo, 2014:14; Kemenkeu, 2015).

The Supreme Audit Institution (SAI) of Indonesia, Badan Pemeriksa Keuangan (BPK), as mandated by Constitution UUD 1945, a state institution authorized to examine the management and accountability of state finances, such as the Central Government, Regional Governments, Central Bank of Indonesia, State-Owned Enterprises (BUMN), Regional-Owned Enterprises (BUMD), Public Service Bodies (BLU), and other state financial institutions or management bodies that accountable for public finance. BPK audit reports shall be submitted to the House of Representatives (DPR), the Regional House of Representatives (DPRD), the Regional Representative Council (DPD), the Central Government, the Regional Government, or other interested parties.

BPK with its over 6.000 employees, about 2.200 of whom are non-auditors, can be perceived as a big SAI, when compared with its counterparts in other countries, e.g. the UK NAO has 860 officials and employees and Polish NIK has 1.700 officials and employees. As the fourth biggest nation with more than 17.000 islands and the quickly developing in economic, it is a very demanding subject of state auditing. Organizationally the BPK consist of one head office in capital city Jakarta and 34 widely spread representative offices in all provinces of Indonesia. Types of BPK's audits are financial audit, performance audit, and

audit with a special purpose or investigative audit. The financial audit is mandated by Constitution of UUD 1945 which is now about 3.100 entities must be audited each year (SAO Poland, 2014:4-5).

This study focuses on the audit of local government financial statement (LKPD). Based on data from Second Semester Examination Result Report (IHPS II) in 2016, the number of provincial, city and regency governments that must submit financial statements of fiscal year 2015 are of 542 LKPDs. It means that the number of financial statements that must be audited by BPK increase of 18 LKPD compared to LKPD fiscal year 2011 that is 524 LKPD. The IHPS II year 2016 reports that the quality of local government financial reporting fiscal year 2011-2014 which applied the cash to accrual basis (CTA) financial reporting that received unqualified opinion showed an increase from 13% of LKPD in fiscal year 2011 to 47% LKPD in fiscal year 2014. Interestingly, in IHPS II year 2016 report, the LKPDs year 2015 which is the first year of all local governments are required to implement an accrual-based financial reporting that get unqualified opinion is of 58% (311 local governments). Thus, compared to local governments that receive unqualified opinion of LKPDs in fiscal year 2014, the LKPDs 2015 which is received the unqualified opinion increased by 7%.

Table 1 shows the audit opinion from year 2011 to 2015. In 2011, all of 542 local government throughout of Indonesia have implemented accrual-based accounting. There are four types of financial audit opinions: unqualified, qualified, disclaimer, and adverse opinion. In carrying out the financial auditing task, the auditor has to provide an opinion that the financial statements present fairly, in all material respects, on the conformity of the financial statements with accounting standards, adequacy of disclosure, compliance with legislation, and effectiveness of internal control system (SPKN, 2017: 42).

Based on the above description, there is an interesting phenomenon to examine, how and why BPK does in maintaining audit quality of LKPD 2015 as it was the first year in implementing accrual-based financial reporting as required by the Government Regulation Number 71/2010 for all public entities. In the following sections described the research method, chronology of accrual accounting regulations, audit strategy, audit quality, conclusions and recommendations.

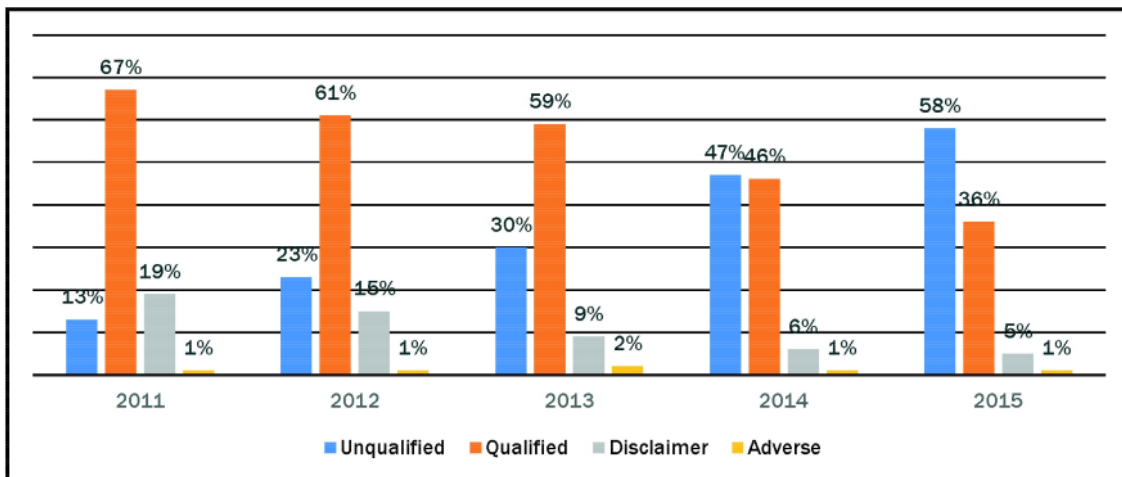


Figure 1: LKPD Audit Opinion for 2011-2015

Source: Second Semester Examination Result Report (IHPS II) 2016 – BPK (2017)

II. RESEARCH METHOD

The research method used is a case study with an analytical and descriptive approach to explain “how and why” audit strategies of BPK in auditing LKPD 2015 as a response of the changes in regulation which require all of local governments to apply accrual-based financial reporting, from which in previous applied a Cash Toward Accrual (CTA) financial reporting.

The case study research, according to Yin (2014), is one form of social science research especially to answer the question of “how” and “why” a contemporary phenomenon in the context of the real world occurs, whereas the relationship between phenomena and the context has not been clearly proven. Analytical and descriptive approach to describe the results of research as this study is not problem-oriented (Monash University, 2007). The application of case study research in this study intends to elevate the core attributes of a decision or some decisions “why it is done, how it is implemented and how the outcome” based on the results of the investigation that is expected to be important and useful for similar cases in auditing (Rowley, 2002).

The data used in this case study are secondary data such as reports issued that can be publicly accessed and downloaded through the official website of BPK and interviews among others with members of BPK, principal auditors, and auditors who conduct study visit to SAI other countries that have experienced on auditing accrual-based financial statements.

III. ACCRUAL-BASED ACCOUNTING REGULATION

In Indonesia, the adoption of the accrual-based accounting is first suggested on Article 36 (1) of Law Number 17/2003 on State Finance that explicitly expect to be implemented in 2008. However, due to some difficulties, the Government issued Regulation Number 24/2005 on Cash-basis Towards Accrual (CTA) financial reporting standard to record revenues, expenditures and financing on a cash or accrual basis, but for assets, liabilities and equity must be recorded in accrual basis. Until the year 2008 most entities still have not been able to present accrual-based financial statements, finally the Government issued a Regulation Number 71/2010 which is mandatory for all public entities since LKPD year 2015 (Cindo, 2014:14; Kemenkeu, 2015).

Government Regulation No. 71/2010 on Government Accounting Standards (SAP) explains that the accrual basis is accounting that recognizes the effect of transactions and other events at the time of the transaction or event, regardless of when cash or cash equivalents are received or paid. So the recording time of the transaction will reflect the moment of the occurrence of the resource flows. Regulation No. 71/2010 states that the Government should apply accrual based accounting standards in financial reporting. The accrual-based SAP records the recognition of income, expenses, assets, debt and equity accruals, and records revenues, expenditures and financing in reporting budgets based on the bases set forth in the provisions of state and local budgets (APBN/APBD). Compared to CTA-based accounting, the effect of accrual-based accounting is not much different because accrual treatment in CTA-based accounting has been accommodated in the financial statements, especially the Balance Sheet compiled in accordance with Government Regulation No. 24/2005 on CTA-based Government Accounting Standards. The existence of receivables, fixed assets, debt accounts is evidence of a bookkeeping process that is influenced by the accrual principle. The very basic difference between accrual-based accounting standards and CTA-based accounting standards is on revenue and expense recognition and financial statement formats. The difference

automatically requires changes or adjustments to the government accounting system (Accrual Audit Guide BPK, 2015:3-4). In addition to SAP, the central government issued several regulations related to accrual basis financial reporting. For local government, the Ministry of Home Affairs issued a Regulation Number 64/2013 on the Implementation of Accrual Based Accounting Standards for Local Governments (Pendapat BPK, 2015: 1).

In practice, however, the most crucial thing in the accrual-based financial reporting transition period is the establishment of a beginning balance (IFAC, 2002: 30). In Indonesia, the determination of beginning balances through three stages, those are data collection, conversion, and correction or adjustment. The first stage of data inventory, Budget Realization Report accounts are linked to Operational Report and Statement of Changes in Equity. In the second stage, the results of data inventory are converted into accounts of assets and liabilities globally, meaning conversion without regard to the concept of accrual accounting both on income and expenses. Conversion of Budget Realization Report data generates a surplus or deficit balance of Operational Report and adds or decreases the balance of equity of Statement of Changes in Equity. In the third stage, the conversion data is corrected or adjusted to get the beginning balance of the accrual based accounts. Revenue transactions originating from the settlement of the previous receivables, including expenditure transactions and depreciation of property, plant and equipment, amortization and write-off of intangible assets are not recorded as Operational Report revenue (Cindo, 2014: 15; BPK, 2013; IHPS II 2016).

Common problems in establishing the beginning balance are inadequate human resource competencies in accrual accounting, unintegrated information systems, and weaknesses in internal control, which overall have high potential risks for material misstatement (Cindo 2014: 15; Kemenkeu. 2015). This problem is recognized by The Minister of Home Affairs of Indonesia who states that some obstacles faced by local governments in implementing the accrual accounting system are the lack of human resources financial managers that has accounting background, HR competence, information technology and information systems, and strong commitment of officials to apply accrual based financial reporting (Kemendagri, 2015).

Until 2014, there are only ten of 539 local governments that are able to provide accrual based financial reporting (Pendapat BPK, 2015). The heads of local government in Banyumas who have first conducted a trial run of Accrual Government Accounting System in 2014, and successfully received unqualified opinion on the local government financial report (LKPD) of 2014, stated that in order to successfully implement LKPD based on accrual accounting, the first is to recognize that the time limit for applying the accrual accounting standard in accordance with Government Regulation Number 71/2010 is very clear, so it cannot delay anymore. In applying accrual accounting requires a strong belief and commitment that the application of SAP accruals is a necessity, not merely to carry out the mandate of legislation. Such beliefs and commitments will provide motivation. But these commitments and motivations must be supported in an organizational environment that owns and implements organizational values and culture without conflict of interest. Then audit findings and recommendations that usually result in LKPD getting qualified opinion, for example due to misstatement of fixed assets and revolving funds, should be immediately followed up and resolved (Bupati Banyumas, 2016).

Implementation of accrual-based accounting for the first year must bring potential difficulties and constraints that if not addressed will have an impact on the deterioration of the quality of financial reporting and audit opinions. According to some local government officials, these difficulties and constraints are overcome by discussions with auditors and consultants of information systems, so that in 2014, most of

the preparation in implementation the ⁶⁶ accrual-based accounting standards related to the regulations, human resources and information technology has been completed. To overcome the problem of human resource competence, employees are given further study opportunities with a concentration of accounting, finance and information technology education. Educational and training activities and technical guidance are always budgeted every year. Another important thing is the synergy of all local government officials. At a strategic ²² level, the Head of the Regional Working Unit (SKPD) must have a strong commitment to support the implementation ⁴⁵ of accrual accounting standards. At the managerial level, asked to care, pay attention, and implement internal control system and encourage compliance with laws and regulations. While at the technical level, formed a task force team to carry out the bookkeeping process up to the preparation of financial statements. In the initial application, should also consider the risk of failure of implementation. To avoid these risks, a strategy of applying in parallel two bases of accounting at the same time, namely the cash basis toward accrual and accrual basis (Bupati Banyumas, 2016).

The other problem of ²⁸ accrual accounting implementation in Indonesia is the local governments widely spread in various islands with different level of economic development. In 2015 there ²⁸ are 542 provincial, municipal, and district governments. Hence, besides as mentioned above, it is likely that the understanding of accrual accounting systems by officials in certain local governments is varied so that the implementation is perceived to be complex and difficult.

IV. RESEARCH RESULT

²¹ 4.1. Changes in the audit strategy

The audit strategy is the auditor's plan for designing a cost-efficient audit and provide sufficient assurance for the detection of material misstatements that help users of financial statements in decision making (Messier, 2017: 85-90). To understanding and determining which area is at the most significant risk of misstatement, an audit strategy should take into consideration the recent ²¹ client's situation (Arens *et al.*, 2012: 213). In situations where local governments are subject ⁵² to regulatory changes in financial reporting such as a change of accounting and reporting regulation from a cash accounting basis to an accrual accounting, the audit strategy should change.

Under the Government Regulation Number 71/2010 on accrual basis financial ³ reporting, local government financial reports LKPD fiscal year 2015 consists of seven reports, those are Budget Realization Report, Balance of Budget, Balance Sheet, Operational Report, Cash Flow Statement, Statement of Changes in Equity, and Notes to Financial Statement. Formerly, under the Government Regulation Number 24/2005 on cash basis towards accrual, local government has to present ³⁹ four financial statements, those are Budget Realization Report, Balance Sheet, Cash Flow Statement, and Notes to Financial Statement (Rimadewi, 2015). As the new regulation adds the number of financial reports, the scope of audit becomes wider. Thus, the strategy for audit planning must change.

4.1.1. Performance Audit

The first strategy of BPK for planning the financial audit of LKPD year 2015 is conducting performance audit. During the transition period, from 2013 to 2015, in addition to financial audit, the auditors are also assigned to assess the effectiveness of local governments in accrual-based financial reporting preparedness.

Thus, in contrast to financial audit of LKPD until 2014 that was relied on audit reports from the previous year audit, the audit planning for auditing LKPD year 2015 is heavily relied more on the results of performance audit.

In 2013, all financial auditors are required to conduct an in-depth audit of fixed assets including depreciation calculations, assesses the availability of local government regulations, organizational structure, availability and competence of human resources, accrual-based information systems and documentation of beginning balances and accounting policies. Based on performance audit, the auditor team is required to submit the audit reports and constructive recommendations and actively monitoring for ensuring that local governments officials take follow-up by improvements needed, so that financial reporting based on accrual accounting for fiscal year 2015 presented in accordance with government accounting standards as stipulated in Government Regulation Number 71/2010.

In the first semester of 2014, based on samples of 184 local governments, in general, performance auditors found some ineffectiveness, such as the lack of competent human resources for financial management and accounting, training and socialization of Government Regulation Number 71/2010 not intensive, the organizational structure has not accommodated accrual basis financial reporting, policy of accrual accounting of local government and accounting system has not been prepared, the financial management application system has not been integrated between the accounting entity and the reporting entity, has not allocated a special budget for accrual basis financial reporting activities, and does not have an accrual accounting system development plan for financial management (Biro Analisa APBN, -:3-4).

In 2015, BPK performs thematic audit on 109 local governments focusing on three aspects: commitment and regulation, human resource competence, and information technology. BPK issued the opinion report on the preparedness of local governments. In general, local governments are not fully effective as they do not have a comprehensive strategy for accrual basis financial reporting, lack of accounting policies and regulations, many human resource are not competent, and there is no self-assessment to evaluate the effectiveness of internal control on accrual-based financial reporting (Pendapat BPK, 2015: 3-4).

In terms of information technology and information system, the application system has not been able to produce accurate and valid financial statements in accordance with government accrual accounting standards. For example, the application system does not provide facilities for calculation of asset revaluation, allowance for receivables, inventory impairment, and its related expenses. Posting and inserting journals on batch basis with significant number of transactions, the risk of misstatement of the balances is very high as the relationship amongst balances are not yet fully valid (Pendapat BPK, 2015: 8). Table 4.1 shows ineffectiveness found in 109 local governments.

Table 4.1
Performance Audit Findings in 2015

	<i>Na of Local Government</i>	
Planning of HR competence	89	(82%)
Database of HR	88	(81%)
Training & socialization	81	(74%)
Accrual FR implementation strategy	74	(68%)

Source: Pendapat BPK (2015)

The findings of BPK's performance audit are in line with some studies such as [Siliana et al. \(2015: 296\)](#). Using the framework applied by the government of New Zealand, they found that the adoption of accrual accounting in Indonesia continues to face challenges and major inadequacies such as insufficient training, lack of accounting background, non-integration of various information technology systems. Hence, public sector readiness towards implementing accrual accounting becomes an issue that requires serious attention. Also, Maimunah's (2016:485) research results using a sample of 25 local government staff in Palembang found that most staff had not received adequate socialization and training, as most staff did not have an accounting education background. Thus, even if the adoption of the accrual accounting in LKPD 2015 is required by Government Regulation Number 71/2010 does not guarantee the successful implementation.

Based on performance audit reports on general problems and current conditions of some local governments, in order to mitigate the audit risks, BPK prepares and improves auditor competence and independence.

4.1.2. Auditor Competence

Audit competence indicates the competency and capacity of the person who undertakes the auditing duty and it is the first condition for the authority of the auditors ([Avci, 2015:52](#)). The perceived competency of the audit team members is key to successful audits i.e., an audit whose findings are accepted and that results in corrective actions ([Kearney et al., 2013:334](#)). Based on peer review on BPK in 2013, SAO Poland (2014:8) found that "In the Reviewer's opinion the SAI of Indonesia has sufficient competence in the audit process planning, conducting, and identifying audit subjects".

However, as is evident from BPK's audit performance, the stated conditions and circumstances require that the auditor gains an understanding of audit expectations before commencing work. Failure to do so would result in the auditor assuming considerable risk ([Kearney et al., 2013:334](#)). The International Standard Auditing (ISA) 300 states that in establishing the audit strategy, the auditor considers overall risk of material misstatement at the financial statement level. Therefore, in developing the audit plan, audit manager has to consider the competency and experience of the audit team members in performing the audit work ([IAASB, 2004:6](#)). The audit strategy and audit plan must meet the "experienced auditor" requirement. That is to say, an experienced individual with audit competence and skills must be able to follow and understand the proposed audit strategy ([Kearney et al., 2013:184](#)).

In order to maintain professional competence, auditors have ongoing professional development ([ISSAI 100:11](#)). Furthermore, at engagement level, the mandate in public sector audit are sometimes wide and require auditors to also provide assurance on matters such as compliance with law or performance indicators ([IAASB, 2013:62](#)). In 2013, According to SAO Poland (2014), the superiority of BPK is because it has comprehensive audit guidelines, educated staff, open-minded, and has a good organizational culture, compliance and discipline of procedures.

The strategy to improve auditor competence, in 2015 BPK issued LKPD Accrual Audit Guide BPK. 2015, conducts intensive training, workshops at the BPK training center and each representative office, conducting focus group discussion (FGD), and build communication forums via BPK's official web titled "frequently asked questions" (FAQ) for sharing experiences, knowledge and methodology audit. The FAQ

outlines solutions and policies on issues that often arise in the LKPD audit and is part of the audit guidelines (Accrual Audit Guide BPK. 2015: 5).

The FGD is focused on financial audit results of ten LKPD year 2014 that had applied the accrual-based accounting. The outcome of FGD are such as additional guidelines in relation with restatement procedures, financial reporting by process and by adjustment procedures, revenues and expenditures sourced from central government, and guidance on reporting and audit opinion decision. In addition, to have more understanding of auditing accrual based financial reporting, in 2014 and 2015 BPK delegates some auditors to ANAO Australia and New Zealand. The result of the visit is getting an overview of the real issues of applying the accrual basis and audit methodology for the central and local governments level.

BPK has implemented human resources management plan (HRM Plan) including planning activities, job analysis, recruitment, performance management, career development management and other functions holistically. The recruitment process is currently more open, transparent, accountable, and competency-based (LAK BPK 2016:12). Circular Letter No. 5/2012 requires direct supervisors give feedback on previous auditor assessment results. The indicator of effectiveness is measured by the percentage of auditors who meet the competency standards. In 2015 it shows that 70.67% of the target of 75% who have not meet the standards.

The State Auditing Standards (SPKN) requires the auditor follow at least 80 hours of education or audit-related training within a period of two years. In fact, in 2015, the number of auditors who meet the standard hours of training is only 74.73% of the target set at 90%. This achievement tended to be lower than in the previous periods due to the high intensity of audit activities but were not matched by the addition of auditors so that some auditors were unable to attend the training (LAK BPK, 2015: 59).

In 2016, there were 17 BPK audit reports that were sued, but based on court decisions all claims were won by BPK (LAK BPK., 2016: 44). This provides evidence that output of BPK's auditor reflect their competence as stated by IFAC (2002: 40), competencies are most useful when they are expressed in terms of outputs.

4.1.3. Auditor Independence

The Constitution and Law No. 15 Year 2006 states that the audit Board of the Republic of Indonesia shall be a free and independent institution, which is obliged to audit the management and accountability of state finance. The legal base of the BPK's functioning grants then its broad autonomy in all aspects of public financial auditing (SAO Poland, 2014:8; Kearney *et al.*, 2013:334). However, INTOSAI in ISSAI 10 (Mexican Declaration) states Supreme Audit Institutions (SAIs) can accomplish their tasks only if they are independent of the audited entity and are protected against the outside influence. According to NAO (2017: 16) auditor independence of the audited entity results in an objective and effective audit. While the credibility and legitimacy of the audit can overcome audit expectation gaps (Gendron *et al.*, 2000: 278).

SAO Poland's peer review on BPK in 2013 reveals that based on interviews with the BPK's stakeholders, it [BPK] is regarded as a strong, independent and professional organization (SAO Poland, 2014:18). Independence is an attitude and action during an audit to be impartial to anyone and not influenced by anyone. As a consequence, the auditor should maintain independence in mind as well as in appearance

(SPKN, 2017: 16). Independence of mind or independence in fact as described INTOSAI in ISSAI 30 is a situation that makes the individual auditor able to maintain professional integrity and skepticism because it does not have a relationship of interest that affects professional judgment. Independence in appearance is a condition that makes some information known to the auditor not disclosed resulting in doubts about the integrity, objectivity, and skepticism of professional auditors and raises the perception of compromise with the auditee (ISSAI 30:11).

To increase its auditors' independence and to boost their professional development the BPK has implemented a procedure of auditor rotation every 4-5 years, among its working units in the head office in Jakarta and its provincial representative offices. There is a general agreement among the BPK staff that a rotation procedure is necessary as the BPK has to address Indonesia's great internal diversity and size and contributes to the independence of individual auditors (SAO Poland, 2014:23-24). BPK auditor is also required to comply with the Code of Ethics in obtaining reasonable assurance whether the financial statements are free from material misstatement (SPKN 2017: 69-70). The Code of Ethics prohibits auditor from requesting and receiving money, goods and or other facilities, directly or indirectly from parties related to the audit, directly or indirectly involved in the activities of audit objects, such as assistance, consulting services, system development, compiling and reviewing financial statements of objects examining, discussing his or her work with those examined outside the BPK office (MKKE, 2016: 8-9). Sanctions for violations if proven to have a negative impact on audit duties State and or institution, are subject to written warning sanctions and dismissal from the membership (MKKE, 2016: 10-11). In 2016, there is a violation of 0.25% of the 0% target on employee. (SPKN 2017: 81-82).

According to Gendron *et al.* (2000: 278-279) independence is a social construction so that the claim against independence becomes valid if the survey is conducted by independent party. Neri and Russo (2014: 26) argued that auditor independence affects audit quality. "SAIs (as 'apex' institutions) need real independence to carry out their mandates. In that respect, peer reviews should be encouraged between SAIs" (CIPFA, 2015: 28). SAO Poland (2014) found through interviews with the BPK's stakeholders that BPK is regarded as a strong, independent and professional organization. PT Sucofindo an independent surveyor in 2016 with the respondents of Local Government, State and Region (BUMN and BUMD) shows that the BPK's auditors behavior and practice of independence categorized "very satisfactory" as the average score is 4.74 from 5 (LAK BPK, 2016).

4.2. Audit Quality

The possibility for performing quality audits of financial statements rests with auditors (IAASB, 2013: 62). DeAngelo (1981: 186) argues that audit quality is the probability and ability of auditors to find and report irregularities in the client's accounting system. However, the term "audit quality" is frequently used in debates among stakeholders, in communications of regulators, standard setters, audit firms and others, and in research and policy setting. According to IAASB (2014: 2) "Audit quality is a complex subject ... there is no definition or analysis of it that has achieved universal recognition". The Financial Reporting Council (FRC, 2006) argues that although empirical studies suggest various definitions of audit quality, "no perfect definition can be used as a guideline to evaluate real audit quality". Bing *et al.* (2014: 2), based on analysis of previous research concludes that "There is no consensus as to which proxies for audit quality are best suited for any particular research objectives".

According to Deloitte (2015: 54-55) ⁴⁰ “Audit findings help improve the financial statements to enable full compliance with IPSAS”, hence audit quality is part of the financial reporting quality component (De fond & Zhang, 2014: 276). De fond & Zhang (2014: 275) argued ⁵⁴ the higher the quality of audit the higher the quality of financial statements. From users’ perspective, financial statements with unmodified or unqualified audit opinions are ⁶ an important signal about the reliability of financial information (IAASB, 2014: 15). Unqualified auditor’s reports increase the confidence of parliament, legislative councils and other stakeholders of the entity (ANAO, 2015).

IAASB (2014:4) ¹⁹ believed that the audit quality is best achieved in an environment where there is support from participants in the financial reporting supply chain. The quality of the audit will only be well realized if it is supported by the financial reporting system and environmental characteristics within the entity, since both factors often hamper the quality of financial statements (IFAC, 2014: 4; De fond & Zhang, 2014: 276). Therefore IFAC (2013: 62) states “actions taken by the entity in response to recommendations are often recorded and viewed as an expression of the value of the audits”. According to ISSAI 3000, the objectives of follow-up auditing are basically to help augment the effectiveness of an audit report (INTOSAI: 50). Thus, Ince (2016: 120) argued that the best practices and performance for public sector audits are only through effective follow-up mechanisms, so that follow-up monitoring is a complement to the most critical audit philosophy in order to increase accountability awareness.

The State Finance Audit Standards (SPKN 2017) ⁶⁷ it is stated that follow-up monitoring of the results of the audit is one of the elements of the state financial audit to improve the effectiveness of the reporting of audit results and assist the representative and government agencies in improving governance (SPKN 2017: 61). Recommendations are directed to persons ⁹ or bodies authorized to perform acts and or improvements. Law Number 15 Year 2004 states explicitly that ⁵ officials are required to follow up recommendations in audit reports and shall provide answers or explanations to BPK on the follow-up to those recommendations. Officials who are known to ⁵ not perform their obligations to follow up on recommendations may be subject to administrative sanctions in accordance with the provisions of the employee legislation and or criminal law sanctions (IHPS II 2016: 278). According to BPK Regulation No. 2/2012 on Monitoring the Implementation of Follow-Up ⁷⁰ Recommendations of BPK Audit Results, follow-up review results are classified into four statuses, i.e. follow-up has been in accordance with recommendations, follow-up is not in accordance with recommendations, recommendations have not been followed up, recommendations cannot be acted upon. Causes of recommendations cannot be followed up because of changes in regulation, force major, changes in auditee organizational structure, and court decisions that already have permanent legal force (IHPS II 2016: 278-280). The level of follow-up on the recommendations is one of the indicators of the assessment of the quality of audit. The follow-up level on BPK’s recommendations will also be one of the critical successes to improve state financial management. Increasing the level of follow-up on BPK’s recommendations affect the existence of the BPK to be more perceived by the auditee or other stakeholders. BPK continues to strive to encourage all entities to complete all BPK recommendations and improve the utilization of the application of the Follow Up Monitoring Information System (LAK BPK 2017: 14).

Based on the data on the follow-up to the recommendations of BPK audit results from 2005-2016, for all audit types i.e. financial audit, performance audit and investigation, the total number of findings and recommendations were 473,343 recommendations with value of Rp242.71 trillion which had been followed-up 304,679 recommendations (70%) worth Rp121,82 Trillion (50%).

Table 4.2
Follow Up on Recommendations of Audit Results (Year 2005-2016)

Progress Status	Recommendations		Followed up	
	Number	in Value (Rp Trillion)	Number	in Value (Rp Trillion)
Has been done	304,679	121.82	70%	50%
Not yet (in process)	94,971	77.54	22%	32%
Not followed up yet	35,416	30.56	8%	13%
Discontinued legally	2,277	11.79	1%	5%
Total	437,343	242.71	100%	100%

Source: IHPS II Year 2016

As indicated in Table 5, the audit recommendations that have been followed up by auditee until the year 2016 reach 70% in the number or 50% in its value. Compared to the percentage of local government financial statements or LKPD that received unqualified opinion is of 58% in 2015, it can be said that the level of follow-up on the recommendations is closely related to the number of unqualified opinion and both are as the indicators of the quality of audits. Referring to DeAngelo (1981: 186), IFAC (2013: 12; 2014: 4), De fond & Zhang (2014: 276), Ince (2016: 120), Deloitte (2015:54-55), audit quality is higher level of the follow up of audit recommendations and unqualified opinion.

4.3. Audit Strategy and Audit Quality

The audit strategy adopted by BPK in preparation and planning for LKPD audit 2015 is very different from previous years' financial audit. Performance audit is generally conducted to assess the efficiency, effectiveness, and economics of the program or other public service activities. However, in order to minimize the risk of first year audit of all LPKDs are required to implement an accrual basis, performance audit is specifically aimed at assessing the level of readiness of local governments in implementing accrual basis financial reporting. The results of these performance audits are particularly useful for providing audit guidelines for auditors to focus more on auditing areas most at risk of material misstatements, such as validity and accuracy of beginning balance, fixed asset valuation, and various calculations of reserves, depreciation, and impairment.

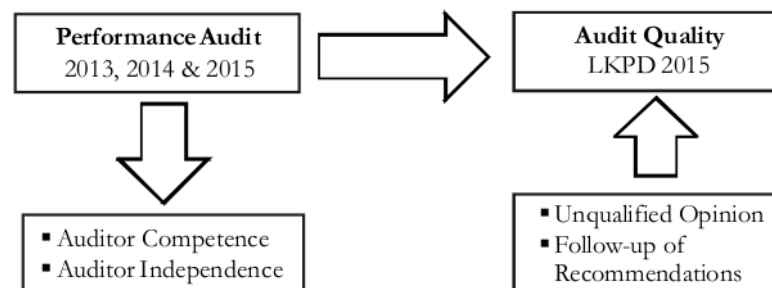


Figure 4.1: Performance Audit and Audit Quality

As discussed above, the audit strategy is associated with the quality of BPK audit of LPKD audit 2015 the first year of accrual-based accounting application for all local governments as follows:

Based on performance audit results, auditors are better able to understand the problems and constraints that hamper the successful implementation of accrual basis financial reporting. In contrast, to mitigate audit risks and improve audit quality, BPK auditors receive various training and media discussions and communications along with benchmarking through visits to other countries of New Zealand and Australia to improve auditor competence in accordance with LKPD audit needs in 2015. While to maintain objectivity and audit effectiveness, in addition to the auditor's competence, the auditor must retain its independence by applying the established professional code of practice.

In addition, in order to improve audit quality, BPK performs quality assurance and quality control activities which are intended to obtain the required quality. Measurement of level of fulfillment of quality assurance and quality control is using a checklist filled by examiners. The checklist contains a list of questions relating to all activities of the audit from planning to reporting of audit results in accordance with standards and code of ethics (SPKN, 2017; LAK BPK, 2017: 62). However, up to fourth quarter in 2016 only reached 82.37% from the target of 100% quality assurance and quality control compliance levels. The main factors causing the indicator target to be missed are the limited time of examination so that the quality assurance and quality control process does not perfect nor optimal (LAK BPK. 2017: 63).

To overcome this, several strategic routine activities to be carried out by BPK include an improvements in the mechanism of assignment of auditor within the audit team so that each element of the examining team understands its duties and responsibilities in accordance with its roles and competencies; improvements in the procedures and execution of supervision and review in the audit team and among inspection teams so that the inspection is carried out efficiently, effectively, and the whole process performed well documented by utilizing the progress of information technology; increasing the competence of the Structural Officials of Audit and the executing officer at the Directorate of Evaluation and Reporting of Inspection related to the acquisition of quality assurance through training and coaching; providing rewards for quality audit reports assessment, including assessment of audit working paper (LAK BPK 2017:64).

As known, in financial reporting 'supply chain', entity leadership are the most significant effect on financial reporting quality, and vice versa on fraudulent financial reporting (CAQ, 2010; 2013; Kepsu, 2012; Amernic, *et al.*, 2010; Beasley, *et al.*, 2010; Staicu *et al.*, 2013 in Iriyadi and Yadiati 2017: 3), since financial reporting quality is fundamentally related to manager's intention and behavior that has no intention to misleading and deceiving financial report information (Dechow and Skinner, 2000; Richardson and Tuna, 2008; Kepsu, 2012). For example, of all entities examined by BPK during 2016, as many as 10 entities have completed following up on the BPK recommendations in the same period. These entities are the National Defense Council, the State Intelligence Agency, the National Resilience Institute, the Investment Coordinating Board (BKPM), the National Counterterrorism Agency, the West Lampung District Government, the Pringsewu Regency, the Boyolali District Government, the Bima Municipal Government and the Lamandau Regency Government. This demonstrates the high commitment of the entity's leadership to follow up the recommendations of BPK, so that the audit opinion on the financial statements increases to be unqualified (IHPS II, 2016).

According to IAASB (2011), conceptually the perspective of audit quality can be seen from three fundamental aspects, namely input, output, and context factors. The input factors include personal auditor

attributes, such as skills and auditor experience, ethical values, mindset, and audit processes including audit methodologies, the effectiveness of audit tools, and the availability of other technical supporters. Among these input factors, the competence and independence of auditors are most often noticed. Auditor competence is related to the skills and auditor experience, while independence is related to ethical values and mindset. The results of previous research by Novianti and Hayuningrum (2012), based on a sample of 75 BPK auditors with primary data obtained with questionnaire 33 showed that the independence and competence of auditors together influenced audit quality. Thus, the higher the competence and independent of the auditor 74, the higher the quality of the audit produced. Octavia Widodo (2015: 189) with the unit of analysis of Public Accounting Firm in Yogyakarta with the total 7 sample of 50 respondents based on the questionnaire data showing the results of the research that the competence and independence of the significant 26 effect on audit quality. Similarly, the ACCA survey results (2014: 4) prove that audit quality is viewed as a function of both auditor competence (in discovering misstatements) and auditor independence (in reporting them).

In the fundamental aspect of output 73, the most important effect on audit quality is audit report because it is often considered by stakeholders in audit quality assessment. The auditor's report has a positive effect on the quality of the audit if the outcome of the audit is clearly accompanied by the communication of the problems found with the responsible party of governance (IAASB, 2011). However, De fond & Zhang (2014: 276) argues that audit quality will only be achieved if it is supported by financial reporting system and innate characteristic in auditee, since both of these often hinder the achievement of financial report quality. Thus, the quality of the audit followed by management intentions with high commitment to follow up audit findings and recommendations will improve the quality of financial reporting so that unqualified audit opinion is increasing.

In relation to changes in financial reporting regulations from Cash Toward Accruals (CTA) to Accrual Basis, for the auditor, in addition to improving the competence and independence of the auditor, it is necessary to change the audit strategy to obtain updated information faced by the auditee. By conducting a performance audit, the auditor knows the effectiveness and risk issues of misstatement as well as audit risk so that the audit becomes more effective as it focuses more on the audit area most at risk of material misstatement. In contrast, for audited entities, based on reports of performance audit findings and recommendations, management can promptly improve the financial reporting system so that at the presentation of LKPD 2015 shows quality in accordance with accounting standards of government on the accrual basis.

Based on the description as mentioned above, it can be said that the higher level of follow-up improvement on audit recommendation 62 of BPK is an indicator of the higher quality audit (e.g Ince, 2016: 120; IFAC, 2013: 62) thereby impacting on the increasing quality of financial reporting (e.g Deloitte, 2015: 54-55; De fond & Zhang, 2014: 275; ISSAI 100) and unqualified audit opinion (IAASB, 2014). In contrast, the large number of local government financial reports that have not received an unqualified audit opinion may be due to non-specific BPK audit recommendations (Gichana, 2015: 9), or because BPK has no auditee punishment authority that does not make improvements (Septiana, 2011:180). Another thing that causes the audit strategy that has not resulted in an optimal audit quality is the addition of sufficient number of auditors so as to fulfill the audit duties in a manner without sacrificing training to improve competence and independence.

V. CONCLUSIONS

Unqualified audit opinion of local government financial report (LKPD) in 2015, although it is the first year on an accrual basis, represents a 7% increase over LKPD 2014. The quality of BPK audits can be sustained because of different audit strategies applied compared to previous years, i.e. from 2013 until 2015 BPK conducted a performance audit to assess the effectiveness of local government readiness in accrual basis financial reporting. Based on performance audits, BPK provides constructive recommendations to local governments, especially on the insufficient problems of quantity and quality of human resources that understand accounting and financial management, unintegrated information systems, and the validity and accuracy of balances. For BPK, the potential risk of material misstatement of local government financial reporting and potential audit risks to LKPD 2015 is mitigated by increased auditor competence and independence.

However, despite the fact that there is an increase of unqualified opinion on LKPD 2015 to as much as 58% or an increase of 7% compared to LKPD 2014, when compared to the total number of LKPD in 2015 in Indonesia as much as 542 LKPD, it means there are still 42% as many as 325 LKPD that have not received unqualified opinion. This is in line with the level of follow-up on the overall BPK audit findings and recommendations that only reached 50% in the money value or 70% in the number of recommendations. Based on this research, in relation to the fact that the change in the accounting basis resulted in the addition of the number of audited financial statements and the fact that there is still a low level of follow-up on audit recommendations, the most crucial and needing special attention by BPK is the addition of a number of competent BPK auditors, because in 2015 the number of auditors who meet the standard hours of training is only 74.73% of the target set at 90% due to the high intensity of audit activities. Hence, in 2015 the indicator of auditors who meet the competency standards shows 70.67% of the target of 75%. If this is not resolved soon, it is likely to have an impact on the quality of the audit in the future. Moreover, in contrast to the recommendation of an investigative audit that has a legal effect on the perpetrators of irregularities that do not follow up on audit recommendations, BPK does not have the authority to impose penalties for auditors that do not follow up on audit recommendations for non-conformity with government accrual accounting standards.

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