

# ROLE OF FINANCIAL MANAGEMENT IN THE IMPROVEMENT OF LOCAL GOVERNMENT PERFORMANCE

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## ROLE OF FINANCIAL MANAGEMENT IN THE IMPROVEMENT OF LOCAL GOVERNMENT PERFORMANCE

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### Abstract

**Purpose of Study:** This study aimed to analyse the influence of the financial management of local government on its performance related to internal control and the competence of the apparatus.

**Methodology:** The study population includes all local government managers in 38 cities of East Java provinces and out of 1067 units of local government (offices) only samples of 81 local government offices are used in this study for analysis. Partial Least Squares and t.test were used to test the hypotheses.

**Results:** It has been found that the competence of personnel directly affect the performance of local governments' public services, but has no effect indirectly through local financial management, while internal controls affect the performance of local governments' public services, either directly or indirectly through local financial management.

**Keywords:** *Internal Control, Competence, Financial Management, Performance, Local Government*

### INTRODUCTION

Performance is the achievement of what is planned, either personally, by group or by an organization. Performance is interpreted as good if achievements are according to plan. [Sedarmayanti \(2004\)](#) suggests that performance is a record of the results obtained from the functions of a particular job or a certain activity over a certain period. For government agencies, performance measurement is intended to increase accountability, transparency, organizational management and to improve service to the public. In this study, the performance of government agencies means the performance of public services, which is the scope of the field of public-sector accounting. As [Indra \(2006\)](#) explains, public sector accounting involves accounting at higher state institutions, departments, local governments, foundations, political parties, universities, and other non-profit organizations. [Shelton and Troy \(2000\)](#) contend that measuring the performance of a local government is required for accountability. Performance measurement is certainly not limited to use in budget problems, but includes various aspects that provide information about the efficiency, effectiveness, and economical achievement of government performance.

There is also a substantive and structural phenomenon that costs in the budget are sucked into the larger, regular budget, while the portion allocated to public services is very small. [Setiaji and Priyo Hari Adi \(2007\)](#) revealed that the proportion of local revenues allocated to regional spending for autonomy has not increased and tends to be no different before and after decentralization. In East Java, for example, of the 38 local governments, public-administration expenditure on average absorbs 76.5 percent of recurring expenditure (Jawa Pos Institute of Pro Autonomous Region).

Financial management in local government is defined as the establishment of a plan for the allocation of economic resources in the form of a budget. Local budgets can also be used as a tool for the surveillance of future expenditure authority, a tool for coordinating all the activities of the various working units, as well as a standard for performance evaluation, forming a basis for the public services delivery.

Internal control involves executive oversight of the budget, monitoring that is usually done through budget efficiency ([Ott and Anto, 2001](#); [Purnama, 2014](#); [Chielotam, 2015](#); [Albasu and Nyameh, 2017](#); [Maroofi et al., 2017](#); [Mowlaei, 2017](#); [Kucukkocaoglu and Bozkurt, 2018](#)). Empirical studies related to internal controls and financial management areas as well as the performance of local government, public services were performed in positivism research approach ([Shields and Michael, 1998](#); [Pamungkas, 2005](#); [Tuasikal, 2007](#); [Santhi and Gurunathan, 2014](#); [Anyanwu et al., 2016](#); [Jones Osasuyi and Mwakipsile, 2017](#); [Mosbah et al., 2017](#); [Malarvizhi et al., 2018](#)). The results of their research provide empirical evidence of the positive effect of internal monitoring mechanisms on regional financial management and performance.

Financial management should be supported by a competent apparatus and internal control. The better the competence of the apparatus and supervision, the better is the internal financial management, and the better the financial management, the better is the performance of public services.

Contingency theory underlies this research. This theory says that the structure of the management-control system depends on factors both inside and outside the organization. This theory accepts that there is no basic standard that is a benchmark for the best organizational structure or control system, but there is rather only a system that works in one organization and may not work in other organizations, because the influencing factors are conditional on the organization.

Research into financial management also involves efforts to evaluate the performance of local governments. Referring to Agency Theory, the budget is a contract between the local work unit (the chief executive of the local government offices) and a regional head (regent or executive mayor) at the top. Relationship problems arise as the principal (owner) and the agent (manager) are both assumed to rationally maximize their own individual economic situations, which is known as the principal-agent problem. The owner wants expected monetary returns obtained from his or her investment in the company, while the manager wants wealth and leisure. Performance-based agency theory proposes a solution through a performance contract agreed to by the principal agent. [Lupia and Mathew \(2000\)](#) state that delegation occurs when one person or group, a principal, select another person or group, an agent, to act on the principal's behalf. Previous studies include [Beckett-Camarata, 2003](#)) and [Dwianasari \(2004\)](#) observed financial performance of local government agencies related budgetary competence variables. This study is intended to elaborate contingency theory and agency theory to improve the performance of local government through competence in local financial management, with either direct or indirect influence.

## LITERATURE REVIEW AND HYPOTHESES DEVELOPMENT

### The Influence of Personnel Competence of Local Government Financial Management

[Kimsean et al. \(2004\)](#) examined the performance of public service work units, finding that the factors of leadership, structure, human resources / competencies, culture, and facilities affect the performance of a public service, one stop service unit. The results of [Afiah, 2005](#)) showed that 25 counties and cities in West Java believe that parliament and local government officials affect financial information.

[\(Anigbogu and Nduka, 2014; Chang and Liang, 2015; Le et al., 2018; Maldonado-Guzman et al., 2018\)](#)state that competency is an organization's intellectual capital. Thus, it may be presumed, supports the notion that competence may affect the execution of financial management. As explained above, contingency theory argues that there is no basic standard or benchmark for organizational structure or the best controlled system. The focus is fixed instead on factors that drive the selection and design of the most suitable organization according to the characteristics of certain situations and implementing a particular system (i.e., a local financial-accounting system) to achieve stated goals (i.e., the performance of public services).

Based on the foregoing, the prediction can be made that the competence of qualified local personnel has a positive influence on the implementation of financial management:

**H1: Better competence of officers leads to better local government financial management.**

### The influence of internal controls on local government financial management

Government agencies use budgets as a surveillance tool [\(Freeman et al., 2014\)](#).The executive can implement supervision over the budget as a form of internal control [\(Awio and Northcott, 2001\)](#). Financial management is one type of internal control that is run by executive oversight in order to ensure the achievement of government objectives, such as improving people's welfare [\(Hussain et al., 2018\)](#). Audit as a control system create transparency and accountability in local government financial management [\(Rahma, Yuhertiana, & Sundari, 2016\)](#)

As affirmed by [Siegel and Ramanauskas-Marconi \(1989\)](#), the main focus of financial control subsystems is on the behavior of people in the organization, not on the machine or equipment used. [Zimmerman \(2000\)](#) also confirms that in making decisions related to accounting control, the budget is part of the performance measurement system, so monitoring is needed to determine whether the plan accords with the intended target. [Miah and Mia \(1996\)](#) indicate, that the relationship between decentralization and local-employee performance is moderated by the design of the accounting control system.

[Tuasikal \(2007\)](#) examined the effects of control, understanding of financial accounting, and financial management on the performance of the unit of government work using a sample of 114 respondents in the government district/city of Maluku, Indonesia. The results showed that partial internal control affected neither the financial management units of government work nor their performance.

Good local financial supervision can reduce irregularities resulting from human behavior, because supervision is designed to be observant of human behavior and an organization's circumstances. A reference to the concept of contingency theory



explains that each organization requires different and conditional supervision, so the adjustment to existing conditions is expected in order that effective supervision may be carried out. So, it can be presumed to influence the implementation of financial management.

Based on the above, it can be surmised that the internal controls performed by the executive have a positive influence on the area of financial management:

## **H2: The better the internal control, the better the local government's financial management.**

### **The influence of financial management on local government performance**

[Case \(1951\)](#) states that a budget is a plan of action prepared regarding how financial resources should be used by the government to achieve its functions and objectives. [Hogye \(2002\)](#) also reflects that an accountable budget is one of the key instruments leading to the transparency of government activities. The budget is prepared by a number of competent personnel reflecting government employee behavior and motivation in the form of services provided to the public. Budgets impact employee behavior because they can affect their motivation to work ([Welsch, 1976](#)); therefore, the involvement of employees is required in the preparation of the budget.

[Herminingsih \(2009\)](#) described the effect of participation in budgeting and financial management on local government performance, whereas the participation in budgeting and financial management had a positive effect on the performance of local governments.

Based on the above view that better financial management supported by good mechanisms will improve the performance of public services, and with reference to contingency theory, it can be presumed that effective, efficient, and transparent financial management in accordance with applicable legislation has a positive influence on the performance of services provided by the local government to the public:

## **H3: Better financial management leads to better local government performance.**

### **Competence influences the apparatus for public service performance, with local government fiscal management as the intervening variable**

[Afiah, 2005](#) found results indicated that the competence of members of parliament, the competence of local government officials, the implementation of accounting information systems, budgeting, and accounting information quality affect the principles of good local governance. It was a part of behaviour budget in ratification phase ([Yuhertiana et al., 2016](#))

[Kimsean et al. \(2004\)](#) examined the performance of public service work units, finding that the factors of leadership, structure, human resources, culture, and facilities affect the performance of a one-stop public service unit. [Walker and Boyne \(2006\)](#) suggested that the uneven distribution of the quality of human resources at government agencies has become a major problem for local governments today. Not all government agencies have the human resources to plan programs and activities on a medium-term framework. Many units of government are unable to plan programs and activities in the next budget period that are still associated with programs and activities in the current period. Performance-based agency theory explains that the implementation of the budget also needs to be supported by the presence of officers who are competent, have integrity, and can perform tasks with high professionalism. The principal (i.e., head of the district/city) also needs to assess how achievements have been defined so that the performance of local government officers may be measured.

Referring to the above, it can be surmised that competence influences the performance of public services:

## **H4: Better competence of government personnel leads to better performance of public services.**

## **H5: Better competence of personnel leads to better performance of public services through local government financial management.**

### **Effect of internal oversight of public service performance of local government, with fiscal management as the intervening variable**

[Tuasikal \(2007\)](#) studied the internal monitoring of the performance of local government units, indicating that internal control units directly influence performance, but the effects were not statistically significant at the 0.05 level of significance. Thereby, it can be stated that internal control has no effect on the performance of the unit of local government work.

Interpreting the results of this study, internal controls are not one of the instruments supporting improved performance of the unit of local government work. Personnel in the field supervising the mechanisms, monitoring the unit of local government



work has low meaning. Theoretically, internal control should be striving towards public service performance, but these empirical findings indicate something else. Premchand (1993) confirms the capabilities and skills needed in the local apparatus budgeting process. This suggests that supporting internal control is very important.

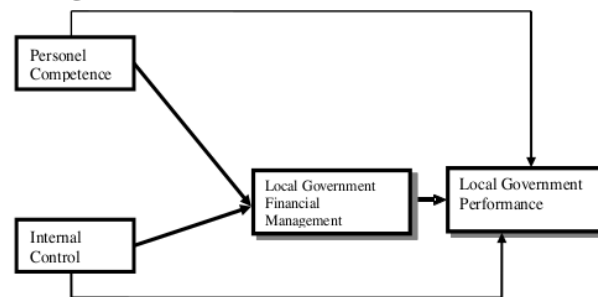
Another factor to consider is that the implementation of financial management is currently in a transitional state. There are still many executives who experience technical difficulties with the preparation, adoption and implementation of the budget, because their knowledge in the field of internal control remains inadequate. Qualified staff should implement internal control, as this can reduce the potential for fraud. Boynton and Raymond (2006) and Awio and Northcott (2001) state that the process of internal control is influenced by the board of directors, management, and others, further explaining that it is designed to provide an adequate assessment in order to achieve organizational goals. Supervision become an important activities for management to assurance that all of performance congruence with the organization vision. Supervision is part of the performance measurement system, so monitoring is needed to determine whether a plan has been set to run in accordance with the intended target. Meanwhile, Miah and Mia (1996) indicate that the relationship between decentralization and local employee performance is moderated by the design of the accounting control system.

Agency theory explains that the achievement of better performance based on a budget requires monitoring efforts (i.e., internal control) so that government officials act in accordance with the systems and procedures that have been established. Agency theory in public sector explained by Yuhertiana (2003). Based on the above, it can be concluded that internal control encourages the performance of local governments:

H6: Better internal controls lead to better performance of local government public services.

H7: Better internal controls lead to better performance of public services through better financial management.

Research framework describe in figure 1 below.



(Figure 1: Components of Local Government Performance)

## METHODOLOGY

This study uses a hypothesis testing research design, empirically testing the effect of apparatus competence, internal controls and financial management on the public-service performance of local governments. The East Java province and its capital city of Surabaya consist of 38 local governments, covering 29 districts and 9 cities having a total of 1067 units of local government (offices). Purposive sampling techniques is used, with two criteria. First, to determine location, this study uses gross regional domestic product (GRDP) ranking. Sidoarjo was chosen to represent a region with high GRDP. Tuban was chosen to represent a region with moderate GRDP. Lamongan represents regions with low GRDP. Second, to determine respondents used management positions in the organization. Only the head of the office as the top management in each work unit used as the respondent. The sample totalled 81 offices, and each respondent was sent one questionnaire.

There are four variables used in this research. Personel Competence (X1): Competence can also be interpreted as the capabilities of the apparatus, both professional and moral. Internal Control (X2): Oversight in the form of internal control by executives, conducted in the area of resource allocation and reflected in the budget. Financial Management (Z): The overall activities of planning, establishment, implementation, administration, reporting and accountability in the area of financial controls. Public Services Performance (Y): All service activities undertaken by public-service providers addressing the needs and implementation of the provisions of legislation.

## RESULT AND DISCUSSION

### 1) Measurement model

Outer model is observed in convergent validity (the magnitude of loading factors for each construct). Loading factor above 0.7 is recommended, however loading factors from 0.5 to 0.6 can still be tolerated as long as the model is still under

development. After the 3rd round of processing data, the results shown that all latent variables have an outer loading value of more than 0.5 (as seen at table 1)

**Table 1.** Outer loading value

	PC	PC* LGFM	LGP	IC	IC* LGFM	LGFM
PC.3	0.734284					
PC.5	0.806128					
PC.8	0.746957					
LGP.2			0.846816			
LGP.3			0.858569			
LGP.5			0.782941			
IC.1				0.732491		
IC.2				0.791861		
IC.3				0.663623		
IC.4				0.793818		
IC.5				0.871371		
IC.6				0.569439		
LGFM.1						0.547563
LGFM.10						0.691110
LGFM.2						0.602243
LGFM.3						0.530723
LGFM.4						0.568798
LGFM.7						0.510503
LGFM.8						0.645412

PC : Personel Competente

LGP : Local Government Performance

LGFM : Local Government Financial Management

IC : Internal Control

Composite reliability. Outer model can also be seen from composite reliability and cronbach alpha, composite reliability value and cronbach alpha for all exogenous constraints above 0.7

Outer loading for each exogenous contract can also be seen from the Average Variance value. Constructs with good validity require AVE values of each construct above 0.5

2) Assess the inner model or structure model. To see the relationship between laten variables done by looking at the value of R2 and the significance value can be seen from the t-statistic value obtained by using the bootstrapping method

with the requirement of a t-statistic value above 1.96

**Table 2.** Composite reliability value

	AVE	Composite Reliability	R Square	Cronbachs Alpha	Commuality	Redundancy
PC	0.582320	0.806782		0.642315	0.582320	
PC *						
LGFM	0.101776	0.432442		0.836524	0.101777	

LGP	0.689079	0.869077	0.514025	0.775292	0.689079	0.072659
IC	0.552946	0.879401		0.837888	0.552946	
IC* LGFM	0.100692	0.736548		0.930170	0.100690	
LGFM	0.346075	0.785674	0.129728	0.692319	0.346075	0.011116
PC : Personel Competence						
LGP : Local Government Performance						
LGFM : Local Government Financial Management						
IC : Internal Control						

Detail of hypotheses result explain in table 3. The test results showed that the H1 hypothesis was rejected, which means empirical data do not support the hypothesis that a better competent apparatus yields better financial management. The results further confirm that the competence of personel in implementing financial management still inadequately accords with the standards established by the Regional Employment Board. The results of this study are not consistent with the theory of performance-based agency, which states that the parties, the principal and the agent, will make a contract, either implicitly or explicitly, that the agent will act/perform the work as desired by the principal. These results also do not agree with the results of research conducted by (Priono, 2011).

The results of hypothesis testing showed that H2 is accepted. Meaningful empirical data support the hypothesis that better internal controls lead to better financial management.

These results are consistent with previous studies conducted by Tuasikal (2007) and Priono (2011).

The results of hypothesis testing showed that H3 is accepted, meaning that empirical data support the hypothesis that better financial management leads to better performance of public services by local government.

**Table 3.** Status of Local Government Performance

	Hyphotesis	t statistic	t value	Conclusion
H1	PC -> LGFM	1.454450	1,96	rejected
H2	IC -> LGFM	2.999428	1,96	accepted
H3	LGFM->LGP	2.141120	1,96	accepted
H4	PC-> LGP	2.071229	1,96	acceppted
H5	PC*LGFM -> LGP	1.231346	1,96	rejected
H6	IC-.LGP	0.267300	1,96	rejected
H7	IC * FM-> LGP	1.182067	1,96	rejected
PC : Personel Competence				
LGP : Local Government Performance				
LGFM : Local Government Financial Management				
IC : Internal Control				

An interpretation of these results is that the financial management has significant role in improving public service performance. Therefore, it is necessary to the financial management area in accordance with the mechanism or process of financial management, which includes the preparation, adoption and implementation and intended for the welfare of the community through public services provided by the local government.

These results are not consistent with previous studies conducted by Tuasikal (2007) and Priono (2011).



The results of hypothesis testing showed that H4 is not rejected. Meaningful empirical data support the hypothesis that better competence of the apparatus leads directly to better performance of public services. These results support the previous research of (Kimsean et al., 2004; Afiah, 2005).

The test results showed that the H5 hypothesis is rejected, meaning that empirical data do not support the hypothesis that better internal controls lead directly to better performance of public services. Therefore, it can be stated that internal controls have no direct influence on the performance of local government public services.

The results of hypothesis testing showed that H6 was rejected, meaning that empirical data do not support the hypothesis that better competence leads directly to better performance of public services. Therefore, it can be stated that internal controls have no direct influence on the performance of local government public services.

Test results do not directly represent the hypothesis, which states that there is no direct influence on the performance of the internal controls of public services through financial management. The results found no indirect effect, which means that the formulated hypothesis is rejected.

These findings support the results of Tuasikal (2007); Boynton and Raymond (2006). The results of this study, in addition to existing data support the underlying theory of contingency. The new findings of this research are as follows. Internal control could not support the performance of public service office directly or indirectly through financial management. The provision of adequate services to the public needs support from intensive supervision and financial management done directly by local government offices. The argument is that the better the financial management and supported by a good control mechanism, the better performance of local governments in the form of public service. The findings of this study suggest, however, that there is no direct or indirect influence of internal controls on the performance of public services through local financial management. This view refers to the contingency theory, which asserts that there is not a specific concept that can be applied to all situations or circumstances. Rather, the application of a method or concept is influenced by the circumstances in which these concepts are applied (Anthony, 2003).

Table 4 below explained the result of PLS analysis that is relevance with the t test.

#### RESEARCH LIMITATIONS

Some limitations that may affect the results of this study areas follows. First, the sample comprised only 81 respondents who were the head of 81 local government offices in three regions. Second, the investigated variables affecting the performance of local government in this study were limited to the competence of personel, internal controls and financial management. Many other variables were not being addressed in this study and may affect the performance of local governments. Third, the public service providers of local government in this study rated themselves, so there is the possibility of bias in their answers.

#### CONCLUSION

The competence of the apparatus does not contribute to financial management, while internal controls contributed to financial management. Financial management does not contribute to the performance of public services. The competence apparatus contributes directly to the performance of public services. The competence of the apparatus does not contribute indirectly to the performance of public services through local financial management, while internal controls contribute neither directly nor indirectly to the performance of public services through local financial management. Contingency theory argues that the design of a system, method, theory, or concepts and its successful application depends on the circumstances in which it will be applied (Donaldson, 2001). Normative logic suggests that designs must be adapted to the circumstances and characteristics of each area, as required by this theory.



**Table 4.** Partial Least Squares results

	Original Sample (O)	Sample Mean (M)	Standard Deviation (STDEV)	Standard Error (STERR)	T Statistics (O/STERR)
PC -> LGP	-0.173403	-0.164520	0.083720	0.083720	2.071229
PC-> LGFM	0.159026	0.148529	0.109338	0.109338	1.454450
PC* LGFM -> LGP	-0.395080	-0.151989	0.320852	0.320852	1.231346
IC-> LGP	-0.028075	0.029272	0.105033	0.105033	0.267300
IC-> LGFM	0.303584	0.341165	0.101214	0.101214	2.999428
IC * LGFM-> LGP	-0.428387	-0.209106	0.362405	0.362405	1.182067
LGFM-> LGP	0.172360	0.189105	0.080500	0.080500	2.141120

PC : Personel Competence  
LGP : Local Government Performance  
LGFM : Local Government Financial Management  
IC : Internal Control

The conclusions of this study lead to some recommendations. Apparatuses of government should be in accordance with the standards of local civil service agencies, which will create a credible apparatus. Internal controls for each work unit require attention from the heads of the district/city. In this case, personel occupying strategic positions in the areas of financial management must be professionals in the field in accordance with the standards of local staffing agencies, as reflected in their education, training, sufficient experience, and mental attitude.

Local government is spearheading an increase in the overall performance of public services. Therefore, to give appreciation to work units as well as to motivate local governments to provide excellent service, minimum service standards need to be formulated and implemented in accordance with the characteristics of each work unit area.

Researchers who want to conduct research in this field need more in-depth observations of the variables that affect the performance of a local governments' provision of public services. These variables include, for example, the understanding of financial accounting systems, external supervision, employee loyalty, local culture, political budget, political pressure, and demographics. Samples in subsequent research should be grouped based on external government auditor (BPK) opinion, so as to enrich the empirical evidence of public-sector accounting knowledge. A number of areas selected as samples for future research are expected to replicate the findings in accordance with the chosen method. Performance of public services should be assessed by external parties (Parliament, academics, NGOs) so as to minimize bias.

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