

## Do Internal Control Capacity Improve Reporting Quality? Evidence from Indonesian Local Government

Anindyo Aji Susanto<sup>a\*</sup>, Gita Astyka Rahmanda<sup>a</sup>

<sup>a\*</sup>UPN Veteran Yogyakarta, Special Region of Yogyakarta, Indonesia, [anindyoajisusanto@upnyk.ac.id](mailto:anindyoajisusanto@upnyk.ac.id)

<sup>a</sup>UPN Veteran Yogyakarta, Special Region of Yogyakarta, Indonesia, [gitaastyka@upnyk.ac.id](mailto:gitaastyka@upnyk.ac.id)

\*Correspondence: [anindyoajisusanto@upnyk.ac.id](mailto:anindyoajisusanto@upnyk.ac.id)

### Abstract

This study investigates the determinants of local government reporting quality through the use of discretionary accruals in Indonesian local governments, with emphasis on the moderating role of internal control apparatus (APIP) capacity. Drawing on public choice theory, the analysis examines whether accruals are strategically employed to manage financial outcomes or reflect persistent reporting practices. Using the data from 34 province level and applying regression analysis, the results reveal that surplus-deficit before accruals are consistently and negatively associated with the discretionary accruals, indicating the use of discretionary accrual to offset financial imbalances and achieve performance benchmarks. In the baseline model, lagged discretionary accruals are positively associated with current accruals, suggesting persistence and strategic continuation of such practices. However, once APIP capacity is incorporated, the persistence effect weakens. APIP capacity itself significantly reduces discretionary accruals, and its interaction with financial balance further constrains accrual-based adjustments, while its interaction with lagged accruals reinforces persistence in reporting practices. These findings highlight a paradox: institutional oversight reduces opportunistic accrual adjustments but simultaneously entrenches established reporting behavior, limiting substantive improvements in financial reporting quality.

### Keywords:

Discretionary Accruals, Accrual Quality, Local Government, Internal Control Apparatus Capacity, Public Choice Theory.

## 1. Introduction

Indonesian local governments (hereafter, ILG) has mandated the transition on financial reporting basis to accrual-based accounting across all level of local governments as enacted by Government Regulation No. 71 of 2010. This shift is intended to improve the quality, comparability, and enhancing transparency and accountability of ILG's financial reporting practice. Aside from the promising premise of accrual accounting, the inherent versatility of accrual accounting also encourages for discretionary adjustments, potentially leading to manipulative financial reporting practices (Andriani et al., 2010; Pilcher, 2011). Borrowing from the corporate setting, previous research suggests that financial statement figures in local governments are often used for deliberate adjustments, typically in the form of discretionary accruals motivated by political incentives (Ferreira, 2024; Ferreira et al., 2020). Such use of discretionary accruals also reflects on the quality of accruals, as higher levels of discretion indicate lower reporting quality and reliability of financial information.

The effective oversight mechanisms is essential to safeguard the integrity of financial reporting in local governments given the potential political intervention risks. In the Indonesian context, the Government Internal Control Apparatus (Aparat Pengawasan Intern Pemerintah, APIP) plays a pivotal role in this regard (Muhtar et al., 2020). As mandated by Government Regulation No. 60 of 2008 on the Government Internal Control System (SPIP), APIP is tasked with ensuring that financial management and reporting processes comply with principles of transparency, accountability, and adherence to applicable standards. Through both preventive and detective control functions, APIP serves as an institutional safeguard to limit political influence over financial reporting practices (Muhtar et al., 2020;

Nurdiono & Gamayuni, 2018). Strengthening APIP's capacity and independence is therefore crucial to curbing opportunistic reporting behavior and enhancing the reliability of accrual-based financial statements in local governments.

We aim to investigate whether the APIP capacity promotes the better accrual quality in ILG. For that purpose, we formulate our hypotheses based on Public Choice Theory which suggests that bureaucrats, as managers in public sector, are inclined to act in ways that enhance their personal or political interests (Cohen et al., 2019; Cohen & Malkogianni, 2022). We then employ the Leone and Van Horn model (2005) to encapsulate the accrual adjustment as a mechanism for ILG to align the political or performance incentives. Eventually, we extend the original model to figure out the interaction effect of the APIP capacity to the accrual quality. The result shows that the use of discretionary accruals were evident to attain the performance benchmark, which prone to political interest. Interestingly, the expected role of internal control apparatus capacity in constraining the use of discretionary accruals was not supported. This finding contributes empirical evidence to the literature by highlighting the decoupling role of internal control within ILG financial reporting, particularly with respect to accrual quality. The rest of this paper is organized as follows. Section 2 reviews the relevant literature and develops the research hypotheses. Section 3 outlines the research design, including data, variables, and methodology. Section 4 presents the empirical results and discussion. Finally, Section 5 concludes the paper and provides implications for policy and future research.

## **2. Theoretical Framework and Hypotheses**

### **The Settings**

ILG Financial Reporting Framework establishes a structured approach to financial accountability and transparency, requiring local governments to prepare financial statements that integrate both cash and accrual bases. Under Government Regulation No. 71 of 2010 on Government Accounting Standards, this dual-reporting basis serves to give a thorough view of financial performance. The requirement for accrual-based reporting, however, introduces additional complexity, as differences in recognition criteria between cash- and accrual-based transactions may create disparities in reported figures, thereby opening opportunities for adjustments or discretionary practices that affect financial disclosures (Andriani et al., 2010; Cohen et al., 2013).

### **Accrual Adjustment in ILG**

Accrual adjustment vigorously refers to the adjustments made to align revenues and expenses with the period in which economic events occur. Such adjustments are essential for ensuring that financial reports capture a government's financial activities in a way that supports transparency and accountability. The adjustment in accruals typically exert through the discretionary accruals as deliberate or abnormal adjustments which extracted from the aggregate accruals (Bisogno & Donatella, 2022). Drawing on Public Choice Theory, we posit that the bureaucrats, as managers in local governments are driven to employ such adjustment to meet the financial target or specific benchmark to align the political interest (Bisogno & Donatella, 2022; Cohen et al., 2019).

### **Internal Control Apparatus Capacity**

The internal control apparatus, particularly the Government Internal Control Apparatus (Aparat Pengawasan Intern Pemerintah, APIP), functions as a safeguard designed to uphold accountability and transparency in financial reporting. As mandated under Government Regulation No. 60 of 2008 on the Government Internal Control System (SPIP), APIP is expected to oversee financial management processes, reduce information asymmetry, and limit the scope for opportunistic use of discretionary accruals. Regarding the aforementioned challenges, the capacity of the internal control apparatus becomes critical in ensuring that the adoption of accrual-based reporting achieves its intended objectives, as stronger internal control capacity—reflected in the competence of personnel, independence, leadership commitment, resource adequacy, and system maturity—serves as an institutional mechanism to mitigate political influence and enhance the reliability of local governments' financial statements.

Rachmat and Wijaya (2024) emphasize that management commitment, and competency improvement strengthen APIP capability and improve the effectiveness of internal controls. Similarly, Gamayuni, et.al (2018) demonstrate that APIP supervision significantly enhances local government

accountability. In addition, Prakoso and Aryati (2024) find that SPIP maturity and APIP capability are positively associated with the likelihood of obtaining unqualified audit opinions, underscoring the role of internal control systems in signaling financial reporting quality.

### Research Hypotheses

In the ILGs' setting, the adoption of accrual-based financial reporting is not merely technical reform but also embedded in political environment where incentives may affect reporting behavior. Public choice theory postulates that government officials are motivated by self-interest and political incentives, which influence their decisions in resource allocation and financial disclosures (Buchanan, 2003). The flexibility inherent in accrual accounting provides opportunities for discretionary accruals that can be used to pursue political or managerial objectives, rather than solely serving the purpose of transparent accountability. Accordingly, the ILGs' context offers a relevant setting to examine political incentives and internal control mechanism in influencing the quality of financial reporting. Prior empirical evidence supports this view: Ferreira, et.al (2013) found that local governments in Portugal exert the discretionary accrual as a means to disclose the financial figure in conform to the signalling bureaucrats competence. Cohen et.al (2019) and Ferreira, et.al (2024) further found evidence that the electoral cycle plays as prominent political motivation to the local government behavior in accrual adjustment through discretionary accruals. Given the setting in ILG and the postulate from Public Choice Theory, we then formulate our first hypothesis as follows:

H1: ILG engage in accrual adjustment through the discretionary accruals

Secondly, while political incentives encourage ILG to exercise discretion in financial reporting, the varying institutional capacity of internal control systems plays a pivotal role in constraining opportunistic behavior in financial reporting. Stronger internal control capacity—manifested in personnel competence, leadership commitment, adequacy of resources, and system maturity—functions as a safeguard against political intervention on financial statements. In line with the institutional perspective, APIP capacity reduces managerial discretion by increasing oversight and reinforcing compliance with reporting standards. Therefore, we expect that internal control capacity moderate the magnitude of accrual adjustments. We thus propose the second hypothesis:

H2: Internal control apparatus capacity negatively moderate the adjustment through discretionary accruals

### 3. Method

This study adopts a quantitative research design, utilizing data obtained from the audit reports (Laporan Hasil Pemeriksaan / LHP) of all local government financial statements for the period 2016–2022, which are publicly accessible through the website of the Indonesian Supreme Audit Board (BPK). The dataset consists of 34 provincial governments over the research period. The provincial level of ILGs is selected as the sample because the APIP capacity score is consistently available at this level. The research period of 2016–2022 is deliberately chosen, as it represents the second phase of accrual accounting implementation in ILGs, which is expected to reflect a more mature stage of accrual-based financial reporting compared to the initial phase (2011–2015). This study employs discretionary accrual ( $DA_{it}$ ) as proxy to reporting quality. We derive the  $DA_{it}$  variable using Modified Jones Model which used in previous studies. We then examine the exert of  $DA_{it}$  as accrual adjustment using the modified Leone and Van Horn model to test our first hypothesis. The model is modified to align the ILGs' financial reporting framework and denote as follows:

$$DA_{it} = \alpha + \beta_1 \text{SurpdefBDA}_{it} + \beta_2 L.\text{Surpdef}_{it} + \beta_3 L.DA_{it} + \varepsilon \quad (1)$$

The  $DA_{it}$  represent the deliberate accrual adjustment of observation  $i$  in  $t$  period,  $\text{SurpDefBDA}_{it}$  represent Surplus Deficit Before Discretionary Accrual of observation  $i$  in the period of  $t$ ,  $L.\text{SurpDef}_{it}$  denote for Lagged Surplus Deficit of observation  $i$  in  $t$ , and  $L.DA_{it}$  represent Lagged Discretionary Accrual of observation  $i$  in  $t$ . All variables scaled with Lagged Total Asset in period  $t$  to address the heteroscedasticity issues. The model introduce the  $\text{SurpdefBDA}_{it}$  variable which derive by subtracting the  $DA_{it}$  from the  $\text{SurpDef}_{it}$ . This variable is incorporated into the model to capture the reverse mechanism of  $DA_{it}$  implying that ILGs rely on their ex-ante financial condition to determine the direction and magnitude of discretionary accruals. This reverse mechanism is plausible given the

political incentives to achieve specific financial targets, such as maintaining a balanced budget or reporting only a small surplus/deficit, which are common in the decentralized financial management of ILGs. The lagged variable,  $L.Surpdef_{it}$  is included in the model to control the omitted variable in the error term regarding that the previous period Surplus Deficit figures potentially affect the magnitude of  $DA_{it}$ . The  $L.DA_{it}$  is incorporated to address the autocorrelations issues. We then incorporated the APIP Capacity score to the model as the moderating variable to test our second hypothesis. The necessary diagnostic test are also performed for robust estimation in our competing models.

## 4. Results and Discussion

### 4.1 Results

Our sample consist 272 year entity observations of 34 provincial level during the research period. However, our sample shrink due to the discretionary accrual ( $DA_{it}$ ) measurement which use the lagged value ( $TA_{it-1}$ ) for the scale and the change on the value of the 2 consecutive period ( $\Delta Rev_{it} - \Delta Rec_{it}$ ). The outliers are also removed from the sample resulting 200 observation for the final sample. The descriptive statistic of the variables is shown in the Table 1 as follows:

**Table 1 Descriptive Statistics**

Variables	Obs	Mean	Std Deviation	Minimum	Maximum
$Rec_{it}$	238	0,0156	0,0234	0,0001	0,1720
$Rev_{it}$	238	0,6080	0,2525	0,0033	186,3280
$TA_{it}$	238	1,1079	0,1245	0,9251	191,9120
$At_{it}$	238	0,8742	0,1472	0,5677	1,6409
$CFO_{it}$	238	0,3125	1,4990	-0,0479	1,4236
$SurpDef_{it}$	238	0,0820	0,1164	-0,0949	0,9811
$TAcc_{it}$	238	0,2305	1,4958	-0,9000	1,4025
$\Delta Rev_{it}$	204	-0,0347	0,1756	-1,1561	0,6119
$\Delta Rec_{it}$	204	-0,0035	0,0163	-0,1471	0,0554
$\Delta Rev_{it} - \Delta Rec_{it}$	204	-0,0313	0,1750	-1,1625	0,6102

$Rec_{it}$  represent Receivable of observation  $i$  in  $t$  period.  $Rev_{it}$  represent Revenue of observation  $i$  in  $t$  period.  $TA_{it}$  represent Total Asset of observation  $i$  in  $t$  period.  $At_{it}$  represent Fixed Asset of observation  $i$  in  $t$  period.  $CFO_{it}$  represent Cashflow from Operation of observation  $i$  in  $t$  period.  $SurpDef_{it}$  represent Surplus Deficit (LO) of observation  $i$  in  $t$  period.  $TAcc_{it}$  represent Total Accrual of observation  $i$  in  $t$  period.  $\Delta Rev_{it}$  represent Change in Revenue of observation  $i$  in  $t$  period.  $\Delta Rec_{it}$  represent Change in Receivable  $i$  in  $t$  period.  $\Delta Rev_{it} - \Delta Rec_{it}$  represent the gap of change in revenue of observation  $i$  in  $t$  period subtracted by the change of receivable of observation  $i$  in  $t$  period.

The descriptive statistics reveal substantial variation in the variables employed for discretionary accruals ( $DA_{it}$ ) measurement. Total Accruals ( $TAcc_{it}$ ) exhibit a positive mean (0.2305) with a very wide dispersion (standard deviation 1.4958), reflecting heterogeneity in accrual practices across entities. Changes in Revenue ( $\Delta Rev_{it}$ ) average slightly negative (-0.0347) with relatively large variation (standard deviation 0.1756), while Changes in Receivables ( $\Delta Rec_{it}$ ) remain close to zero (mean - 0.0035), suggesting relatively stable receivable volatility. The variable  $\Delta Rev_{it} - \Delta Rec_{it}$  has a mean of - 0.0313, capturing revenue changes adjusted for non-cash components, and is central in the Modified Jones framework. Cash Flow from Operations ( $CFO_{it}$ ) also shows extreme variation (mean 0.3125, standard deviation 1.4990), reinforcing the importance of distinguishing accrual-based earnings from cash performance. In contrast, scale variables such as Total Assets ( $TA_{it}$ ; mean 1.1079, standard deviation 0.1245) and Fixed Assets ( $At_{it}$ ; mean 0.8742, standard deviation 0.1472) are more stable, providing a consistent basis for model estimation. Overall, the dispersion in accrual-related variables underscores the potential for discretionary reporting behavior.

The following diagnostic test is then conducted prior to the  $DA_{it}$  measurement and the result suggest the random effect estimation over the fixed effect estimation as the significance level of the Hausman test exceed the the treshold ( $\chi^2 = 0.01$ ,  $p = 0.994$ ). We then deriving the  $DA_{it}$  and conduct the

Leone - Van Horn Model to test our hypotheses. For the shake of the variable measurement in the Leone-Van Horn Model, the sample for the hypotheses testing shrink to 166 observations. The descriptive statistics and the result of the Leone - Van Horn model is shown in Table 2 and 3 respectively:

**Table 2 Descriptive Statistics of Leone Van Horn Model**

Variable	Obs	Mean	Std. Dev.	Min	Max
DA <sub>it</sub>	166	0.20077	0.05469	-0,07659	0.32697
SurpdefBDA <sub>it</sub>	166	-0,15154	0.09056	-0,34482	0.31329
L. Surpdef <sub>it</sub>	166	0.07941	0.12174	-0,09486	0.98114
L. DA <sub>it</sub>	166	0.18275	0.10687	-0,73419	0.33652

Source: compiled by authors. DA<sub>it</sub> represent the discretionary accrual of i in t period, L. Surpdef<sub>it</sub> denote for the lagged Surplus Deficit of i in t period and L. DA<sub>it</sub> represent the lagged discretionary accruals of i in t period.

**Table 3. Result**

Variables	Exp Sign	Main Model	Interaction Model
<i>Constant</i>	?	0.0606***	0.2067***
L. SurpDef <sub>it</sub>	+	0.2564***	0.0670
SurpDefBDA <sub>it</sub>	-	-0.4884***	-0.2932***
L. DA <sub>it</sub>	+	0.2503***	-0.2583
Apip_cap <sub>it</sub>		-	-0.0519***
L. SurpDef <sub>it_apip</sub>		-	0.0669
SurpdefBDA <sub>it_apip</sub>		-	-0.0696*
L. DA <sub>it_apip</sub>		-	0.1805***
F		229.76***	104.57**
Adj R <sup>2</sup>		0.806	0.814
Obs		166	166

Source: compiled by authors. \*\*\*, \*\*, and \* indicate significant level at 0.01, 0.05 and 0.1 respectively. DA<sub>it</sub> represent the discretionary accrual of i in t period, L. Surpdef<sub>it</sub> denote for the lagged Surplus Deficit of i in t period, L. DA<sub>it</sub> represent the lagged discretionary accruals of i in t period, Apip\_cap<sub>it</sub> represent APIP Capacity of i in t period. L. SurpDef<sub>it\_apip</sub>, SurpdefBDA<sub>it\_apip</sub>, and L. DA<sub>it\_apip</sub> represent the interaction of each variable in the main model with the Apip\_cap<sub>it</sub>

The results in Table 3 provide important insights into the determinants of discretionary accruals (DA<sub>it</sub>) and the moderating role of APIP capacity. In the baseline model, the lagged surplus-deficit (L.SurpDef<sub>it</sub>) shows a positive and significant coefficient (0.2564, p<0.01), indicating that financial balance pressures persist over time and continue to influence accrual-related choices. Surplus-deficit before accrual adjustments (SurpDefBDA<sub>it</sub>) is negative and significant (-0.4884, p<0.01), suggesting that when ILGs record favorable ex ante financial positions (surpluses), they tend to reduce them through accrual adjustments, vice versa. This finding supports H1 by demonstrating that accruals serve as a balancing mechanism to manage reported financial outcomes. Moreover, lagged discretionary accruals (L.DA<sub>it</sub>) are positively associated with current accruals (0.2503, p<0.01), confirming the persistence of accrual practices across periods.

When APIP capacity is incorporated as a moderating variable, several important dynamics emerge. First, APIP capacity is negatively associated with discretionary accruals (-0.0519, p<0.01), indicating that stronger internal audit capacity constrains the opportunistic use of accruals. Second, while the effect of L.SurpDef<sub>it</sub> becomes statistically insignificant, the coefficient of SurpDefBDA<sub>it</sub> remains negative and significant (-0.2932, p<0.01) with reduced magnitude, suggesting that APIP capacity partially mitigates accrual-based adjustments to ex ante financial positions. Importantly, the interaction between SurpDefBDA<sub>it</sub> and APIP capacity is negative and marginally significant (-0.0696, p<0.1), consistent with H2 and reinforcing the institutional perspective that stronger oversight reduces

accrual discretion. By contrast, the interaction between lagged  $DA_{it}$  and APIP capacity is positive and significant (0.1805,  $p < 0.01$ ), implying that while stronger audit capacity reduces accrual discretion contemporaneously, it also reinforces the persistence of previously established accrual strategies. The explanatory power of the models remains high, with adjusted  $R^2$  values of 0.806 and 0.814, and the inclusion of interaction terms further enhances model fit.

## 4.2 Discussion

The results provide important insights into the determinants of discretionary accruals in ILG and the moderating role of internal control apparatus capacity. First, the negative and significant coefficient of surplus-deficit before accruals indicates that ILG utilize accruals to adjust ex ante financial outcomes toward a more balanced ex post position. Specifically, when facing a favorable surplus, they tend to reduce it by applying negative accruals, conversely in the case of deficits, they increase accruals to improve reported performance. This finding supports the notion that accruals are employed as a financial smoothing instrument, consistent with public choice theory which posits that government officials seek to manage reported figures to meet political or institutional benchmarks. The significant and positive coefficient of lagged discretionary accruals in the main model further confirms persistence, suggesting that accrual management is not merely reactive but also strategically maintained over time.

Secondly, the introduction of APIP capacity reveals important moderating effects. The direct negative association between APIP capacity and discretionary accruals suggests that stronger internal audit institutions constrain deliberate use of accruals. Moreover, the interaction between surplus deficit before discretionary accrual and APIP capacity is negative and significant, implying that robust audit capacity reduces the extent to which governments use accruals to offset favorable or unfavorable financial balances. In contrast, the interaction between prior period discretionary accrual and APIP capacity is positive and significant, indicating that while APIP limits current-period adjustment, it also reinforces the persistence of prior-period accrual practices. This paradox points to a compliance-oriented oversight structure, which may reduce opportunism at the margin but inadvertently entrench established reporting patterns. Finally, the consistently high explanatory power of the models demonstrates the central role of ILGs' financial conditions and oversight capacity in shaping accrual practices. The evidence suggests that discretionary accruals in ILG are simultaneously driven by financial incentives and institutional capacity, with both constraining opportunistic behaviour and institutionalizing reporting persistence.

## 5. Conclusion

This study provides empirical evidence on the determinants of discretionary accruals in ILG and the moderating role of APIP capacity. The findings reveal that discretionary accruals are systematically associated with ex ante financial positions as when under condition of surplus, governments tend to reduce reported outcomes through accrual adjustments, whereas under deficits the adjustment is exert conversely. This pattern indicates that accruals are employed as a tool to smooth reported figure rather than solely representing underlying economic activities. The significant effect of lagged discretionary accruals further highlights the persistence of such practices across periods.

The moderating analysis underscores the dual role of APIP capacity. In one regard, stronger internal audit capacity reduces the discretionary use of accruals in response to contemporaneous financial pressures, suggesting greater restraint under stronger institutional oversight. On the other hand, its interaction with lagged accruals suggests that accrual adjustment practices may persist despite enhanced audit capacity. Overall, these results suggest that accrual-based reporting in ILG is shaped by both financial incentives and institutional oversight. Strengthening APIP capacity remains essential to limit opportunistic use of accruals, yet complementary improvement are needed to address the persistence of such practices over time and to ensure that accrual accounting enhances transparency and accountability in Indonesian local government financial reporting practice.

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