

**UNIVERSITI TEKNOLOGI MARA**

**THE EFFECT OF AUDIT RESULTS,  
PERFORMANCE MEASUREMENT  
SYSTEM, AND GOOD  
GOVERNANCE ON LOCAL  
GOVERNMENT PERFORMANCE**

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## ABSTRACT

The issuance of the Presidential Decree No.81 of 2010 (Article 2) regarding the Grand Design Bureaucracy Reform has benefited the local governments that made the execution of their performance to the public more crucial. Previously, the local governments were only responsible for using a part of the resources raised through taxation to provide services to the citizens. However, since the existence of the law, local government have been more creative to improve the welfare of the citizens by exploring the potential of regional wealth resources. The higher the potential for resources that can be discovered for revenue improvement, the more the financial performance of the local government in increasing the wealth of the region. For the past decade, the Indonesian local governments have been highly criticized due to the lack of financial performance. In addition, the Supreme Board Audit Republic of Indonesia Report 2018, showed that 12,780 cases of financial leakages occurred due to weaknesses in the internal control system and non-compliance with standards amounted to Rp2.54 trillion in the 2017 local governments' financial reports. Despite many complaints and issues on the poor performance of Indonesian local governments, only a handful of empirical studies examining factors that contribute to the financial performance of Indonesian Local Governments. Thus, this study aims to analyze the effect of audit results (audit finding and audit rectification), Performance Measurement System (PMS), and Good Governance (GG) on the performance of Local Governments. Furthermore, this study also analyses the moderating role of PMS and GG on the performance of local governments. It is important to investigate whether the control mechanism is from the internal or external part of the local governments. This study also develops a comprehensive GG index that combines principles of GG; based on Indonesia Government Index (IGI) by Kemitraan, which is a non-profit organization that pools the knowledge, expertise, and experience in the implementation of governance reform in Indonesia. This study collects secondary data from annual reports of the local governments and Public Ministry Republic of Indonesia offices. The study uses the dataset for 134 Indonesia's local governments from 2013 – 2017. Using a quantitative approach, this study utilizes panel data models to gauge the best estimators for the dataset. The empirical results show that audit results, PMS, and GG have significant effects on the performance of local governments. The findings show that higher audit finding means higher degree of non-compliance with laws and regulations, which lead to regional losses as well as potential losses to the region and reducing local revenue. A high audit recommendation facilitates extensive rectification to take place which subsequently increase realized local revenue. The findings also revealed that performance measurement system and good governance contributes significantly to Indonesia's local governments revenue. This study contributes to the literature by providing empirical support that PMS and GG strengthen the relationship between audit rectification and the performance of local governments. This implies that high audit rectification supported with strong PMS and GG promote better financial performance. Meanwhile, this study showed that PMS and GG weakens the relationship between audit findings and the performance of local governments. In other words, high audit finding followed by lack of PMS and GG further contribute to poor financial performance. Overall, the findings assert that an implementation of comprehensive monitoring system, from outside and within the institutions, create a higher performance of local government.

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# CHAPTER ONE

## INTRODUCTION

### 1.1 Overview

This chapter presents an overview of this study. Section 1.2 discusses the background of this study. Section 1.3 explores the common problems of local governments in addressing local governments performance in Indonesia. Section 1.4 discusses problem statement in this study. Section 1.5 and 1.6 outlines the research objectives and research questions. Section 1.7 the significance of the study, while section 1.8 is a summary of the overall structure of the thesis.

### 1.2 Background of Study

Local governments are multifunctional organizations that provide a wide scope of services, ranging from education and welfare to firefighting and sanitation services. Therefore, local governments are at the forefront of delivering and providing the core public services which citizens rely on in their everyday life (Carmeli, 2002; Diaz, 2016; Hussein et al, 2016). Local governments represent the lower tiers of public administration being the closest to the general public. Local citizens expect their local government to deliver high-quality services and spend the budget allocated by the central government wisely. In addition, citizens expect government workers to perform as efficiently as possible so that every cent of tax paid is put to the best use.

Raudla et al. (2016) and Dubnick (2005) state that a local government's effectiveness is directly related to how productive its organizations are, such as the ability of an organization to perform and turn that capacity into outcomes. The efficacy and efficiency of public sector organizations in providing public goods and services are referred to as excellent performance (in terms of volume and quality) (Hay & Cordery, 2018). (Bruns, 2014; Putu et al, 2007; Jiang et al, 2011). Hence, the performance of local governments may be used to assess a region's capacity to manage regional autonomy and accomplish its goals.

In the year 2019, several government programs and activities have been conducted with the aims to improve citizen welfare such as; (i) Program Keluarga