Local Governments Characteristics and Quality of Financial Reporting in Indonesia

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Abstract. This study aim to propose measurement of local governments financial reports (LGFR) quality in Indonesia and compare the quality of financial reports based on the local governments' characteristics. Measurement of LGFR quality is based on qualitative characteristics of government financial statement. Local governments characteristics consists of size, wealth, age, and number of legislative. The sample used is 1002 local governments during 2016-2017 using the content analysis method and the mean difference test. The result show that the mean value of LGFR quality in Indonesia is 37,78 or only 68,69% from the full score. We also found that larger size of local governments have better quality of financial reports compared to smaller size of local governments. On the other hand, local governments with greater wealth, longer age, and larger member of legislative have lower quality financial reports compared to local governments with smaller wealth, shorter age, and smaller member of legislative.

Keywords: Local Government Characteristics, Quality of Financial Reporting

1 Introduction

Local Governments in Indonesia adhere the principle of local autonomy in organizing its government affairs. It means that every local government has the right, authority, and obligation to regulate the affairs of all matters relating to the implementation of government and also the society's interests [1]. As a form of accountability for what has been done, the local government must create accountability reports, one of which is the financial statement. Financial reports one of the essential components of creating accountability. In preparing the financial reports, the local government refers to the applicable regulation [2]. In ensuring the reliability and fairness of a government financial reports , it is necessary for external parties to review and audit the government's financial reports who is conducted by Supreme Audit Institution (BPK) [3]. Audit activities both internal and external have function to ensure the reliability of financial reports and detect whether there is a fraud or non-compliance activity in accordance of applicable laws and regulations to provide useful information [4], [5].

Based on summary of audit report [6], all local governments have implemented accrual-based accounting as the implementation of applicable regulation [2] concerning Government Accounting Standards (SAP). In the last two years (2016-2017), there was an increasing number of local governments that receive unqualified opinions (WTP)

which previously 70% becoming 76% in 2017. In addition, there was also an improvement from disclaimer opinion (TMP) become qualified opinion (WDP) of 7 LGFR and from qualified opinion (WDP) become unqualified opinions (WTP) of 45 LGFR. The increase in opinion indicated that the financial statement complies with applicable regulations and free from material misstatements.

Policies in the public sector especially government accounting differ from one country to another. Thus, in determining and measuring the quality of financial reports must be aligned to the conditions of certain countries. Some studies in the public sector try to measure the quality of financial reports with restatement [7] and financial reporting deficiency score [8]. Financial reports contain useful financial information in the decisions making process [9]. In order to present useful information, financial reports must meet several qualitative characteristics. The qualitative characteristics of financial information consisting of relevant and correct presentation, comparable, verified, timely, and understandable [10]. In the Government Accounting Standards (SAP) which is a reference for local governments in creating financial reports explained that the qualitative characteristics of financial reports consist of relevant, reliable, understandable, and comparable [11]. A study that have tried to measure the qualitative characteristics of financial reports by using 21 items of qualitative characteristics in 231 annual reports of companies listed on the US, UK and Dutch capital markets in 2005 and 2007 [12]. This measurement measurement of qualitative characteristics is quite comprehensive using proxy of the qualitative characteristics of financial reports into 21 items. When comparing between private entities (companies) and public entities (government), the concept of the qualitative characteristics in the financial reports has the same basic principles. This measurement [12] also has been used to develop a questionnaire related to the quality of government financial reports [13]. Research on the quality of financial reports which focuses on the qualitative characteristics of financial reports on a national scale is still relatively rare.

Each local government has different characteristics. Several studies in Indonesia that discuss the characteristics of local governments are usually associated with the level of disclosure in government financial reports [9], [14], [15], [16], [17], [18]. The results indicate that several characteristics of local governments such as size, age, wealth, and also the number of local government legislatures are related to the level of disclosure in government financial reports. The higher level of disclosure shows that local governments are more transparent, and the quality of financial reports will also improve. There is still limited research focusing on the effect of local government characteristics toward the quality of financial reports. A study that examined the effect of government characteristics on the quality of government financial reports found that several characteristics such as government size, intergovernmental revenue, and also governmental spending affect the quality of financial reports as measured by the values relevance in the financial statement [19]. Otherwise stated, local government characteristics has aneffect to the quality of local government financial statement.

The purpose of this study is to compare the quality of local government financial reports between small and large groups based on the characteristics of the local government itself. The local government characteristics used in this study are size, wealth, administrative age, and also the number of legislatures. Therefore, the research questions in this study are:

RQ1: How does the comparison of the quality of financial reports between small size and large size governments?

RQ2: How does the comparison of the quality of financial reports between small wealth and large wealth governments?

RQ3: How does the comparison of the quality of financial reports between shorter administrative period and longer administrative period governments?

RQ4: How does the comparison of the quality of financial reports between small number of legislatures and large number of legislatures governments?

This study has two main contributions. The first contribution is to propose measurements related to the quality local government financial reports. The second contribution is to test the differences in the quality of local government financial reports based on the characteristics of local governments.This study uses content analysis methods to assess the quality of local government financial reports, and the mean difference test to figure out whether there are differences in the quality of financial reports in local governments based on the characteristics of local governments in 1002 local governments. The results show that the average quality of the financial reports of local governments is 37,78 or only 68,69% of the full score. According to the research results, the mean difference test on the characteristics of local government shows that the quality of financial reports of large-size local governments is better than the quality of small-size local government financial reports. On the other hand, governments with greater wealth, longer administrative age, and a greater number of legislatures have lower quality compared to local governments with smaller wealth, shorter administrative age, and smaller number of legislatures. The implication based on the results found in this study is that local governments with greater wealth, longer administrative age, and a greater number of legislatures should further improve the quality of financial statement.

2 Literature Review

2.1 Agency Theory

The agency relationship is a contractual relationship whereby one or more acts as the principal appoints another person to act as an agent to carry out the task as a form of delegation of authority [20]. Agency problems arise when there is a delegation of authority from principals to agents [21]. Agency problems can be caused by factors of incentive and avoidance of pressure [22]. Agents as parties who are authorized by the principal to carry out the task, they have information and full power in making a decision. From this situation, it can be seen that the problem that arises is the existence of asymmetric information, which is when one party has more information than the other party [14].

The parties involved in the agency problem in the public and private sectors are different. In the private sector, agency problems occur between those who have capital or shareholders and those who carry out the day-to-day operations of the company or managers. In the public sector, especially government, agency problems that arise involve the publics as principals and also the government as an agent [15]. This statement is also supported a statement that agency problems in local government occur

between elected local officials and the community [14]. In Indonesia, the community can directly elect its local head (government) through local head elections which are held in every 5 years. This local head election creates agency relations when the community as a voter delegates authority to the elected local head [23]. that Agency problems can also occur when the government implements policies that only benefit one particular party at the expense of the interests and welfare of the community [23]. In other words, agency problems arise when the government has more information than the public in the administration of government or public services, and also has the authority to make local decisions and policies that may benefit one party. In these conditions, it appears that the agency problem that arises is asymmetric information between the government and the community.

In term of explaining accountability, agency theory is the main theory that is often used to explain conditions that occur and formulate hypotheses [24]. Accountability in the context of the public sector is defined as the obligation of the party that is authorized (the government) to provide accountability, present, report, and disclose what has been done while running the government to the party that gives authority (the public) [25]. Financial statement are one of the ways to reduce the informationasymmetry. The government is required to make financial reports as a form of government accountability to the community for what they do in carrying out government functions in a period.

2.2 Qualitative Characteristic of Financial Reporting

Financial reports consist of information about what has been done as a form of accountability to certain parties for the delegation of authority. The higher quality of financial reports, the more useful the information contained in the financial reports of its users [26]. Base on applicable regulation in Indonesia, the qualitative characteristics of financial reports are relevant, reliable, comparable, and understandable [11].

2.2.1 Relevant

Relevant characteristics are related to the use and materiality described by the ability to make decisions by users of financial reports [26]. A government financial report is believed to be relevant when the report contains information that can influence in the decisions making by helping them evaluate past or present events, and predict the future, and confirm or correct their evaluation results in the past. All information must be presented in a complete and timely manner so that it can be useful for decision makers [11].

2.2.2 Reliable

For a financial report to be useful, it must contain reliable information. Reliable information means that the information is free of material biases and errors [26]. A government financial report is said to be reliable when the report contains information that is free from misleading notions and errors material, honestly presents every fact, and can be verified [11].

2.2.3 Comparable

The third qualitative characteristic is that it can be compared. This characteristics allow users of financial reports to compare financial reports [26]. A government financial reports is said to be comparable when the information contained in the financial reports will be more useful if it can be compared with the financial reports of the previous period or the financial reports of other reporting entities in general [11].

2.2.4 Understandable

This characteristics can be fulfilled through effective communication between financial reports makers and users of financial reports [26]. The better the understanding of users of financial reports, the higher the quality of financial reports [27]. A government financial reports is said to be understood when information presented in financial reports can be understood by users and expressed in terms and terms that are adjusted to the limits of understanding of users [11].

2.3 Local Government Characteristics

2.3.1 Size of Local Government

The size of an organization reflects how large an organization is [14]. Size is usually reflected by the total assets owned or managed by an organization [17] The greater the assets that are managed, the harder for them to get to be managed by the organization. The demand for transparency on budget management and government affairs would be greater in local governments that have a larger size compared to smaller size local governments [14]. Local governments with greater total assets will tend to increase the level of disclosure and ultimately improve the quality of financial reports [9].

2.3.2 Wealth of Local Government

An organization's wealth reflects the organization's ability to finance its own operational matters. In measuring the level of wealth local governments usually use the amount of original local government revenue (PAD). This is because PAD is a collection of local taxes and levies obtained from the people of an area [14]. The greater amount of PAD shows the greater community contribution; thus, community demands for government disclosure and transparency are also greater [28], [17].

2.3.3 Administrative Age

The administrative age of the local government shows how long a local government has been formed from the beginning based on the law on local formation. An area with a longer administrative age tends to be more experienced in making financial statement because local government implemented recommendation form BPK [14], [17], [18]. The longer the administrative age of the local government, the better the quality of its financial reports [29]. Another study found that when an organization has a longer

administrative age, the possibility of discretion gets smaller and ultimately degrades the quality of financial reports [30].

2.3.4 Number of Legislatives

In Indonesia, Local Representative Council (DPRD) acts as a legislative body. As community representatives, the DPRD's tasks are to conduct monitoring and controlling of the running government to match the aspirations of the community. Legislative members will make sure the budget is allocating properly and ensure the realization of transparency and accountability through oversight of the implementation and financial and performance reporting [28], [14]. The number of legislatures in a region is determined based on the number of population in an area, the city and district governments have a minimum number of 20 and a maximum of 50 legislatures [31]. The greater number of legislatures will increase the number of disclosures in an area, so that in the end it will improve the quality of financial reports [15], [28], [14]. However, another study state that the increasing number of legislatures does not correlate with the function and the oversight role by the legislature to be optimum [32]. Therefore, it can reduce the quality of financial reports of local governments.

3 Methodology

3.1 Data and Sample

The population in this study were all local governments in Indonesia in 2016-2017. This research excludes provincial government, because it has different characteristics. In determining the sample, this study uses a non-probability-purposive sampling technique, by determining several criteria to obtain a research sample. The criteria used are the city/district government, that publish financial statement for 2016-2017, and published number of legislative members. Based on these criteria, the sample of this study are 1002 local government financial statements (table 1).

In comparing the quality of local government financial statements, this study uses two groups for each characteristic. The first group is the smallest group in each characteristic after being sorted. The second group is the largest group in each characteristic after being sorted. The selection of this group uses percentile distribution, by dividing the sample into 100 groups. Group selection in this method is done to avoid grouping values in a particular group, so that two extreme groups are taken.

This study uses secondary data in the form of analysis of qualitative characteristics, total assets, and the Owned SourcedRevenue (PAD) derived from the audited financial statements, the administrative age of the local government obtained from the Ministry of Internal Affairs, and the number of local legislative members obtained from the Puskapol Universitas Indonesia.

Table 1. Research Sample.

Sample Selection Criteria	
Population 2016-2017	1096
Province Governments	(68)
City Administrative (DKI Jakarta)	(12)
Missing Financial Reports	(10)
Missing number of Legislative	(4)
Total Sample	**1002**

3.2 Variable Measurement

3.2.1 Quality of Local Governments Financial Reports

A study tested 21 combined items as a measure of the quality of financial statement [12]. The research indicates that the measuring instrument is valid and reliable to be used in assessing the quality of financial reports. This study measures the quality of LCFR using that measurement adjusted to the qualitative characteristics of government financial reports based on applicable regulation in Indonesia [11] by giving scores for items used and supported by textual analysis to strengthen the consideration of the quality of financial reports to be more accurate and reliable. Textual analysis helps in assessing specific information that can be used as an assessment at a specific index. After making adjustments to applicable regulation in Indonesia [11], the items used to measure the quality of financial reports are 11 items. Each item will be given 1-5, where 1 is the lowest and 5 is the highest.

3.2.2 Size

This study uses total assets to measure the size of a local government based on the measurement methods used in the some research [14], [17], [19].

3.2.3 Wealth

Wealth is a measure of the independence of a local government proxied by Owned Source Revenue (PAD). PAD is a collection of local taxes and levies from the community, which also shows the level of community participation in government [14], [17], [28].

3.2.4 Administrative Age

Administrative age shows how long an organization has been running its activities since it was formed. Thus, the administrative age is measured from the year of local government formed based on the laws of local formation [[14], [17], [18].

3.2.5 The Legislature

The legislative council or better known as Representative Council (DRPD) is the people's representative to ensure that the aspirations of the people are conveyed and the government is well organized. The legislative characteristics in this study measured by the number of members of the city and district DPRD [14], [15], [28].

3.3 Method

This study uses content analysis methods to assess the quality of financial reports and the mean difference test to answer the research questions. Before conducting a mean difference test, local governments will be divided into large groups and also small groups. First, local governments will be sorted from small groups to large groups based on the characteristics of size, wealth, age and also the number of legislature. After being sorted, the local government will be grouped by percentile, meaning the data is divided into 100 groups. In order to do the mean difference test, it requires two groups, the first group with a limit value <P10 represents the small group, and the second group with a limit value> P90 represents the large group. The mean difference test or t-test is a comparative test or different test to find out whether there are significant mean differences between two different independent groups [33]. Before conducting the mean difference test the researcher also conducted the homogeneity test required as a basic assumption of the independent t test.

4 Results and Discussion

4.1 Descriptive Statistics

This study uses a sample of 1002 local government financial reports during 2016-2017. Table 2 shows the descriptive statistical results of all variables in the sample.

Tabel 2. Descriptive statistics.

Variable	N	Mean	Std. Dev	Min	Max
FRQ	1002	37,78	5,90	20	52
Size	1002	Rp. 3 trillion	Rp. 3.7 trillion	Rp. 369 billion	Rp.41 trillion
Wealth	1002	Rp. 228 billion	Rp. 414 billion	Rp. 3.9 billion	Rp. 4.9 trillion
Age	1002	38,72	24,17	2	67
Legislative	1002	34,14	10,03	20	50

Table 2 shows that the average value for the quality of local government financial reports is 37.78 or around 68.69% of the total score. With a scale of level 1-5, these results indicate that the quality of the financial reports of local governments in Indonesia is at level 2 or 3. The minimum value for the quality of financial reports of

20 is given to the local governments of Magelang and Central Lombok. The maximum value for the quality of the financial statements of 52 is given to the local government of Merangin district in Jambi Province. The lowest total amounts of assets are owned by PulauTaliabu district in North Maluku Province. The lowest amount of original local government revenue (PAD) is owned by Maybrat district in the Province of West Papua. The local government with the highest total assets and total owned source revenue (PAD) is Surabaya City. Another interesting result we can see from the administrative age of local governments. In recent years, there have been a number of new regions which have been divided into several existing regions. This can be seen from the significant difference from the minimum number of administrative age of local government that is 2 and the maximum number of administrative age of local government that is 67. For the legislative size of local government has been determined in accordance with applicable regulation [31], with a minimum number of 20 and the number of 50 at maximum.

4.2 Mean Difference Testing Result

Mean difference test or T-Test is used to determine whether there are significant differences between two specific independent groups. The mean difference test result using percentiles can be seen in Table 3.

Table 3. Mean Difference Testing Result – Percentile.

	Small	Large	Diff	T	Prob
Size	37.11881	38.77228	-1.65347	-1.9701	0.0251 **
Wealth	38.62376	36.48515	2.13861	2.7838	0.0029***
Age	38.37624	34.34653	4.02970	5.4986	0.0000***
Legislative	38.65347	34.20792	4.44555	5.7047	0.0000***

Overall, the results show that there are significant differences between the quality of financial reports of one group and the other. To answer the first research question, we compare the size for small and large local government. For Size characteristics, the results show a difference value of -1.65347. This negative result means that when compared between small groups and large groups, the local government with a larger number of assets has a higher quality of financial reports compared to the local government with a smaller number of assets. This result is significant at the 5% significance level. When local governments have a greater number of assets, they have more resources to carry out several activities such as training in phases of human resources, developing information systems, and even conducting some research that can improve the quality of financial reports that they produced. These results support the research which found that government size is positively related to disclosures in financial reports [14]. The higher level of disclosure in the local governments financial statement, the higher expectation on the better quality of its financial reports.

The second research question is comparison of wealth. Table 3 showsthat the difference value of wealth is 2,13861 which means that when compared between small

and large groups, local governments that have a greater amount of owned source revenue have lower financial report quality compared to local governments that have a smaller original owned source revenue. This result is significance at the 1% level. This result contradicts the research which found that the greater amount of original local government revenue, it indicates greater community participation, so the demands for transparency and accountability are also greater [14]. However, these results indicate that the greater amount of original local government revenue, the quality of its financial reports is getting lower which means it also indicates low transparency and low accountability. This can also be caused by the lack of attention and public demand for a better quality of financial reports.

The answer of the third research questionregarding age characteristicshow that the value of the difference between small groups and large groups is 4,02970 which means that local governments with a longer administrative age have lower quality financial reports compared to local governments with shorter administrative ages. This result is significance at the 1% level. These results contradicts with some researches [14], [18], [29]. However, these results support the findings in the other research who argue that the longer life of an organization, the possibility of discretion in financial statements is also smaller [30]. This is caused by local governments with shorter administrative ages tend to make reports based on reports that have been made by governments with a longer administrative age by making improvements so they can produce higher quality of financial reports.

The last research question is the characteristic number of legislatures. The result shows a difference value of 4,44555, which means that local governments with more members of legislative have lower quality financial reports compared to local governments that have fewer legislative numbers. This result is significance at the 1% level. These results contradict the findings of some researches [[14], [15], [28]. This could be caused by increasing number of legislatures making the function and role of supervision carried out by the legislative council less optimal, resulting in a lower quality of financial statements.

4.3 Additional Analysis

We conduct additional mean difference test using median. The result can be seen in table 4. The result in table 4 in line with main analysis in table 3 except for the size. Overall, we can see that by having the small size, wealth, age and legislative member, local government can be focus to increase the quality of their financial statements.

Table 4. Mean Difference Testing Result – Median.

	Small	Large	Diff	T	Prob
Size	38.26148	37.28543	0.97605	2.6237	0.0044***
Wealth	38.79441	36.7525	2.04192	5.5538	0.0000***
Age	39.27745	36.26946	3.00798	8.3332	0.0000***
Legislative	38.57884	36.97806	1.61078	4.3559	0.0000***

5 Conclusion

The purpose of this study is to propose measurement of the quality of government financial reports and compare the quality of financial reports based on the local governments' characteristics. The quality of financial reports measure using 11 items of local governments qualitative characteristics. In general, the average score of quality of local government statements in Indonesia is 37.78 or approximately 68.69% of the total score. This result is quite good considering the local government begin to implement full accrual basis since 2015. The application of accrual-based accounting is expected to improve government performance in preparing the budget and budget realization. The successful implementation of accrual-based accounting requires collaboration from various parties to produce financial statements that are more transparent and accountable [34]. The result of comparison of local government characteristics to quality of financial statement shows that that larger size of local governments has better quality of financial reports compared to smaller size of local governments. On the other hand, local governments with greater wealth, longer age, and large rmember of legislative have lower quality financial reports compared to local governments with smaller wealth, shorter age, and smaller member of legislative.

The implication of this research is that the local government with greater wealth, longer administrative age, and also the greater number of legislative members need to increase the quality of their financial reports. This higher quality of financial reports will increase the transparency and accountability of government financial reports and maximize the function and role of oversight by the legislatives. The limitation of this study are: first, this study only uses mean difference tests based on the several characteristics of the local government, further research could add other variables and also test the causality. Second, the results for wealth characteristics are quite interesting. These results could have been due to the low attention and demands of the public on quality financial reports. Further studies can explore to the extent of public attention to quality financial reports and their usefulness.

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