

Determinants Quality of Local Government Financial Statements in Indonesia

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— *Review of* —
**Integrative
Business &
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— *Research* —

ABSTRACT

This study aims to analyze determinants that affect the quality of local government financial statements in Indonesia. The determinants used in this study are the follow-up audit recommendations from Supreme Audit Institution (SAI) and political competition. The quality of local governments financial statements is measured based on their qualitative characteristics. This study uses a sample of 984 Indonesian local government financial statements from 2016-2017. In general, the average score of the quality of local government financial statements in Indonesia is 68.71%. The results of this study show that the SAI has a role in assisting local governments to improve the quality of their financial statements by giving appropriate recommendations that can be followed up by local governments. The political competition measured by percentage of opposition member in legislative show no significant association with the quality of their financial statements. However, additional testing shows that in the year of election, the political competition has significant positive association with the quality of financial statements.

Keywords: political competition, local government, follow up, financial statement quality.

1. INTRODUCTION

According to the principle of regional autonomy, each local government in Indonesia has the right, authority and obligation to regulate all matters related to the administration of government and also the interests of the society (Law 23/2014). Local governments prepare financial statements as accountability mechanism to the public. Government Regulation No. 71 of 2010 is a reference for local governments in preparing financial statements. In ensuring the reliability and fairness of a local government financial statements, Supreme Audit Institution (SAI) as an external parties are required to conduct a review and audit of the financial statements (Law 15/2004). Audit activities have function to ensure the reliability of financial statements and detect whether there is a fraud or non-compliance activity in accordance of applicable laws and regulations to provide useful information (Kinney and McDaniel, 1989; Tambingon et al, 2018).

Based on summary of audit report (First Semester, 2018) in the last two years (2016-2017), there was an increasing number of Indonesia's local governments that receive unqualified opinions from 70% to 76% in 2017. There was also decrease in

disclaimer opinion and qualified audit opinion. The increase in opinion indicated that the financial statement complies with applicable regulations and free from material misstatements. Several study use opinions on financial statements as a measurement financial statements quality (Din et al, 2017; Suwanda, 2015; Adiputra et al, 2018; and Kusumawati and Ratmono, 2017). The unqualified opinion achieve by the local government means that the financial statements are presented in accordance with applicable regulations and free from material misstatements. The better opinion reflects better transparency and accountability that will ultimately increase the quality of the financial statements.

Previous studies mentioned different methods in determining and measuring the quality of financial statements. Baber et al (2013) measure the quality of financial statements using restatement; while Jhonson et al (2012) uses financial statements deficiency score. Agustiningsih et al (2017) states that financial statements contain useful financial information in the decisions making process. In order to present useful information, financial statements must meet several qualitative characteristics. According to IASB (2015); the qualitative characteristics of financial information consist of relevant and fair presentation, comparable, verifiable, timely, and understandable. Indonesia's Government Accounting Standards (SAP) explained that the qualitative characteristics of financial statements consist of relevant, reliable, understandable, and comparable. Beest et al (2009) measure the quality of financial statements using 21 items of qualitative characteristics. This measurement also has been used to develop a questionnaire related to the quality of local government financial statements by Latjandu et al (2016). Laupe et al (2018) argued that to meet these qualitative characteristics, the financial statements must make complete disclosures. However, complete disclosures do not yet reflect the quality of the financial statements based on their qualitative characteristics.

Several studies in Indonesia have tried to find the determinants that affect the quality of financial statements, such as the quality of human resources, organizational commitment, utilization of information technology, the role of internal audit, and the effectiveness of the internal control system (Dewi et al, 2019; Kusumawati & Ratmono, 2017; Muda et al, 2018; Dewi et al, 2014; Latjandu, 2016; Mokoginta, 2017; Onyulo, 2017, Setyowati et al, 2016; Suwanda, 2015). Research gap to be filled in this study is focus on the role of SAI and legislative on the quality of financial statements. Not only audit opinion, SAI also give recommendation to be followed up by auditee. Several studies have empirically tested the follow-up audit recommendation to the reliability, transparency, or quality of financial statements as measured by the opinion of local government financial statement (LGFS) (Din et al, 2017; Setyaningrum et al, 2013; and Kusumawati & Ratmono, 2017). The results show that the follow up audit recommendation will increase the transparency and reliability of the financial statements and improve the quality of the financial statements. Another determinant use in this study is the political competition measured by the power of opposition parties. The legislatives as a people representative have a functions to ensure that the government system is implemented properly and appropriately starting from the legislation process, budgeting process, and oversight process. Laupe et al (2018) and Adiputra et al (2018) shows that the higher political competition, local government will increase the disclosures in the financial statements. The more disclosures reflect a better transparency and accountable financial statements so the quality of the financial statements is increase. Setyaningrum (2017) found that the higher number of the legislative members will encourage the government to commit to follow up audit recommendation and indirectly affect the audit

opinion. Ariyanto and Bone (2020) found that corruption is one of the problem in Indonesian Government. Through the better quality of financial reports, corruption in Indonesian government can be mitigated (Fizriyani and Maharani, 2018).

Based on these explanations, the purpose of this study is to examine the role of SAI and legislatures using the follow-up audit recommendations and political competition to the quality of local government financial statements (LGFS). This research contributes in providing a direct measurement of the quality of financial reports based on the qualitative characteristics, and to give empirical evidence the role of SAI and legislatures as external parties in improving quality of local government financial statements.

2. LITERATURE REVIEW

2.1. Theoretical Framework

There are three relevant theories used in the study: Agency Theory, Legitimacy Theory, and Decision Usefulness Theory. In the public sector especially government, agency problems occurs when there is a delegation of authority from people through elections to the government as agent. The agents implement policies that only benefit one particular party at the expense of the interests and welfare of the community (Setyaningrum 2017a). Financial statements are one of the way to reduce the information asymmetry. The government is required to make financial statements as a form of government accountability to the community for carrying out the government functions in a period. The legitimacy theory explains how local governments act in accordance with the expectations of social groups, social values and prevailing social norms (Suchman, 1995). The government follow-up the audit recommendation given by SAI to give signal to the society that nations are well managed. In addition, the legitimacy theory also explains that the legislatures give signal that they implement their oversight function and motivate local governments to present high quality financial statement to gain public legitimacy. Decision Usefulness Theory was first developed with the basic assumption that each user of financial reports has a different level of information needs. The preparers of financial statements must consider certain components as criteria in order to provide information for the needs of different users of financial statements (Staubus, 1954). When preparing financial statements, the government must pay attention to their qualitative characteristics to be able to provide useful information to the users (Agustiningsih et al, 2017; Nogueira and Jorge, 2017).

2.2. Qualitative Characteristics of Financial Reports

Financial statements 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 statements, the more useful the information contained in the financial statements for its users (Herath and Albarqi, 2017). Based on SAP (2010), the qualitative characteristics of financial statements are relevant, reliable, comparable, and understandable (SAP, 2010).

2.2.1. Relevant

Herath and Albarqi (2017) state that relevant is the capability of information to make a difference in the decisions. Moreover, accounting information is considered relevant if the information presented timely and with full disclosure (SAP, 2010).

2.2.2. Reliable

Herath and Albarqi (2017) state that for a financial statements to be useful must contain reliable information. Reliable information means that the information is free of material biases and errors. The government financial statement is said to be reliable when the statement contains information that is free from misleading notions and material errors, fairly presented and can be verified (SAP, 2010).

2.2.3. Comparable

Comparability characteristics allow users to compare the financial statements. A government financial statements is said to be comparable when the information contained in the financial statements will be more useful if it can be compared with the financial statements of the previous period or with the financial statements across entities (SAP, 2010).

2.2.4. Understandable

Herath and Albarqi (2017) state that these characteristics when information is classified, characterized, and presented clearly and concisely. The better understanding from users of financial statements, the higher quality of financial statements (Cheung et al, 2010). A government financial statements is said to be understood when information presented in financial statements can be understood by users and expressed in terms that are adjusted to the limits of understanding of users (SAP, 2010).

2.3. Government Audit

Audit is a series of the process of identification, analysis, and evaluation were conducted independently, objectively and professionally based standards examination for assessing the truth, accuracy, credibility, and reliability of information regarding the management and responsibility of the State (Law 15/2004) . The audit conducted by SAI aims to detect and ensuring that the local government financial statements are free from material errors and misstatements that will affect the financial statements. After conducting an audit, the SAI will prepare an audit reports that consist of opinion, along with findings and recommendations. The material audit findings will have a direct effect on the financial statements. These types of findings can cause misstatements, which will affect the reliability of financial statements thus affect audit opinion. In the audit reports, the audit findings are divided into two parts, namely the findings on the weaknesses of the internal control system and the findings regarding non-compliance with applicable regulation.

Furthermore, the SAI will provide recommendations regarding the findings identified during the audit process. Recommendations are suggestions from the auditor based on the results of the examination addressed to persons and or entities authorized to carry out actions and or improvements (SAI Regulation No. 2 of 2010). Law No. 15/2004 states explicitly that local governments must follow up the recommendations by giving actions, answers or explanations to SAI. Setyaningrum (2017) states that the recommendations given by SAI are the responsibility of the local government to be followed up on.

Law Number 22 of 1999 concerning local government precedes the formation of local autonomy, whereby each local government has the right and authority to regulate all matters of government affairs and the interests of its community. Currently the latest law on Indonesia's local governments is Law Number 23/2014. The law confirms that the local government legislature (DPRD) have legislative, budgetary and supervisory functions. The DPRD as a representative of the community have a functions to ensure

that the budget is allocated appropriately and ensures the realization of transparency and accountability through oversight of local governments.

2.4. Hypothesis Development

SAI provides give recommendations based on findings and requires auditee to follow up, so that the financial statements in the next period have better quality. Refer to legitimacy theory, the follow-up can be seen as a way for the government to gain trust and legitimacy from the public. Furthermore, decision usefulness theory underlies the idea that by following up on recommendations, it indicates the efforts of local governments to fulfill the qualitative characteristics of the information presented in the financial statements in order to present high quality financial statements (Agustini et al, 2017).

Local government have a responsibility to follow up audit recommendations (Setyaningrum, 2017). This is also a form of effectiveness of the internal control system (Roussy, 2013). Liu and Lin (2012) also state that improvement efforts through follow-up on audit recommendations are important factors in increasing accountability and transparency. Setyaningrum (2017) and Kusumawati and Ratmono (2017) found that the recommendations that were followed up affect audit opinion. Din et al (2017) argue that the more recommendations that are followed up, it will increase the accountability of the financial statements. Through the follow-up; the local government shows improvement efforts in the preparation of financial statements through providing useful information for its users. Based on the theory and previous research, the first hypothesis is as follows:

H1 : Follow up audit recommendations is positively affect the quality of local government financial statements (LGFS) in Indonesia.

Law No. 23/2014 explained that the local government legislature (DPRD) have functions of legislation, budgeting, and oversight of government administration. Gilligan and Maysuka (2001) state that the size of legislative members is a matter of concern for decision makers. Setyaningrum (2017) also found that the greater number of legislative members, the greater the ability of the legislative to supervise the local government. Setyaningrum (2017) found that the number of legislative members influences follow-up audit recommendations and ultimately affects the quality of financial statements through the audit opinions. Laupe et al (2018) and Adiputra et al (2018) examine the political competition using the percentage of DPRD members from non-party supporters (opposition) in the elections. The results show that political competition has a positive effect on the level of disclosure and also transparency of information. So, the second hypothesis is as follows:

H2 : Political competition is positively affect the quality of local government financial statements (LGFS) in Indonesia.

3. METHODOLOGY

3.1. Data and Samples

This research was conducted at the local government who compiled the Local Government Financial Statement (LGFS). This study uses secondary data from several sources. The number of follow-up audit recommendations data obtained from SAI report first semester 2018, list members of legislative obtained from the Center for Political Studies Universitas Indonesia and the list of local government head (mayors and regents)

with their support party obtained from the Ministry of the Internal Affair. The sample in this study was selected based on purposive sampling. Table 3.1 explains the process and criteria for selecting samples in the study.

Table 3.1 Sample Selection

Sample Selection Criteria	
Population	548
Province Government	(34)
Administratives City (DKI Jakarta)	(6)
LGFS incomplete	(5)
There is no DPRD member by party	(7)
There is no TLRHP data	(4)
Total sampel	492
Total Observasi	984

3.2. Research model

$FRQ_{it} = \alpha_{it} + \beta_1 TLRHP_{it-1} + \beta_2 Pol_Comp_{it} + \beta_3 E-Year_{it} + \beta_4 Size_{it} + \beta_5 Independence_{it} + \beta_6 Age_{it} + \varepsilon_{it}$	
FRQ _{it}	Quality of Local Government Financial Report
TLRHP _{it-1}	Follow-up Audit Recommendations Previous Year
Pol_Comp _{it}	Political Competition
E-Year _{it}	Election Year
Size _{it}	Size
Independence _{it}	Independence
Age _{it}	Administratif Age

3.3. Measurement

3.3.1. Financial Reports Quality

This study measures the quality of LGFS using measurements proposed by Beest et al (2009) that have been adjusted to the applicable regulation based on Indonesia Government Accounting Standard (SAP, 2010). We develop checklist and give score to each item and supported by textual analysis to strengthen the consideration of the quality of financial statements to be more accurate and reliable. Textual analysis helps in assessing specific information that can be used as an assessment at a specific index. The items used to measure the quality of financial statements are 11 items. Each item will be given score 1-5, where 1 is the lowest and 5 is the highest.

3.3.2. Follow-up Audit Recommendations

Follow-up audit recommendations measured using the number follow-up audit recommendations in period t-1 divided by the total number of recommendations in period t-1 (Setyaningrum; 2017, Setyaningrum et al, 2013; Din et al, 2017).

$$TLRHP_{t-1} = \frac{\text{Follow-up Audit Recommendation}_{t-1}}{\text{Total Recommendation}_{t-1}}$$

3.3.3. Political Competition

Political competition is measured by using the ratio of DPRD members from non-supporting parties (opposition parties) to elected mayors and regents divided by the total number of DPRD members (Laupe et al, 2018)

$$Pol_Comp_t = \frac{\text{Number of DPRD not from supporting parties}_t}{\text{Total DPRD Member}_t}$$

3.3.4. E-Year

This variable is measured using dummy 1 when the local government conduct a regional election, and dummy 0 otherwise. When there are regional election, there is a tendency for misuse of grants and social assistance by the government (Ritonga and Alam, 2010). Darmastuti and Setyaningrum (2019) also added that regulations in Indonesia that do not clearly regulate the issuance of grants and social assistance can cause indications of misuse of grants and social assistance and can lead to corruption. Quality financial reports can mitigate the occurrence of corruption (Fizriyani and Maharani (2018)), so that this variabels is expected to be positively affecting the quality of local government financial reports.

3.3.5. Size

Setyaningrum and Syafitri (2012) argue that the size of an organization reflects how large an organization is. This research uses the total assets owned or managed by an organization to measure size of local government (Simbolon and Kurniawan, 2018 ; Novianti and Kiswanto, 2016; Setyaningrum and Syafitri, 2012). Agustiningih et al (2018) argues that local governments with larger total assets will tend to increase the level of disclosure and ultimately improve the quality of financial statements.

3.3.6. Independence

An organization's independence reflects the organization's ability to finance its own operational matters. In measuring the level of independence of local governments , this study uses the amount of regional own-source revenue (PAD) divided with the total revenue. This is because PAD is a collection of regional taxes and obtained from the people of an area (Setyaningrum and Syafitri, 2012). The greater the amount of PAD shows the greater community contribution, so that community demands for government disclosure and transparency are also greater (Maulana and Handayani, 2015; Simbolon and Kurniawan, 2018).

3.3.7. Administrative age

The administrative age of a local government is measured by how long a local government has been formed from based on the law of local formation. An area with a longer administrative age tends to be more experienced in making financial statements because of the previous financial statements have been audited by the SAI and have made improvements to the current financial statements (Setyaningrum and Syafitri, 2012; Simbolon and Kurniawan, 2018; Waliyyani and Mahmud, 2015).

3.4. Analysis Method

This study uses content analysis methods to assess the quality of local government financial statements. To examine the hypothesis, this study use the fixed effect (FE) model to the panel data.

4. RESULT AND DISCUSSION

4.1. Descriptive statistics

The observations use in this study is 984 local government financial reports for 2016-2017. Table 4.1 shows descriptive statistics of all variables used.

Table 4.1 Descriptive Statistics

Variabel	N	Mean	Std. Dev	Min	Max
FRQ	984	0,68722	0.10691	0.42	0.95
TLRHP_{t-1}	984	0.67625	0.22548	0	1
Pol_Comp	984	0.63397	0.19542	0	1
E-Year	984	0.08537	0.27957	0	1
Size	984	3 trillions	3.7 trillions	369 millions	4.1 trillions
Independence	984	0.11973	0.09746	0.004	0.851
Age	984	39.26016	24.04323	3	67

Note:
FRQ:Quality of LKPD, **TLRHP_{t-1}:**Followed-up Audit Recommendation, **Pol_Comp:** Political competition, **E-Year:** Election year, **Size:** Size, **Independence:** Independence, **Age:**Administrative age.

The average quality of local government financial reports is 0.68707 or around 68.71% from the total score. With a scale of level 1-5, these results indicate that the quality of local government financial statements is at level 2 to 3. The lowest value is 23 and the highest value is 52. The average ratio of follow-up audit recommendations is 0.67625 or 67,63%. From the maximum value, it shows that there is a local governments that have been followed up on all the recommendations given. For political competition, the minimum value indicates that there is no political competition, which means that all party from DPRD members are supporting the elected mayors or regents. While the maximum score indicates that there is strong political competition, which means that all party from DPRD members are not supporting the elected mayors or regents. This usually happens to elected mayors or regents who nominate themselves independently or through direct appointment. Another interesting result related to the administrative age of local government. 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 3 and the maximum number of administrative age of local government that is 67.

4.2. Hypothesis testing

To test the hypothesis, this study uses a *fixed effect (FE)* model. The results can be seen in Table 4.2. Table 4.2 shows that the TLRHP_{t-1} variable has a positive coefficient and marginally significant. These results support Hypothesis 1. The follow-up of the audit recommendations is positively related to the quality of the financial statements of local governments in Indonesia. These results consistent with some previous studies (Din et al, 2017; Setyaningrum, 2017; Kusumawati and Ratmono, 2017). This result also confirms several theories that support the assumption that by followed up on the recommendations, the local government seeks to obtain legitimacy from the community through the providing useful information in the financial reports. These results also show that the SAI

has a role in assisting local government to improve the quality of financial reports through the appropriate and easy to followed up recommendations.

Table 4.2 Regression Testing Results for the FE Model

Variabel	Pred	Coeff	t-stat	Prob	Sig
TLRHP_{t-1}	+	0.01493	1.29	0.098	*
Pol_Comp	+	0.00095	0.05	0.479	
E-year	+	0.00830	1.54	0.062	*
Size	+	-0.00003	-0.00	0.499	
Independence	+	0.04596	1.09	0.138	
Age	+	0.02615	8.99	0.000	***
Cons		-0.35611	-1.11	0.133	
N		984			
R ²		0.2773			
F-stat		31.75			
Prob		0.0000			
Significance $\alpha=1\%$ ***					
Significance $\alpha=5\%$ **					
Significance $\alpha=10\%$ *					
Note:					
FRQ: Quality of LKPD, TLRHP_{t-1} : Followed-up Audit Recommendation, Pol_Comp : Pollitical competition, E-Year : Election year, Size : Size, Independence : Independence, Age :Administrative age.					

Table 4.2 shows the coefficient value political competition is not significant, so Hypothesis 2 is not supported. This similar result found by Alcaide-Muñoz and Rodríguez Bolívar (2015), Khasanah and Radardjo (2014), Laswad et al (2005) and Okfitasari (2015). The existence of political competition increases disclosures made in financial statements (Laupe et al, 2018), but does not improve the quality of information disclosed. This indicates that the DPRD as a oversight bodies only ensures the presence or absence of disclosure information in the financial reports, without pay attention to the quality of the information. The lack of DPRD capacity to understand the importance of high-quality financial reports is still low, so their demands on local governments in presenting information that has fulfilled their qualitative characteristics are also low (Okfitasari, 2015; Khasanah and Radardjo, 2014).

4.3 Additional Anslysis

We perform additional analysis by interacting political competition with the election years. The results can be seen in Table 4.3. The results in Table 4.3 show positive and significant effect of the interaction between political competition and election years. Based on the legitimacy theory, the DPRD as a oversight bodies acts according to the social norms to obtain legitimacy from the community who have delegated authority through legislative elections. In the year of the election, the DPRD as a oversight bodies shown strong control to ensure that the administration of the government will be in accordance to give signal to public that they performed well. DPRD want to give evidence

for their political promises given to the community in the campaign and encourage local government to prepare high quality financial statements.

Tabel 4.3 Additional Analysis Result

Variabel	Coeff	t-stat	Prob	Sig
TLRHP_{t-1}	0.01448	1.26	0.104	
Pol_Comp	-0.02818	-1.09	0.138	
E-year	-0.01979	-1.16	0.123	
Pol-Comp*E-Year	0.04815	1.76	0.039	**
Size	0.00005	0.00	0.498	
Independence	0.04848	1.16	0.123	
Age	0.02605	8.96	0.000	***
Cons	-0.33583	-1.05	0.147	
N	984			
R ²	0.2802			
F-stat	28.20			
Prob	0.0000			
Significance $\alpha=1\%$ ***				
Significance $\alpha= 5\%$ **				
Significance $\alpha= 10\%$ *				
Note:				
FRQ: Quality of LKPD, TLRHP_{t-1}: Followed-up Audit Recommendation, Pol_Comp: Political competition, E-Year: Election year, Pol-Comp*E-Year: Interaction variabel, Size: Size, Independence: Independence, Age: Administrative age.				

5. CONCLUSIONS

This study aims to examine the determinants of follow-up audit recommendations and political competition on the quality of local government financial statements. This study also proposes measurement quality of local government financial statements based on qualitative characteristics. The results show that by followed-up audit recommendations, the local government will improve the quality of their financial statements. This result also confirms the role of SAI in improving the quality of government financial reports through the issuance of appropriate recommendations that are easy to follow up. Political competition has no effect on the quality of financial statements. This could be due to the lack of DPRD understanding as an oversight bodies to monitor financial statements. The additional analysis indicates that the DPRD as an oversight bodies maximizes its function and role in providing useful informations when there is an election, to gain public legitimacy.

This study has several limitations which also become suggestion for further research. First, this study only uses two determinants that are considered to have a role in improving the quality of government financial reports. Future studies can add other determinants such as the role of internal auditors in government. Second, the political competition in this study only uses the number of DPRD members from the opposition parties. Future research can consider other factors such as motives re-elections and the percentage of win. Third, this study only uses secondary data in testing hypotheses so there may be a

number of factors that are overlooked. Future studies can use additional data such as interviews or questionnaires to complement analysis based on the perception of preparers, auditors and legislatives regarding the quality of local government financial statements.

ACKNOWLEDGEMENT

This research is funded by HIBAH PITMA B UI 2019.

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