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# The Dynamics of the Political Environment in the Disclosure of Local Government Financial Statements: An Insight from Indonesia

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This study aims to examine factors affecting local government financial statement disclosure based on the legitimacy theory. Factors that are believed to affect the disclosure of local government financial statements consist of local government size, local autonomy, intergovernmental revenue, total government unit, and legislature size. In addition, this study examines the moderating effect of the political environment on the relationship of the disclosure of the local government financial statement and the predicted factors. About 78 audited financial statement of local governments located in Java Island, Republics of Indonesia, were analysed using multiple linear regressions. The findings showed that local government size, local autonomy, intergovernmental revenue, total government units and legislature size significantly affected the disclosure of the Local Government Financial Statement. Finally, the political environment significantly moderated the relationship of such disclosure and all predicted variables.

**Key words:** *Legitimacy Theory, Political Environment, Local Government, Financial Statement.*

## Introduction

The extent of information provided in the financial statement depends on the disclosure level of the local governments (Atrill and McLaney, 2011; Kelly and Tan, 2017; Abdullah *et al.*, 2015). Disclosure in the financial statements can be grouped into two categories: mandatory disclosure and voluntary disclosure (Schipper, 2007; Leuz and Wysocki, 2008; Hassan *et al*., 2009; Suhardjanto and Yulianingtyas, 2011; Kelly and Tan, 2017; Abdullah *et al*., 2015). This implies that the disclosure level of financial statements may vary among local governments because of some reasons. The disclosure level of local government financial statement influenced several factors (Garcia, 2010; Khasanah and Rahardjo, 2014). This study at least contributes to the importance of considering the political environment. The environmental factor is important because political aspects may influence the behaviour of local government leaders in regard to their achievement and performance. Baber and Sen (1984) argue that elected regional head of local government in high political competition is more vulnerable to criticism from his or her political rivals.

## Literature Review

### *Disclosure of Local Government Financial Statement*

Disclosure means the act of making something known, so as there is nothing concealed (Dayanandan *et al*., 2017). In term of financial statements, disclosure implies that financial statements should provide useful information and adequate explanation of business activities (Ghozali and Chariri, 2014; Susanto and Djuminah, 2015). Thus, disclosure of the local government financial statement can be seen as the act to provide the public or users with explanations regarding any important information available in the local government financial statements (Mack and Ryan, 2006; Cohen and Kaimenakis 2008; Cohen *et al*., 2007; Grossi and Reichard, 2009). In general, disclosure of local government financial statement aims to present necessary information, raise the objective of financial reporting, and serve many parties with different interests (Susanto and Djuminah, 2015). Moreover, disclosure of any information in local government financial statements can be seen as a medium to show transparency and accountability of the local government. In this case, local government is requested to present and disclose the mandatory information of the elements of local government financial statement in accordance with the applied accounting standards, which is the Government Accounting Standard (GAS) (Hookana, 2008; Brusca 2010; Nogueira and Jorge, 2015). GAS is implemented with legal force, hence the disclosure of complete and informative Financial Statement under GAS is very important (Bastian, 2006). However, the level of such disclosure may vary because of some factors such as local government size, local autonomy, intergovernmental revenue, total government unit, and legislature size.

### *Hypothesis Development*

Entity size is a scale to categorise an entity based on it's size and several benchmarks. According to (Cohen and Kaimenakis, 2008), a benchmark is a basis to show the size of an entity and includes total sales, average of sales level, and total assets. Moreover, the size of local government is a significant predictor for accounting compliance (Patrick, 2007). Local government with a larger total asset will be more complex to maintain and manage it's asset. Consequently, local government needs to reveal more about asset lists, maintenance, and management (Suhardjanto *et al*., 2010). Therefore, the local government will pay higher attention to disclosure based on accounting standards (Patrick, 2007; Cohen and Kaimenakis, 2008). As claimed by the legitimacy theory, this disclosure is intended to gain and maintain legitimacy from the society. Thus, Local Government with greater assets would be more likely to disclose information in it's financial statements in accordance to the standard rather than those with smaller assets. Indeed, Patrick (2007) found that the size of local government has a positive effect on the disclosure of the local government financial statement. Based on the argument the first hypothesis is proposed a follows:

**Hypothesis 1.** Local government size positively affects the disclosure of local government financial statements

Autonomy of local government demonstrates the ability of the local government to finance it's own activities of governance operations, development, and services to the community. Kuncoro (2006); Henderson and Kuncoro (2010); and Petkovska (2011) define local autonomy as the ability of institutions to manage their financial affairs independently. According to Chapman (1999), the local autonomy of local public administration designates it's ability to increase the revenues in the local economy and to decide how to spend those revenues. Local financial autonomy measures the ability of local governments to run it's operations without only relying on equalisation funds from the central government (Suhardjanto *et al*., 2010). Financial ratio analysis on budget realisation can be employed to analyse financial performance of the government (Ebohon *et al*., 2011), for instance, the ratio of local financial autonomy (Kuncoro, 2006; Henderson and Kuncoro, 2010; Petkovska, 2011). The higher this ratio, the lower the local dependency level on external funding sources. Furthermore, this ratio also describes the level of community participation in paying their taxes and levies. The higher the ratio, the more involvement of public participation in paying taxes, hence public demand transparency of disclosure and financial reporting more (Dwirandra, 2008). As local government has duties to run the government, development and public services, the government is responsible for delivering reports of local financial accountability as the basis of it's financial performance assessment. The above argument implies that when the ratio of local financial autonomy is high, the local governments tend to disclose more information in financial statements.

**Hypothesis 2.** Local autonomy positively affects the disclosure of the local government financial statement

Another factor that may influence the disclosure of the local government financial statement is intergovernmental revenue. Patrick (2007) defines intergovernmental revenue as local government revenue derived from the central government transfers to finance operational activities of the local government. In return, local governments spend the revenue transfer based on the allocation and budget guidelines under the Act (Skoufias *et al*., 2011). In Indonesia, intergovernmental revenue is known as equalisation fund (Tsui, 2005). The equalisation fund comes from the central government income which is allocated to the regional head in the implementation of decentralisation (Sanguinetti and Tommasi, 2004). Under the decentralisation scheme, financial control over local government should be more effectively conducted by the central government to create more transparent and accountable local governments (Lewis, 2005; Skoufias *et al*., 2011; Kruse *et al*., 2012). High intergovernmental revenue encourages local governments to disclose more information on financial matters, in order to express their responsibility to interested parties. Hence, local government is encouraged to increase it's financial transparency to improve the central government trust and to show it's compliance towards relevant regulation. Intergovernmental revenue will increase the disclosure level of financial statements (Banful, 2011). Indeed, a study by Suhardjanto *et al*. (2010) found a positive effect of intergovernmental revenue on the level of disclosure of local government financial statements.

**Hypothesis 3.** Intergovernmental revenue positively influences the disclosure of local government financial statements.

The Government Unit represents functional differentiation in Indonesia's government. Total Government Unit describes total affairs as the priority of local government in development programs. The number of business units in an organisation can create complexity in the government (Damanpour, 1991). Functional differentiation of a region is positively related to administrative innovation (Patrick, 2007). The Government unit is intended as a means to share ideas, information, and innovation (Damanpour, 1991). Therefore, the existence of government units in a region emerges ideas, information, and innovation that will bring more disclosure. Furthermore, the government unit can be used to measure government complexity. A complex government will need more government unit. In this case, the bigger the total government unit, the wider the information to be disclosed by the local government (Khasanah and Rahardjo, 2014). Complex government requires greater information disclosure to assist the financial statement users in understanding the complexity of activities conducted by the government (Fan *et al*., 2009; Goel and Saunoris, 2016). As a consequence, there will be pressure on local governments to disclose more information as required by Government Accounting Standards (Suhardjanto *et al*., 2010). Local Government with a greater number of government units will provide more extensive mandatory disclosure under Government Accounting Standards than those with a fewer number of government units (Fan *et al*., 2009; Goel and Saunoris, 2016). Patrick (2007) found that local government in

Pennsylvania with higher functional differentiation tends to adopt GASB 34 more extensively than local government with the lower level of functional differentiation.

**Hypothesis 4.** Total Government Unit influences the disclosure of Local Government Financial Statement.

Legislative institution in the level of local government in Indonesia is well known as Regional Representatives Council or parliament,which plays a role as a public representative institution and serves as an element of the regional administration (Khasanah and Rahardjo, 2014). Parliament has functions to supervise and control the local government in accordance with public aspirations, to monitor the implementation of government policies and to report financial information of local government (Martinez-Bravo, 2014). More specifically, this supervisory function aims to create transparent and accountable local government governance. Suhardjanto and Yulianingtyas (2011) found that the number of legislators positively affect the level of mandatory disclosure. The high number of legislators tends to increase the level of control over local government and consequently the disclosure of local government financial statement will increase.

**Hypothesis 5.** Legislature size affects the disclosure of Local Government Financial Statement

The political environment is the atmosphere of political rivalry in a region of local government. The political environment is reflected by competition of the regional head election (Zhang *et al*., 2004; Enikolopov and Zhuravskaya, 2007; Martinez-Bravo, 2014; Alrazi *et al*., 2015). More political rivals in the regional head election will result in greater political competition. High political rivalry is a sort of control to the elected government (Reinika and Svensson, 2004; Olken, 2007; Bjorkmann and Svensson, 2009; Banerjee *et al*., 2010). Local Government with high political competition has an incentive to report more information about it's activities due to the surveillance of political rivals (Bardhan and Mookherjee, 2005; Galiani *et al*., 2008). In fact, it is important to note that the opposition parties tend to search any possible mistakes of the government rulers despite good performance (Garcia and Garcia-Garcia, 2010; Mahadeo *et al*., 2011).

An unfavourable political environment is a condition where the regional head is supported only by minority parties in the legislative board (Reinika and Svensson, 2004; Olken, 2007; Bjorkmann and Svensson, 2009; Banerjee *et al*., 2010; Haliah *et al*., 2017). This circumstance encourages local government to disclose more information items in it's financial statements to gain legitimacy for it's performance. Garcia and Garcia-Garcia (2010) argued that political opponents will quickly inform any irregularities committed by the ruling party. As a result, the government will be more cautious and try to release information as much as possible to get public trust. According to Garcia and Garcia-Garcia (2010), there will be greater efforts of local government to gain public legitimacy if there is high political competition within the region, and thus communication strategy is essential to overcome the problem.

The local government head who consistently runs the governance well will be greatly harmed by negative issues from the political rivals (Bardhan and Mookherjee, 2005; Galiani *et al*., 2008). Moreover, the regional head will attempt to provide broad information in it's financial statements and communicate the government's performance to the public (Baber and Sen, 1984). Thus, the competitive political environment emerges more incentives to communicate good government governance through information disclosure in financial statements (Perez *et al.,* 2008). Therefore, it is expected that the political environment may moderate the factors affecting disclosure level of Local Government Financial Statements. The next hypotheses proposed in this study are as follows:

**Hypothesis 6.** The political environment moderates the influence of local government size on the disclosure of Local Government Financial Statement
**Hypothesis 7.** The political environment moderates the effect of local autonomy on the disclosure of Local Government Financial Statement
**Hypothesis 8.** The political environment moderates the effect of intergovernmental revenue on the disclosure of Local Government Financial Statement
**Hypothesis 9.** The political environment moderates the influence of the total government unit on the disclosure of Local Government Financial Statement
**Hypothesis 10.** The political environment moderates the effect of legislature size on the disclosure of Local Government Financial Statement

**Research Method**

This study employed secondary data collected from the 2018 audited financial statements and official websites of local government located in Java Island, Commission of General Election (KPU), and BPS-Statistics Indonesia. The population of this study consisted of 123 local government financial statements. Based on purposive sampling, 78 financial statements of local governments were finally used for further analysis. This study utilised five exogenous variables consisting of local government size, local autonomy, intergovernmental revenue, total government unit and legislator size. In addition, this study also examines an endogenous variable (disclosure of local government financial statements), and a political environment as a moderating variable. Local government size is measured by the total assets of local government, whereas local autonomy is measured by the ratio of local revenue to total regional income (Halim and Syukriy 2006). Moreover, intergovernmental revenue is indicated by total transfer, government unit is gained by total government unit in the region, and legislator size is derived from total legislators in the region.

A scoring system is used to measure disclosure of local government financial statements by employing a disclosure checklist based on Government Accounting Standards. Thus, disclosure scores are calculated by dividing the number of items disclosed with the total items and should be disclosed as required by the standards. Meanwhile, the political environment is a dummy variable; if the elected regional head is supported by major political parties, the value is one and zero if otherwise; the data were then analysed using the following formula:

Direct Effect: Disc = $\alpha + \beta_1 GS + \beta_2 LA + \beta_3 IR + \beta_4 GU + \beta_5 LS + \varepsilon$
Moderating Effect (Residual Model):

(1) Moderating Variable = $\beta_0 + \beta_1$*Independent Variable + e
(2) $|e| = \beta_0 + \beta_1$*Dependent Variable

Whereas Disc is Disclosure of the local government financial statement; GS is Local Government Size; LA is Local Autonomy; IR is Intergovernmental Revenue; GU is Total Government Unit; LS is Legislature Size; PE is Political Environment.

**Results and Findings**

This research model employed five exogenous variables consisting of local government size, local autonomy, intergovernmental revenue, total government unit and legislature size. Meanwhile, the endogenous variable is disclosure of local government financial statements. Table 1. Indicated descriptive statistics of research variables. It can be seen that the level of disclosure of local governments was low as the percentage of the disclosure was under 50%.

**Table 1:** Descriptive Statisitcs

| Variables | N | Mean | Std. Deviation |
|---|---|---|---|
| DISC | 78 | 37.090 | 3.903 |
| GS | 78 | 8.177 | .299 |
| IR | 78 | 27.235 | .349 |
| LA | 78 | 1.967 | .590 |
| GU | 78 | 53.474 | 13.261 |
| LS | 78 | 3.695 | .245 |

Before conducting the regression analysis, it is necessary to carry out several diagnostic tests, such as multicollinearity, autocorrelation, heteroscedasticity, and a normality test to determine the goodness of fit of the data. This is to ensure that the regression results will be meaningful and reliable. Multicollinearity is tested based on the variance inflation factor (VIF). Autocorrelation is evaluated based on the Durbin Waston and Godfrey probability. Meanwhile, heteroscedasticity is examined based on the White value. The problem of normality is tested by the Jarque Bera value and probability of Chi Square Jarque Beray.

**Table 2:** Summary of Goodness of Fit

| Types of Test | Index | Value | Cut off | Result |
|---|---|---|---|---|
| Normality | Jarque Bera (JB) | 0.630 | | |
| | Probability | 5.991 | JB < *Probability* | Fit |
| Multicollinearity | VIF | 1.011 | VIF < 5 | Fit |
| Autocorellatiom | Durbin Waston (DW) | 1.945 | $d_L$<1.945246<$d_U$ | Fit |
| | Prob Godfey | 0.458 | > 0.05 | Fit |
| Heteroscedasticity | Prob Obs*R-Squared | 0.413 | > 0.05 | Fit |

The first objective of this study is to confirm whether exogenous variables (local government size, local autonomy, intergovernmental revenue, total government unit and legislature size) influence disclosure of local government financial statements. Table 3. described the findings of this study. The findings showed that all exogenous variables positively affected the disclosure of Local Government Financial Statements. Indeed, local government size, local autonomy, intergovernmental revenue, total government unit and legislature size have adjusted coefficients *of* 3.53 ($p<0.05$), 2.47 ($p<0.05$), 4.87 ($p<0.05$), 0.203 ($p<0.05$), and 11.50 ($p<0.05$) respectively.

**Table 3:** Result of Regression

| Variables | Standardized Coefficients | Sig | Result |
|---|---|---|---|
| GS | 0.009 | 0.005* | Accepted |
| IR | 0.198 | 0.008* | Accepted |
| LA | 0.077 | 0.020* | Accepted |
| GU | 0.389 | 0.000* | Accepted |
| LS | 0.462 | 0.000* | Accepted |
| Adjusted R2=0.657; F-value = 30.516, sig = 0.000* | | | |

Note: *) significance at 5%

Dependent Variable: Disclosure
Regression Model: $Disc = \alpha + \beta_1 LGS + \beta_2 LA + \beta_3 IR + \beta_4 TGU + \beta_5 LS + e$

The second objective of this study was to investigate whether the political environment moderates the relationship of local government size, local autonomy, intergovernmental revenue, total government unit, legislature size and disclosure of the local government financial statement. Table 4 indicated the results of moderating effects of the political environment. It can be seen from Table 4 that the political environment empirically decreased (negative moderating) the relationship among the observed variables. In fact, the role of the political environment in negatively moderating the relationship of local government size, local autonomy, intergovernmental revenue, total government unit, legislature size and the disclosure, was indicated by the regression coefficients of -0.018 ($p<0.05$), -0.030 ($p<0.05$), -0.029 ($p<0.05$), -0.025 ($p<0.05$), and -0.016 ($p<0.05$), respectively.

**Table 4:** Result of Moderating Effect

| Variables | Adj R-Square | F-Statistics | Coefficient | Probability |
|---|---|---|---|---|
| GS | 0.210 | 21.532 | -0.018 | 0.000* |
| IR | 0.409 | 54.501 | -0.030 | 0.000* |
| LA | 0.287 | 32.108 | -0.029 | 0.000* |
| GU | 0.201 | 20.419 | -0.025 | 0.000* |
| LS | 0.090 | 8.689 | -0.015 | 0.004* |

Note: *) Significance at 5%

Regression Model: (1) Moderating Variable = $\beta_0 + \beta_1$*Independent Variable + e

(2) $|e| = \beta_0 + \beta_1$*Dependent Variable

This study aimed to investigate the influence of local government size, local autonomy, intergovernmental revenue, total government unit and legislature size on the disclosure of local government financial statements. It is believed that information on financial statements is intended to create transparency, provides open and honest financial information to the public (Susanto and Djuminah 2015). However, this finding showed that the level of disclosure of local government was low (less than 50%). This finding did not represent arguments of accounting scholars. According to Setyowati (2016), in the concept of governance policy guidelines, transparency contains disclosure elements and provision of adequate information, which is easily accessible by interested parties. Disclosure and provision of information become an important element in financial statements . Therefore, local government is obliged to disclose a variety of information in financial statements as a medium of it's accountability and transparency in managing public finances. However, Government Financial Statements should be written under applied Government Accounting Standards and submitted to the Legislative board and public after the Audit Board has conducted it's audit (Lapsley, 1999; Hookana, 2008; Brusca, 2010; Garcia and Garcia-Garcia, 2010; Mahadeo *et al*., 2011; Nogueira and Jorge, 2015).

Audited financial statements should include disclosure, as the fact that disclosure is seen as accountability mechanisms of the government to communities regarding public funds' management (Haque, 2006; Navarro and Rodriguez, 2007; Bolivar *et al*., 2015; Goel and

Saunoris, 2016). The findings showed that local government size significantly affected the disclosure of the Local Government Financial Statement. This means that local government with a larger size tends to provide more disclosure of financial statements. Larger local government tends to have more rules and regulations than the smaller ones (Suhardjanto and Yulianingtyas, 2011). Indeed, demand for transparency of financial management as a medium of accountability is expressed by disclosing more information in Financial Statements. Findings of this study is similar to the results of previous studies (Patrick, 2007; Garcia and Garcia-Garcia, 2010; Khasanah and Rahardjo, 2014).

The second finding also indicated that local autonomy significantly influenced the disclosure of Local Government Financial Statements. Local autonomy demonstrates the ability of the local government to finance it's own activities of governance, development, and services to society who have paid taxes and levies (Khasanah and Rahardjo, 2014). The local financial autonomy ratio describes the dependency of local government on external funding sources. The higher ratio of local financial autonomy, the smaller the dependency level on external assistance (mainly by central government or provincial). Nevertheless, high local autonomy ratio also shows high public participation in contributing to the government financial resources through taxes and levies. Public participation leads the government to be more transparent and accountable in managing it's finances, and thus the information disclosed in the Financial Statements is more complete. This finding supported the findings of prior studies (Dwirandra, 2008); Khasanah and Rahardjo, 2014).

Moreover, intergovernmental revenue significantly determined the disclosure of the Local Government Financial Statement. In the case of Local Government Financial Statement, this finding is interesting as intergovernmental revenue encourages the government to be more transparent and accountable. However, the given condition may create high dependence of local government on the central government, as the local government income comes largely from central government transfer. An impression may come out that local government is considered as less creative in gaining it's own local income. Therefore, both central and local government may cooperate to create local autonomy. This result is consistent with the study of (Patrick, 2007) and (Suhardjanto *et al*., 2010).

Furthermore, total government unit significantly plays important roles in determining the disclosure of Local Government Financial Statements. The total government unit describes priority affairs carried out by the local government in development. The more executable affairs, the more complex the government activity. Hence, the level of disclosure tends to be high because it is used to help the financial statement user in understanding the complexity of government activities. This result is consistent with the research conducted by (Damanpour, 1991); (Patrick 2007); (Suhardjanto *et al*., 2010) and (Khasanah and Rahardjo, 2014).

In addition, the findings showed that legislature size is a significant predictor of the disclosure of the Local Government Financial Statement. This finding implies that the Legislative Board is concerned with how much funds are spent by local government and how much income will be accepted. Local governments that generate a substantial income and little expenditure tend to be seen as those with good performance. Generally, the legislator has a duty to monitor local government in allocating the existing budget. Large numbers of legislators are expected to increase oversight over local government, and thus increase it's performance. This finding supported previous research findings (Winarna and Murni, 2007); (Suhardjanto and Yulianingtyas, 2011) and (Khasanah and Rahardjo, 2014).

Finally, the findings showed interesting evidence that the political environment plays a role as a moderating variable on the relationship of local government size, local autonomy, intergovernmental revenue, total government unit and legislature size, and the disclosure of local government financial statements. A competitive and dynamic political environmental will produce a greater supervisory role. Thus, local government (especially the regional head) as a supervised party will bear a higher monitoring cost. The disclosure in financial statements is seen as economical and efficient to offset the unfavourable political environment. These findings are consistent with those of the previous studies such as (Garcia and Garcia-Garcia, 2010) and (Garcia-Sanchez *et al*., 2013)

## Conclusion

The financial statement is management assertions of the government that provides users with useful information for decision-making, as well as demonstrates accountability of reporting entity in managing entrusted financial matters. The financial statement can be used to compare actual revenues, expenditures, transfers, and financing with a set budget, assess the financial condition, evaluate the effectiveness and efficiency of a reporting entity, and help determine the compliance towards legislation.

The financial statement indicates performance achievements and implementation of accountability functions within an entity. Therefore, information disclosure in financial statements should be sufficient, as it is a basis for making precise decisions. Many factors affect disclosure of the Local Government Financial Statement, for instance local government size, local autonomy, intergovernmental revenue, total government unit and legislature size. In addition, the political environmental has an impact as a moderation. An unfavourable political environment, in which the regional head is supported by minority parties in the legislative board, will encourage the government to present various disclosures to gain legitimacy. Hence, a competitive political environment emerges and issues an incentive to communicate good government governance to the public through information disclosure in Financial Statements.

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