KnE Social Sciences
ICE-BEES 2019
International Conference on Economics, Business and Economic Education 2019
Volume 2020

Conference Paper

The Effect of Financial Reporting Quality on Regional Governments' Performance Accountability

Mulyo Agung

STIE Pandu Madania Bogor, West Java, Indonesia

Abstract

Accountability is an important issue in Indonesian government. The present study aims to further analyze performance accountability issue in regional governments in Indonesia, which is affected by the quality of financial reports. The fact shows that regional governments in Indonesia have low performance accountability. This study attempts to attest for or against the statement through testing whether or not financial reporting quality has an effect on regional governments' performance accountability. Subjects of the study are 40 *Satuan Kerja Perangkat Daerah* (SKPD/Regional Government's Work Units) of Regencies/Cities in Indonesia. Survey is the research methodology implemented. Hypothesis is analyzed and tested using Structural Equation Model (SEM). The findings show that good Financial Reporting Quality will improve Performance Accountability of regional governments in Indonesia, with positive path coefficient.

Keywords: Financial Reporting Quality, Regional Government's Performance Accountability

Corresponding Author:
Mulyo Agung
mulyoagung@stiepm.ac.id

Received: 7 February 2020
Accepted: 9 March 2020
Published: 23 March 2020

Publishing services provided by Knowledge E

Selection and Peer-review under the responsibility of the ICE-BEES 2019 Conference Committee.

1. Introduction

Indonesian Government in both central and regional levels is currently facing a demand for public sector accountability in order to realize good governance in the nation. The demand is a result of, among others, the economic crisis due to bad governance and bureaucracy (Sunarsip, 2001). The demand can only be satisfied when the government is able to provide high quality financial report, i.e. a report that contains reliable and relevant information on financial condition of all transactions as a form of government's responsibility for its allocated budget. With the issuance of Law No. 17/2003 on State Finances, Government Regulation No 71/2010 on Government Accounting Standard (GAS), and Minister of Domestic Affairs' Decree (2007), every regional government in Indonesia is expected to manage their finances in economic, efficient, effective, and transparent ways that adheres to the law and will be accounted for in a financial report written in accordance to general accounting principles.

Financial report is written to provide information on financial condition during certain period of time to be used for comparing the budget plan and the realization, assessing the entity's condition, measuring the entity's effectiveness and efficiency, and evaluating the entity's conformity to laws and regulations (Nikundabanyanga, *et al.*, 2012). Financial report aims to provide the conceptual framework for financial reporting. For the financial information to be useful for decision making, it should be of high quality, i.e. having qualitative characteristics (IFRS). The importance of high quality financial reporting has been stressed by previous studies (Dechow & Dichev, 2002; Schipper & Vincent, 2003; Botosan; 2004). In Indonesia, the state's financial reporting needs to be improved. It is indicated by the fact that the Central Government's Financial Report (LKPP) has not achieved the Unqualified Opinion from the Audit Board of the Republic of Indonesia (BPK) (Mardiasmo, 2011). In addition, 20 ministries/boards (M/B) or 23% of total M/B, and 431 regional government (87% of 498 government audited by BPK) also have not received Unqualified Opinion. 326 regional governments (91% of total 358 regional government audited by the Audit Board of the Republic of Indonesia) are cited as 'Bad' and only 32 regional governments received Unqualified Opinion. "Amongst all regional governments, the number of LKPD [regional government's financial report] that received Unqualified Opinion for the 2010 fiscal year was only 32 or 9% of the total 358 LKPDs being audited in the first semester of 2011" (Poernomo, 2011).

2. Literary Review

2.1. Financial Report Quality

Alexander *et al.* (2007) argue that financial reporting is aimed at communicating the performance and efficiency of the business to existing and potential-shareholders. Nikolai, *et al*. (2010) note that financial reporting should provide useful information for present and potential investors, creditors, and others external users in making investment, credit and similar decisions. Kieso, *et al.* (2012) agree that the objective of general purpose financial reporting is to provide financial information about the reporting entity that is useful to present and potential equity investors, lenders, and other creditors in making decisions in their capacity as capital providers.

According toWahlen *et al*. (2013), financial reporting should provide financial information about the reporting entity that is useful to existing and potential investors, lenders, and other creditors in making decisions about providing resources to the entity. Decision usefulness is the ultimate objective of accounting information. Indonesia's Government

Regulation No.71/2010 stipulates that the qualitative characteristics required for the government's financial report to be of good quality are relevancy, reliability, comparability, and comprehensibility.

Based on these experts' arguments, it can be concluded that financial reporting is a process that covers all aspects pertaining to the provision and reporting of high quality financial information that will be useful for investors, creditors, and other users in making investment-related or other decisions.

2.2. Regional Governments' Performance Accountability

Mardiasmo (2006:3) states that performance accountability is a form of obligation to periodically account for the success or failure in implementing organizational missions to achieve preset goals and objectives through an accountability media. Mahmudi (2011: 23) argue that agent (government) is obligated to manage resources, report, and disclose all activities pertaining to public resources utilization to the mandate giver (principle). In summary, public accountability refers to legal obligation according to law to serve or facilitate independent observers that have the rights to report any findings or information on existing financial administration in accordance to the government's high requirements.

Mardiasmo (2006:5) notes that public accountability consists of two types; vertical accountability and horizontal accountability. Vertical accountability is the accountability for budget management to a higher authorities; for instance, work units' accountability report to regional government, regional governments' accountability report to the central government, and the central government's accountability report to the People's Consultative Assembly.

Horizontal accountability is the accountability report to Regional People's Representative Council and the general public. In the context of government organizations, public accountability is providing information and disclosure of government's financial performance and activities to concerned parties (Mardiasmo, 2006: 4).

2.3. The Effect of Financial Reporting Quality on Regional Governments' Performance Accountability

Austin*et al*. (2017) argue that financial reporting may support top-to-bottom performance accountability objectives.McConville & Cordery state that financial reporting approaches have significant effects on performance accountability in every jurisdiction. Meanwhile, Lys, *et al.* (2015) find strong correlation between CSR reporting quality and financial performance.

Haider, *et al.* (2018) also find that good financial reporting will improve performance and, consequently, reduce the level of corruption. In a similar note, Bose *et al*. (2017) state that there is positive correlation between disclosure/reporting of financial inclusion and performance of banking institutions. Similarly, Sanusi *et al*. (2015) note that accurate and appropriate recording of financial transactions will improve performance effectiveness and accountability. In their study, Nugraheni & Subaweh (2008) conclude that SAP implementation affects financial reporting quality improvement in Indonesia's National Education Department.

Santoso (2008) argue that theoretically, the implementation of Public Sector Accounting and Supervision on Financial Reporting Quality of government institutions will affect government institutions' performance accountability in part and as a whole. Based on these studies, it can be concluded that financial reporting quality has significant effect on performance accountability. Good or high quality financial reporting indicates good accountability of regional government's performance.

3. Methodology

The study is a descriptive and verification study. SEM is a combination of factor analysis and regression analysis, consisted of two types of model analyses, i.e. Confirmatory Factor Analysis (CFA) and Multiple Regression Analysis.

The analysis units in this study are individuals; i.e. the employees of *Satuan Kerja Perangkat Daerah* (Regional Government's Work Units) in Regional Governments that consist of Agencies, Bodies, and Regional Inspectorates. Regional Government's Work Units (or SKPD) are work units in Regional Governments (Provinces and Regencies/Cities) in Indonesia. Total sample is 40 SKPDs.

The research hypotheses are as follows:

H_0: γ_{12} = 0 Financial reporting quality has no effect on regional governments' performance accountability.

H_1: γ_{12}= 0 Financial reporting quality has effect(s) on regional governments' performance accountability.

4. Discussion

The following is the result of SEM analysis in path diagram:

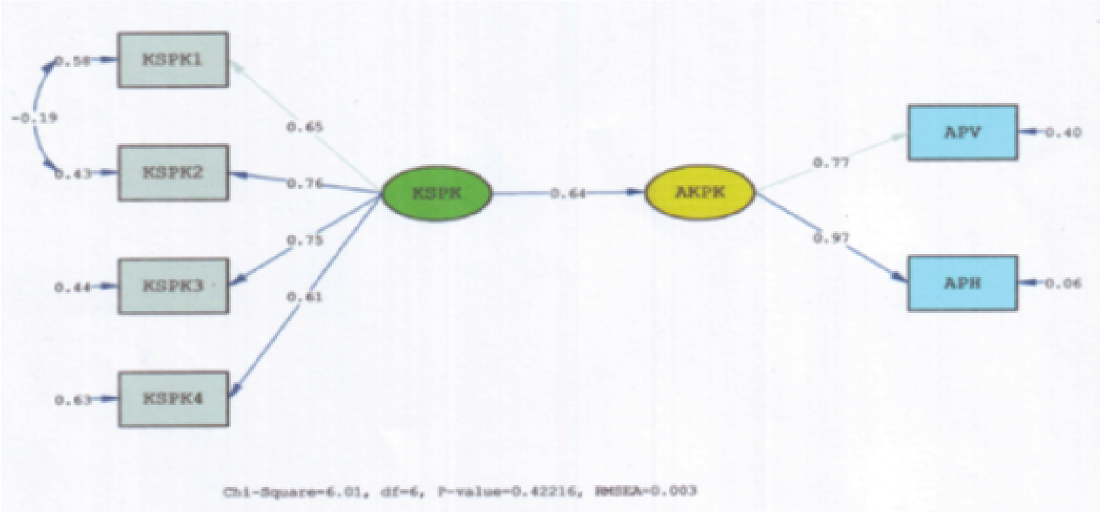

Figure 1: Full Model Path Diagram.

Figure 1 displays the path coefficient between the exogenous and endogenous variables. In SEM, each latent indicator usually has several observable measures or indicators. Latent variables with observable variables are connected through factor analysis model. In this model, each latent variable is modeled as a factor that determines related observable variables. The figure displays the measurement model of all latent variables.

4.1. Hypothesis Testing

4.1.1. Test of Significance

Test of Significance is conducted to measure the effect of Financial Reporting Quality (KPK) on Regional Governments' Performance Accountability (AKPD). The simplified result of the test is displayed in the following table:

Table 1: Result of Test of Significance.

Exogenous Latent Variable	Coefficient of Determination (R^2)	F-$_{table}$	F-$_{calc}$	Result
KPK on AKPD	0.888	3.04	403.418	t-$_{calc}$>t-$_{table}$. H_0 is rejected. H_1 is accepted.

Source: Processed data

The table shows the effect of financial reporting quality on performance accountability with t_{calc} of 403.418 > t_{table} of 3.04. It means that the effect of financial reporting quality on regional governments' performance accountability is significant, with determination coefficient of 88.8%.

5. Conclusions

Public sector organizations in Indonesia are now facing a phenomenon of higher demand for their accountability, in both central and regional levels. Accountability is an obligation to answer for an organization's success or failure in achieving its preset goals and objectives through periodic accounting media. Government is a reporting entity that has to write financial report as a form of its accountability because: (a) the government is in charge of, and is controlling, significant public resources; (b) government's utilization of these resources widely affects public welfare and economy; and (c) the management and ownership of these resources are separated.

Financial reporting is a form of accountability in governance implementation as stipulated in Law No. 17/2003 on State Finances and Law No. 32/2004 on Regional Governments. The concrete steps to realize transparency and accountability of financial management in both central and regional governments include writing and providing accountability report in the form of financial report. The produced government's financial report has to comply to the timeliness principles and the Government Accounting Standards as stipulated in Government Regulation No. 24/2005.

6. Recommendations

Accountability of policies is closely related to both central and regional governments' accountability on policies they implemented upon the public. To improve the quality of Regional Government's Financial Report, regional governments have to continue improving their control and monitoring system through systematic consideration of delegating tasks to certain people in order to ensure checks and balances. The supervision agency (Regional Inspectorate) should be more effective in its development activities, including routine control and monitoring to regional governments.

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