

THE IMPACT OF GOVERNANCE ON THE INFORMATIVENESS OF LOCAL GOVERNMENT FINANCIAL REPORT: EVIDENCE FROM INDONESIA

Johan Arifin

*Faculty of Economics, Universitas Islam Indonesia Yogyakarta
Email: johan@fe.uii.ac.id*

Abstract

This research proposes to investigate the impact of governance mechanisms on the informativeness of local government financial report in Indonesia. The research framework borrows from agency theory hypothesizing that governance mechanism might mitigate the conflict between the agent and principal resulting in a more informative financial report. The main analysis uses Ordinary Least Square regressions. This issue is considerably importance for the governance literature as the agency research has emphasized private sector entity.

It is asserted that agency conflict, informativeness of financial report of local government and governance mechanisms are theoretically related. In the public sector domain, ownership distribution and board of directors might be argued as identical to the voter's distribution and local parliament respectively while the standard provision is similar to local government regulation. Therefore the study predicts that the voters' distribution, local parliament structure, and local government decree affect the informativeness of local government financial reporting.

Financial reports are collected from local governments for the period of December 31, 2008 consisting of the population of 424 local governments in Indonesia. Local government voters and local parliament data are collected from the election commission (KPU) data base. Furthermore, local government provisions are collected from Indonesia Association of Regency Government (APKASI), and local government budget size figures are collected from Ministry of Finance data base.

Dependent variable of this research is informativeness of financial reporting. The independent variables consist of distribution of voters, independence of local parliament, and local government provision. The model include budget size as control variable. This research will use t-test, ANOVA, and multiple regressions analysis.

Keywords: *informativeness, agency theory, governance mechanisms, ownership distribution, board of directors, voter's distribution, standard provision, Indonesia Association of Regency Government*

Background

This research investigates the impact of governance mechanism on the informativeness of local government financial report in Indonesia. The research framework borrows from agency theory hypothesizing that governance mechanism might mitigate the conflict between the agent and principal resulting in a more informative financial report. The main analysis uses Ordinary Least Square regressions.

In terms of local government, the agency problem possibly emerges between the voters as the principal that trust the management decision to executive party as the agent. The Act no. 17 2003 obligates government agencies in Indonesia, including the local government, to make a financial report that should be based on the regulation no 24 of 2005 on Government Accounting Standard. Although the regulation has been applied for seven years, the level of compliance is still in question (Sri Mulyani, 2010). In other words, the local governments in Indonesia have not fully obeyed the regulation of financial report. Accordingly, it might be argued that in the circumstance there is possibility for large scale agency conflict.

Governance literally means a system that regulates and controls an entity that can create the value added for all stakeholders (Colley *et.al*, 2005). The governance system can influence the behavior of each party involved in the contracting environment, where the governance system has been argued as determining the level of accountability

and disclosure (Ryan *et al.*, 2002). Literature posits that governance relies on mechanisms that might be categorized as internal factors such as ownership, board of directors, provisions, and external factors such as market for corporate control and legal systems (Michael *et al.*, 2008). Although empirical works focused on the corporate entities, Jensen and Meckling (1976) argue that agency concept is relevant to every contractual relationship. Therefore, governance mechanism might mitigate the agency conflict between voters and executive. It has been asserted that a good governance adopted by government would benefit the voters (Davis 1999)

The financial report is a form of communication between the voters and executive serves as a basis for evaluating the performance of executive. Financial report of the local government are considered as the main media of accountability although the whole of accountability of local government might be communicated through alternative devices other than such a report (Patton, 1992). Ryan *et al.* (2002) and Sinclair (1995) also contend that the commonly accepted purpose of the governance annual financial report are accountability and decision usefulness. The work of Ryan *et al.*, (2002) implies that the informativeness of financial report might be enhanced with the presence of strong governance mechanisms.

The previous discussion reveals that agency conflict, informativeness of financial report of local government and governance mechanisms are theoretically related. Accordingly this study proposes to find empirical confirmation concerning the impact of governance mechanism on financial report in Indonesian local government. In the public sector domain, ownership distribution and board of directors might be argued as identical to the voter's distribution and local parliament respectively while the standard provision is similar to local government regulation. Therefore the study predicts that the voters' distribution, local parliament structure, and local government decree affect the informativeness of local government financial reporting. This leads to the testable hypotheses:

H1: The level of voters concentration is negatively related to the informativeness of local government financial reporting

H2a: The proportion of local parliament members, who are independent of executive (major of local government) is positively related to the informativeness of local government financial reporting

H2b: The local parliament chairperson who are independent of executive (major of local government) is positively related to the informativeness of local government financial reporting

H3: The local government provision is positively related to the informativeness of local government financial reporting

Research Method

Financial reports are collected from local governments for the period of December 31, 2008 consisting of the population of 424 local governments in Indonesia. Local government voters and local parliament data are collected from the election commission (KPU) data base. Furthermore, local government provisions are collected from Indonesia Association of Regency Government (APKASI), and local government budget size figures are collected from Ministry of Finance data base.

Model

Dependent variable of this research is informativeness of financial reporting. The independent variables consist of distribution of voters, independence of local parliament, and local government provision. The model include budget size as control variable. The detail of proposed model is presented in the following equation:

$$INF_FR_{it} = \alpha + \beta_1 VOTERS_{it} + \beta_2 LOCPAR_{it} + \beta_3 LOCPROV_{it} + \beta_4 BUDGET_{it} + e$$

Sensitivity:

$$WEBSITE_{it} = \alpha + \beta_1 VOTERS_{it} + \beta_2 LOCPAR_{it} + \beta_3 LOCPROV_{it} + \beta_4 BUDGET_{it} + e$$

Where:

INF_FR_{it} : the informativeness of local government financial reporting

$VOTERS_{it}$: the distribution of voters of local government i at year t

$LOCPAR_{it}$: independence of local parliament of local government i at year t

$LOCPROV_{it}$: local government provisions of local government i at year t

BUDGET_{it} : budget size in each local government i at year t

Measurement

Informativeness of financial reporting is measured by using composite index based on regulation no 24 of 2005 about Government Accounting Standard. This regulation stipulates that a local government financial report should contain budget realization, balance sheet, cash flow, and disclosure, where each item comprises the detail of sub item. In this regard every detail of sub item is equal to 1 if the particular detail of sub item is available and 0 otherwise. The composite score of the index would be stated in percentage.

Distribution of voters will be measured by Herfindahl index, as the index better portrays the contestability of control. The index is measured by the first different of vote between those of the party having the highest vote with the second, and the second with the third, and the third with the fourth. The score of Herfindahl index is the sum of that first different.

Independence of local parliament is measured by the proportion of non-controlling parties in the local parliament. This measure is chosen as, the executive (major) of local government is nominated by a coalition consisting of several political parties. The second measure is local parliament chairperson that takes 1 if the chairperson is the member of non controlling parties, and 0 otherwise.

Local government provision is measured using composite index, comprising several items such as local government information system, local government financial institution, local government accountant, local government auditing institution, and communication network that might affect the compilation of local government financial reporting. The score of the index is based on the availability of such items and is presented in percentage. The composite index would be constructed by a panel of local government provision expert.

Analysis Technique

This research will do quantitative analysis by using some statistical methods to analyze the data, such as t-test, anova, and multiple regression analysis.

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