

An Investigation of Financial Statement Disclosure in Local Government Financial Statements

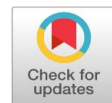
CENDY MARSELLA ^{1*}, KHOIRUL ASWAR ²

^{1, 2} Universitas Pembangunan Nasional Veteran Jakarta, Depok, Indonesia

Abstract: This study aims to examine the level of mandatory disclosures in the local government's financial statements with the factors which influence them, which are financial conditions, transfer and funds, political competition, and income level in the municipality. The population in this research was the district/city government in Sumatra Island. Sampling was conducted by cluster sampling method, which produced 151 samples of district/city governments on Sumatra Island. Testing the hypothesis in this research was through multiple linear regression using SPSS. The test results obtained that the transfer of funds and political competition did not affect the disclosure of financial statements. While financial conditions negatively affect the disclosure of financial statements. Furthermore, the income level in the municipality has a positive and significant relationship with the financial statement disclosure. The contribution to the local government is expected to be able to give useful input in improving the quality of their external communication, governmental accounting standards, and improving public governance. Furthermore, the Indonesian government is to formulate public policy by considering potential factors which can enhance pressure for the government to conduct financial statement disclosure. A strategy for local governments to promote the disclosure of financial statements is the use of information technology to meet social demands which are more efficient and effective.

Keywords: Financial condition, Transfer and funds, Political competition, Income level in municipality, Financial statement disclosure

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INTRODUCTION

Law (UU) Number 17 Year 2003 about State finances explains that the financial accountability report states that the financial statements are stated in the form of Budget realization report, statement of financial position, cash flow statement, and notes to the financial statements and prepared according to Government Accounting Standards (KSAP, 2010). The law marks the start of a new era of state financial management, marked by Law number 1 Year 2004 concerning state treasury and Law No. 15 concerning audits of management and financial responsibility of the State. This reform is the desire of various parties to create public finance management which is more transparent and can improve efficiency and effectiveness to the public. This is in accordance with Law No. 14 Year 2008, which states that public bodies are required to publish and provide public information under their authority in addition to the excluded information.

In 2010, Indonesian government released Government Regulation (PP) Number 71 Year 2010, which stated that SAP is as a base to enhance quality and accountability of government performance (Aswar & Saidin, 2018). Therefore, the local governments respond to the regulation, then the issuance of Minister of Domestic Affairs Regulation No. 64 of 2013 concerning the Application of Accrual-Based Government Accounting Standards to Regional Governments. There it is stated that the financial statements prepared by the regional government are added to the presentation of financial statements which are reports on changes in budget balances, operational reports, and statements of changes in equity.

In 2009, Audit Board of the Republic of Indonesia (BPK) stated that financial statement of local

*Corresponding author: Cendy Marsella

†Email: cendymarsella55@gmail.com

government had not been in accordance with the government's expectation. They stated that local governments in Indonesia have not fully prepared their financial statement in accordance with applicable standards and regulations. In addition, Audit Board of the Republic of Indonesia gave an opinion of the 2016-2017 review report which could be explained in the 2018 Semester Examination Results I (IHPS) for the results of the examination of 542 (100%) Regional Government Financial Statements (LKPD). From the 542 LKPDs in 2017, the BPK gave 411 WTP opinions (76%), 113 WDP opinions (21%), and 18 TMP opinions (3%). Based on the level of government, WTP opinion was achieved by 33 of 34 provinces (97%), 298 of 415 district governments (72%), and 80 of 93 city governments (86%). From the summary of BPK's audit results above, there is a problem with the level of financial statement disclosure in Indonesia which explains in real terms the level of compliance with local government disclosures in this research.

It is also supported by some international research which observed issues about disclosure such as Abu Bakar (2001); Boonvut (2017); Owusu-Ansah and Yeoh (2005); Tagesson, Klugman, and Ekstrom (2011). Owusu-Ansah and Yeoh (2005) found that financial statement disclosures have an average of up to 93%. Whereas other researches show an average disclosure of 45.9% (Abu Bakar, 2001), and 43.57% (Tagesson et al., 2011). In Indonesia, the studies about financial statement disclosure have been conducted by previous researchers (Arifin, 2014, 2018; Muqorobin, 2013; Pujiyanti, 2011; Setyowati, 2016; Suhardjanto & Yulianingtyas, 2011). For example, Setyowati (2016) found that the average level of mandatory disclosure of financial statements is 64%. From 314 samples, there are only 38 local governments who make mandatory disclosures below the average value of 36%. The lowest level of disclosure of Regional Government Financial Statements is in Southeast Aceh District, Aceh Province, which is 58% or only 46 items of mandatory disclosure. Other researches show that full disclosure rates are on average 30.85% (Suhardjanto & Yulianingtyas, 2011), 40% (Muqorobin, 2013), 60.64% (Retnoningsih, Suhardjanto, Rusmin, & Brown, 2011). According to (Arifin, 2014), (Arifin, 2018) found that the main mandatory disclosures were 69.6% and 64.6%. Furthermore, Pujiyanti (2011) found that local government financial statement disclosures were only 42% while in 2012, the disclosure rate was 35%.

Previous researches have largely discussed affecting factors of financial statement disclosure, such as researcher conducted by Giroux and McLelland (2003). It explained the role of governance can be measured by financial conditions, the level of disclosure represents the extent to which the information is complete and in accordance with applicable regulations. Financial conditions can affect financial statement disclosures because they are an integral component of the government's financial credibility (Laswad, Fisher, & Oyelere, 2005).

Besides, financial statement disclosure is affected by transfer and funds received by the local government. Some funds from the central government can function to increase the influence of the central government in carrying out greater monitoring of public financial statement disclosures. This is in line with other research which states that with the increasing transfer of funds by the central government, local governments need to disclose that the funds received have been well-allocated (Alcaide-Muñoz & Bolívar, 2015).

Political competition is a factor which needs to be paid attention to in the effect of financial statement disclosure. Pérez, Bolívar, and Hernández (2008) found a positive and significant relationship statistically between political competition and disclosure of public financial statements. It was because political leaders who sought to get more votes tried to meet the needs of as many voters as possible. Factors Per capita income in local communities can influence the disclosure of financial statements by local governments. According to Ingram and DeJong (1987), when residents' incomes increase, they receive better services and more information that the tax paid is being implemented effectively. Other support states that local income per capita will affect the disclosure of financial statements (Giroux, 1989; Giroux & McLelland, 2003).

The aims of this research are to study how Local Government conducts disclosure on its financial statements and their relationship with financial conditions, transfers and funds, political competition and income level in the municipality.

THEORETICAL PERSPECTIVE

Agency theory

Harahap (2011) states that agency theory explained that the company is the place for its contractual relationship with management, owners, creditors and the government. According to Halim and Abdullah (2006), it states that the principal-agent relationship is a very important approach for analyzing public policy commitments. The application of public policy is related to symmetrical information, moral hazard and adverse selection. Agency theory is usually used to be able to identify a combination or mix of work contracts and information systems. Thus, it can improve the function of the principal's benefit as well as behavioral obstacles which arise from the interests of the agent itself (Raharjo, 2007).

Institutional theory

In institutional theory, the organization faces institutional pressures, and they respond to these pressures (Arifin, 2014). The intended response can be socially acceptable practices and structures as an appropriate organizational choice in order to obtain legitimacy from their institutional context. Practices in the context of gaining legitimacy occur in organizations through 3 mechanisms (isomorphism) which are mimetic isomorphism, which is the imitation of other organizations that have successfully adopted and obtained legitimation. Pressure from other organizations has a strong effect. Thus, the responding organization has a large dependency (coercive isomorphism). This research examined the coercive isomorphism of financial condition and income level in the municipality. Normative isomorphism refers to pressures arising from group norms that affect managers.

THE DEVELOPMENT OF HYPOTHESIS

The effect of financial condition toward financial statement disclosure

The research conducted by Alcaide-Muñoz and Bolívar (2015) stated that talking about organization or institution, the common issue which is often discussed is about financial condition. Financial conditions are an integral part of the government's capacity to fulfil payment commitments (Giroux & Deis, 1993; Kamran & Zhao, 2016). This means that to produce a positive signal for its performance, local governments need to disclose their financial statements as a mechanism for monitoring their activities (García & García, 2008). In addition, users of financial statements want to know the use of government finances, especially those related to financing service providers and public programs (Styles & Tennyson, 2007).

The information asymmetry in the agency theory explains that the government is the agent and user of financial statement as the principal in order to have no interest in regional government needs. Furthermore, the theory is in line with the pressure for eradication, whereby the financial local government condition has carried out its activities positively. Based on the description above, it can be formulated as follows:

H1: There is a relationship between financial conditions and the financial statement disclosure.

The effect of transfer and funds toward financial statement disclosure

Transfer and funds are in accordance with agency theory due to the local government (agent) given the mandate by the central government to manage and run their own government. Therefore, they are required to account for all the activities that they have done. As a sample by carrying out disclosure practices, local government controls their government. Based on the institutional theory, local governments will carry out institutional practices due to demands from the central government to transparency.

The previous study stated that transfer and funds accepted by local governments become an important factor in financial statement disclosure in order to be able to control by the public (Copley, 1991; Ingram & DeJong, 1987; Tindaon & Rahman, 2018). Spending regional government balanced funds are required to carry out accountability by disclosing complete financial statements. Furthermore, Ingram and DeJong (1987) found that the presence of funds from the central government could serve to improve the monitoring of financial statement disclosures. It means that the funds received by the central government have been realized in the public interest and all of that can be seen from the disclosure of its

financial statements. Based on the description above, it can be formulated as follows:

H2: There is a relationship between transfer and funds and financial statement disclosure.

The effect of political competition on financial statement disclosure

Agency theory explains political competition related to the policies and motivation of local governments, especially in the disclosure of financial statements. The political competition that is elevated is demanded to be more transparent; the demand is due to the supervision of the public and rival political parties. The institutional theory also explains that the pressures from competing parties make elected local government prioritize the public interest and increase transparency.

Some researches find the positive and significant relationship statistically between political competition and financial statement disclosure. It is because political leaders who are trying to get votes try to meet the needs of as many voters as possible. Therefore, the more competition, the more incentives received to be disclosed (Pérez et al., 2008). According to Rahim and Martanti (2010), it states that political competition is shown by competition in occupying local government positions. The high political competition will be one form of oversight to the elected government and local governments who have high political competition and have intention to disclose financial statement because of the supervision of political parties. Based on the description above, it can be formulated as follows:

H3: There is a relationship between political competition and the financial statement disclosure.

The effect of level in municipality toward financial statement disclosure

The previous research in economic level of the local community's economy can affect financial statement disclosure. Agency theory is related to the information asymmetry between local government (agents) and community (principals) where people with high economics will be more demanding of local government to carry out transparency. The institutional theory states that local governments will conduct disclosure practices due to the pressure from other stakeholders, in this case, local communities, which community will demand the local government to prioritize the interest of the community.

Previous studies have shown that when people's incomes increase, they will pay taxes and ask for more information to confirm whether the taxes paid have been carried out effectively (Giroux, 1989; Giroux & McLelland, 2003). Regions with large income populations will have a high level of supervision. Communities will increase demand for government performance (Styles & Tennyson, 2007). Based on the description above, it can be formulated as follows:

H4: There is a relationship between income level in Municipality and the disclosure of financial statements.

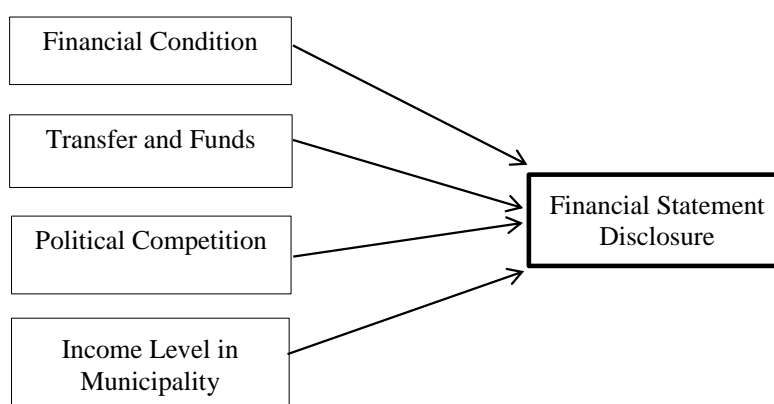


Figure 1. Research model

RESEARCH METHOD

This research used financial statements of 151 local governments (district/city) in Sumatra island. Hypotheses were examined using multiple linear regression analysis by SPSS. The dependent variable in this research was the disclosure of financial statements measured using the scoring index

adopted from (Arifin, 2014). The independent variable in this research was the financial condition measured by the total debt ratio, transfers and funds measured by making a comparison between the total balance funds of the central government and total income multiplied by 100% according to the research. Furthermore, political competition was measured by comparing number of candidates with positions available according to research conducted by Laswad et al. (2005). Income level in municipality was measured by comparing the Gross Regional Domestic Product in 2017 with regional residents in 2017 according to the research (Hudoyo & Mahmud, 2014).

RESULT

Descriptive statistic result showed that the average of financial statement disclosure level of local governments in Sumatra island was 82.7%. The lowest level of financial statement disclosure was found in Bangka District which was 66% or only 39 items were disclosed. It was followed by Meragin District, Solarangun District, Batam City which were the regions that had the highest level of disclosure of 96% or 48 mandatory disclosure items. This showed that the level of financial statement disclosure was quite high but there was no local Government on the island of Sumatra that required 100% mandatory disclosure. The level of mandatory disclosure in previous research varied from 30.85% (Suhardjanto & Yulianingtyas, 2011) to 93% (Owusu-Ansah & Yeoh, 2005). This research seemed to be influenced by the implementation of PP No. 71 of 2010.

T-test aims to find out the effect of each independent variables such as financial condition, transfers and funds, political competition, and income level in municipality on the disclosure of the financial statements of the Regional Government of Sumatra Island. *T* test results are shown in Table 1. It is the result of testing the variables of financial conditions, transfers and funds, political competition and income level in municipality on the disclosure of the Sumatra Island Local Government's financial statements. This research used $\alpha = 5\%$. Regression test results indicate that individually financial conditions provide coefficients of -2.060 with a significant probability of 0.041. Based on these results, it can be considered that financial condition has a negative effect on the disclosure of the financial statements of the Local Government of District/City of Sumatra Island.

Table 1: *T*-test result

		Coefficients				
Model		Unstandardized Coefficient	Standarized	<i>t</i>	Sig.	
		<i>B</i>	Std. Error	Coefficients		
1	(Constrant)	0,814	0,029		28,524	.000
	FC	-0,097	0,047	-0,164	-2,060	.041
	TF	0,015	0,031	0,040	,040	.629
	PC	-0.003	0,003	-0,091	-1,085	.280
	ILM	0,000	0,000	0,313	3,953	.000

Transfer and funds gave coefficient value of 0.40 with significance probability of 0.629 and it was bigger than significance level of 5%. thus, it can be considered that there is no effect between transfers and funds to financial statement disclosures. This research was not in line with research by Ingram and DeJong (1987) and Alcaide-Muñoz and Bolívar (2015) and it is in line with research by Pérez et al. (2008) and (Setyowati, 2016). With agency theory, there were several reasons why this occurred, namely in the era of decentralization the relationship between the central government (principal) and the regional government (agent) on the island of Sumatra was not so close that the central government did not give special control over the financial disclosure of the regional government of the island of Sumatra. In addition, it was not in accordance with the institutional theory, in which after the financial reporting incentives were given in 2010, but rather directed towards the achievement of opinion not the quality of financial statements.

T value in variable of political competition was -1.085 and significance probability was 0.280 bigger than significance level of 5%. Thus, it can be considered that political competition does not affect the

disclosure of financial statements. This research was not in line with the research of Zimmerman (1977), Serrano-Cinca, Rueda-Tomás, and Portillo-Tarragona (2009), Laswad et al. (2005), and Alcaide-Muñoz and Bolívar (2015) and it is in line with research by Pérez et al. (2008). The results of this research were not in accordance with agency theory, in which political rival parties in Sumatra Island were not competitive enough and did not influence local governments to make disclosures in their financial statements. Besides, it was not in line with institutional theory. It means that the Regional Government of Sumatra Island didn't obtain pressure from political competing parties to make disclosures meaning that the local government would conduct disclosure activities because of its own desire to prove the quality of the Regional Government.

Furthermore, the income level in municipality had *t*-value of 0.313 and the probability value was 0.000. Thus, it can be considered that income level in municipality affects the disclosure of financial statements. The results of this research are in line with research by Serrano-Cinca et al. (2009), Hudoyo and Mahmud (2014) and Alcaide-Muñoz and Bolívar (2015). Income level in municipality in this research affects financial statement disclosures meaning that regions with high per capita income will add to disclosures in financial reports because local governments get pressure in financial reporting because of the higher level of needs and education of the people who demand transparency from their local government especially on the island of Sumatra.

DISCUSSION

Financial condition on the financial statement disclosure. This H1 is accepted. It means that a government with a high debt ratio will find it increasingly difficult to make disclosures in the financial statements. The results are not in line with the study of Serrano-Cinca et al. (2009) who examined 92 local public administrations stating that financial conditions have no effect on financial statement disclosures due to the lack of a relationship between financial conditions and financial statement disclosures is a reflection of maturity. In line with the study of Alcaide-Muñoz and Bolívar (2015). This research was not in accordance with agency theory, in which the local government debt ratio becomes a factor of financial performance and will pose a great risk of abuse as well. It makes it difficult for local governments to make disclosures in their financial statements because they do not want to look unfavorable on the principle (Central Government, Investors, community) which will later reduce trust in the Local Government.

Transfer and funds on the financial statement disclosure. This H2 is rejected. The results not in line with Ingram and DeJong (1987) who examined the regional government of the United States of America states that transfers and funds affect the disclosure of financial statements, also, Alcaide-Muñoz and Bolívar (2015) who conducted research with meta-analytic on 36 articles stated that transfers and funds affect the disclosure of financial statements of his research stating that the Regional Government's financial dependence on the Central Government is highly motivated to make disclosures in its financial statements to show that the funds received have been used in accordance with applicable terms and conditions. In line with research by Pérez et al. (2008) who examined the public sector in large cities in Spain found that transfer and funds had no effect on financial statement disclosures. Waliyyani and Mammud (2015) examined the District/City Regional Governments in Indonesia that found the results that transfers and funds had no effect on the disclosure of the financial statements.

Setyowati (2016) examined the District/City Regional Governments in Indonesia. The results found that transfer and funds ban had no effect on disclosure of financial statements.

The hypothesis in this study was rejected, and this research is not in accordance with agency theory, there are several reasons why this happened, namely in the era of decentralization of the relationship between the central government (principal) and the regional government (agent) on the island of Sumatra, not so much oversight that the central government did not give control specifically on the financial disclosure of the regional government of Sumatra island. This study is not in accordance with the theory of institutional where after financial reporting incentives were given in 2010, but rather directed towards the achievement of opinion rather than the quality of financial statements.

Political competition on the financial statement disclosure. This H3 is rejected. The results not in line with Zimmerman (1977) stated that Local Governments in the United States of America which states

that political competition has an influence on financial statement disclosure. Furthermore [Serrano-Cinca et al. \(2009\)](#) examined 92 local public administrations in Spain found that political competition had an effect on financial statement disclosure, [Laswad et al. \(2005\)](#) examined the Local Government in New Zealand which stated that political competition had an effect positively towards the disclosure of financial statements and [Alcaide-Muñoz and Bolívar \(2015\)](#) with a meta-analytic technique of 36 articles stating that political competition has an effect on financial statement disclosure, the results of his research suggest that the competing political parties demand the disclosure of financial statements in order to carry out the control role. This research is in line with the research of [Pérez et al. \(2008\)](#) found that political competition does not significantly influence the disclosure of financial statements. The hypothesis in this research is rejected, it means that political competition in Sumatra Island does not put pressure on the disclosure of financial statements. If the elected official does not fulfill his political promises it will not weaken his power. The results of this study are not in accordance with agency theory, where political rival parties in Sumatra Island are not competitive enough and do not influence local governments to make disclosures in their financial statements. And not in line with institutional theory means that the Regional Government of Sumatra Island does not get pressure from political competitors to make disclosures meaning that the local government will conduct disclosure activities because of its own desire to prove the quality of its Regional Government.

Income level in municipality on the financial statement disclosure. This H4 is accepted. In line with research by [Serrano-Cinca et al. \(2009\)](#) examining 92 local public administrations in Spain states that income level in municipality affects the disclosure of financial statements, [Hudoyo and Mahmud \(2014\)](#) examining the Regency/City Local Government in Indonesia found that income level in municipality influences financial statement disclosure and [Alcaide-Muñoz and Bolívar \(2015\)](#) meta-analytic research on 36 articles which found that income level in municipality influences financial statement disclosure. Income level in municipality in this study affects the disclosure of financial statements. This shows that the hypothesis is accepted, meaning that regions with high per capita income will add to the disclosures in financial reports because local governments are under pressure to do financial reporting because of the higher level of needs and public education. which demands transparency from the local government, especially on the Sumatra island. The results of this study are in accordance with agency theory, where information asymmetry occurs between the Regional Government (agents) and the community (Principals) where people with high economics will be more demanding that the Regional Government carry out its government activities transparently. And in line with institutional theory, where the government will conduct disclosure practices due to pressure from other stakeholders and in this case the local community.

CONCLUSION AND RECOMMENDATIONS

This research aims to examine the extent to which local governments make disclosures in their financial statements with the factors which influence them such as financial conditions, transfers and funds, political competition, and income level in municipality. After conducting a hypothetical analysis and testing, the conclusions drawn in this research are as follows: The level of financial statement disclosure to the regency/city local government in Sumatra Island is 82.7%. It means that the district/city local government in Sumatra Island is quite large compared to the previous research. Financial condition has a negative effect on the disclosure of financial statements. Financial condition as measured by the debt ratio shows that when the debt ratio is high, it is difficult to make disclosures in the financial statements. Furthermore, transfer and funds do not affect the disclosure of financial statements. It is because the central government does not provide special control over financial statement disclosures.

Political competition doesn't have effect toward financial statement disclosure. This means that political competition in Sumatra Island does not put pressure on the disclosure of financial statements. Income level in municipality affects the disclosure of financial statements. When they have a population with high income per capita, they will demand transparency.

This study has a several limitations which is: the results of the study only use the object in Sumatera island which not been able to provide a clear or generalized picture the whole disclosure of local government financial. Financial statement are the main source of information although there ae

other source such as internal reports and quarterly reports, however, it can be chosen as the main data source due to easily accessible and also widely communicated.

The suggestion for Indonesian government is to formulate public policy by considering potential factors which can enhance pressure for government to conduct financial statement disclosure. A strategy for local governments to promote the disclosure of financial statements is the use of information technology to meet social demands which are more efficient and effective. For further researchers, it is recommended to expand the object of research. this research only investigates the disclosure items in the financial statements of the local government and explores other financial statement disclosure such as on the local government website and uses other variables outside of the variables in this study such as the number of parliaments, internal auditors and adds control variables. Therefore, it is more corroborating to other studies which are considered to influence the disclosure of financial statements.

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