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Factors Affecting The Financial Performance of Local Government Antecedents in Indonesia

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Abstract

This research aims to determine the effects of provincial revenue of the Audit Board of Indonesia (Badan Pemeriksa Keuangan, BPK) on the financial performance of district and city governments. Furthermore, financial performance is measured by four criteria: independence, economy, efficiency, and effectiveness. Multiple regression with panel data and fixed models were used by the 15 district and city governments from 2015 to 2019. The results showed that size of local government and the audit opinion of BPK have a positive effect, while the intergovernmental revenues does not have a positive effect.

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INTRODUCTION

The Indonesian local government has been granted the autonomy to manage its finance according to Number 32 of 2004 constitution. The contribution of locally-generated revenue (*Pendapatan Yang Dihasilkan Secara Lokal,* PAD) in regional income and expenditure budgets (*Anggaran Pendapatan dan Belanja Daerah,* APBD) is an important indicator of successful regional autonomy. However, public welfare requires the improvement of services through the financing sources of the region. In Indonesia, local government is still dependent on central government funding (*Dana Alokasi Umum,* DAU) and PADs are smaller than DAU in the structure of APBDs. The dependence on local government shows a low financial performance.

On 16 August 2016, the government issued Regulation 125/PMK.07/2016 on the delay in budget allocations. Furthermore, Lampung Province is among the regions experiencing delays in the distribution of DAU**.** This delay affects all funding structures, budgets, and work programs.

Several Indonesian research have been conducted on the effect of local government size and the Indonesian Audit Board (Badan Pemeriksa Keuangan, BPK) on financial performance. However, the majority of research employ single-valued financial performance proxies. Masdiantini & Erawati (2016) performed research employing four financial factors, namely independence, economy, efficiency, and effectiveness, to demonstrate that local government size and BPK opinion strongly influenced Bali's financial performance. On the other hand, the variables of *prosperity* and DAU have no effect. In addition, this research is extended to all local regions, regencies, and cities across Indonesia, utilizing more precise panel data models than Masdiantini & Erawati (2016).

RESEARCH PROBLEM

Based on the description above, the following problems can be formulated:

1. Does intergovernmental revenue negatively affect the financial performance of district/city governments?
2. Does BPK's audit opinion positively affect the financial performance of district/city governments?
3. Does the size of the local government have a positive effect on the financial performance of the district/city government?

LITERATURE

Agency Theory

Jensen & Meckling (1976) explained an agency relationship as a contract between one or more owners of economic resources (the principals) with other people (the agents) where the principal employs agents to manage and control the resources. The principal is the community in the public sector, while the agent is the government. The government should adhere to its rules and avoid conflicts of interest, while acting as principal and appointing agents to conduct diverse operation. The community, as the principal, has the right to judge the performance of local government, as the agent tasked with providing services that meet the expectation and interests of the society.

Financial Performance

Financial performance is defined by Sularso & Restianto (2011) and Masdiantini & Erawati (2016) in four ways:

- independence,
- economics,
- effectiveness, and
- efficiency.

Independence signifies the local government's ability to finance its administration, while *economics* indicates savings in expenditure. Furthermore, *effectiveness* determines the amount of revenue received by the local government, while *efficiency* indicates how much cost is incurred in their doing so.

Local Government Size

Patrick (2007) stated that district size is the most significant predictor of accounting compliance. It is measured using the number of employees, total assets, total revenue, and production level. For example, Hidayat &Isroah (2016) derived *size* from the company's total fixed assets, not cash, because the asset value is more stable.

Central revenue is also known as balance funds regarding Regulation Number 33 years 2004. Balance Funds is money from APBN (*Anggaran Pendapatan Belanja Negara*, the Indonesian State Budget) allocated to finance the districts needs in the context of decentralization. These funds consist of DBH (*Daerah Bagi Hasil*, Revenue Sharing), DAU, and DAK (*Dana Alokasi Khusus*, Special Allocation Funds).

BPK Audit Result

Regulation Number 15 of 2004 specifies that BPK audit results consist of:

- an *opinion*,
- a report containing the *findings*, conclusion, and recommendation, and
- a conclusion.

BPK *findings* is strictly evidence of violations of regulations committed by a region (Ara, etall, 2016).

Every audit identifies one or more problems, usually due to an SPI weakness and disregarding regulations. *Opinion* is a professional statement by the examiner about the quality of the information presented in the financial statement (Masdiantini&Erawati, 2016). For example, regulation number 15 of 2004 specifies five possible opinions:

- Unqualified Opinion (*Wajar Tanpa Pengecualian*),
- Unqualified Opinion with Explanatory Paragraph (*Wajar Tanpa Pengecualian –Dengan Paragraf Penjelas*),
- Reasonable with Exceptions (*Wajar Dengan Pengecualian*),
- Unreasonable (*Tidak Wajar*), and
- No Opinion (*Tidak Memberikan Pendapat*).

Local government revenue allocation is dominated by provincial revenue. Kelly (2010), Utomo (2015), and Suryaningsih & Sidyani (2016) demonstrated that districts' reliance on central government impairs their performance (cities and regencies).

Central money makes local governments less enthusiastic on exploring the potential of their PAD. Therefore, hypothesis 1 is:

H1: Central revenue negatively affects the financial performance of local governments

Opinions (as distinct from *findings*) by BPK shows the level of fairness and compliance of Local Government Financial Reports (*Laporan Keuangan Pemerintah Daerah,* LKPD) with applicable accounting standards. Therefore, BPK audit opinion is the benchmark for accountability of local government. Masdiantini & Erawati (2016) and Suryaningsih & Sisdyani (2016) show that BPK audit opinion significantly affects local government financial performance.

Good opinion shows better financial performance, unlike bad opinion which shows poor performance. A good opinion shows that the local government has managed its finances well. Therefore, hypothesis 2 is:

H2: BPK audit opinion positively affects the financial performance of local governments

Patrick (2007) explained that local government size is a significant predictor of accounting compliance. According to Kristanto (2009), the size of a government may be determined by the total income generated each year under its jurisdiction. However, Hidayat & Isroah (2016) assert that the government's total assets determine the size.

According to Cooke (1992), larger companies have more pressure from the public to make their disclosures mandatory. Mustikarini & Fitriasari (2012), Kusumawardani (2012), and Utomo (2015) explained how local government size has a significant positive effect on performance. The size is directly proportional to the demand for better financial performances. Therefore, hypothesis 3 is:

H3: The size of local governments positively affects their financial performance

METHOD

Population

About 72 LKPDs between 2015 and 2019 provided data which is taken from the Examination Result of 1st Semester in 2016, available at www.bpk.go.id.

Table 1. The Results of Descriptive Statistical Analysis

Variables	Average	Maximum	Minimum
Independence Ratio	0.0661	0.3911	0.0110
Economic Ratio	0.9131	0.9737	0.7722
Efficiency Ratio	0.0014	0.0065	0
Effectiveness Ratio	0.9881	1.0978	0.7929
IR	0.7571	0.8825	0.5513
OPN	3.764	5	1
Ln_SIZE	28.1155	28.9384	26.4376

Data Analysis

Secondary quantitative and *qualitative* data were used in this research. The quantitative were sourced from LKPDs, while the qualitative were from the *findings* and *opinions* in LKPDs. Financial data and *findings* were from the Report on LKPDs issued by the State Audit Board. Furthermore, *opinions* were obtained from the Summary of Examination Results 1st Semester in 2016.

Research Model and Operational Definition

The research model is as follows:

$$KNJ_{it} = \alpha + \beta_1 \, IR + \beta_2 OPN + \beta_3 Ln\_SIZE + e$$

Description:

KNJ_{it}= Financial Performance of Regional Government

Ln_SIZE = Local Government Size

IR = ProvincialRevenue

OPN = BPK audit opinion

A = Constanta

$\beta_1, \beta_2, \beta_3, \beta_4$ = Regression Coefficients
E = Error

Table 2. The Operational Definitions of Each Research Variables

Variables	Sub Variables	Scale	Measurement
Intergovernmental Revenue		Ratio	$\frac{\text{Total Balancing Fund}}{\text{Total Revenue}}$
BPK Audit Findings	Audit opinion	Scale	BPK audit opinion is rated between 1 and 5
Local Government Size		Nominal	Logarithm (Ln) total assets
Local Government Financial Performance	Independence Ratio	Ratio	$\frac{\text{PAD}}{\text{Central and Province Governments Subsidies and Loans}}$
	Economic Ratio	Ratio	$\frac{\text{Realization Expenditure}}{\text{Budgeting Expenditure}}$
	Efficiency Ratio	Ratio	$\frac{\text{Actual Costs to Acquire}}{\text{Revenue Realization}}$
	Effectiveness Ratio	Ratio	$\frac{\text{Revenue realization}}{\text{Revenue Budget}}$

Factor Analysis

The local government financial performance dependent variable was proxied by four ratios: independence ratio, economic ratio, efficiency ratio, and effectiveness ratio. Factor validity analysis using SPSS software version 21 also produces two-factor scores. In multiple regression model testing, the extraneous variable was eliminated.

Ghozali (2011:397) stated that factor analysis should determine the *anti-imagematrix*to to know the variables to be discarded, which is the one with the smallest value of *anti-imagecorrelation*. The economic ratio has the smallest, 0,371.

After re-testing by removing the economic ratio, the results were obtained below.

Table 3. KMO MSA Results and *BartlettTestOfSphericity*

Kaiser-Meyer-OlkinMeasureof Sampling Adequacy.		.560
Bartlett'sTestofSphericity	Approx. Chi-Square	67.098
	Sig.	.000
	Df	3

Source: Results of data processing, 2017

KMO MSA is 0.560, more significant than 0.500, and the significance level of the *Bartletttestofsphericity* is 0 to 3 places of decimals, smaller than 0.05. This means factor analysis can be continued yielding a one-factor score for the dependent variable.

Data Transformation

The research data passed the multicollinearity test but did not pass the normality, autocorrelation, and heteroscedasticity tests. The dependent variable is transformation data using logarithm transformation (ln). The new equation is:

$Ln\_KNJ_{it} = \alpha + \beta_1 IR + \beta_2\ OPN + \beta_1 ln\_SIZE + e$

Double Regression Analysis

The regression test results appear below.

Table 4. The Double Regression Result for Fixed Effect Model

Variable	Coefficient	Std. Error	t-Statistic	Prob.
C	-16.16513	4.040387	-4.000887	0.0002
IR	0.040385	0.913068	0.044230	0.9649
OPN	0.103256	0.047367	2.179935	0.0340
LN_SIZE	0.552673	0.149556	3.695433	0.0005
R-squared	0.883143			
Adjusted R-squared	0.841075			
F-statistic	20.99304			
Prob(F-statistic)	0.000000			

Based on the table above the regression equation can be written as follows:

$$Ln\_KNJ_{it} = (-16{,}1651) + 0{,}0404 IR + 0{,}1033\ OPN + 0{,}5527\ ln\_SIZE + e$$

Hypothesis Test

Significancy-F Test

The probability value obtained in the regression model is 0, smaller than 0.05. Therefore, it can be concluded that the regression model fits the hypothesis, and the three independent variables simultaneously affect financial performance.

Regression Coefficient Test (Significant-t-Test)

In this research, the t-test is used with a significance level of 5%, which means that the requirements are:

1. Ha is rejected when t count < t table, or probability value > 0.05, which means the independent variable does not affect the dependent.
2. Ha is accepted when t count > t table or probability value < 0.05, which means the independent variable does not affect the dependent.

These results show that the significance of BPK audit *opinion* and the local government *size* variables is smaller than 0.05. Therefore, the first, third, and fourth hypotheses were accepted. The second hypothesis is rejected because the significance value of IR is more significant than 0.05.

Coefficient of Determination Test (R^2)

From the table above, the adjusted value of R-Squared is 0,8411 or 84,11%. This means 84,11% variation of local financial performance is explained by (a) central revenue, (b) BPK opinions, and (c) the size of local government. Other variables outside the independent can explain the remaining 15,89%.

Limitations of Research

1. This research focuses exclusively on Indonesia, limiting its generalizability to a single nation.
2. It is confined to performance testing regardless of whether the region expands or receives a WTP opinion.

RESULTS

Effect of Central Revenue on Local Government Performance

The IR variable is 0.9649, more significant than 0.05, with coefficient β_1 positive. Therefore, the first hypothesis is incorrect, which means central revenue does not affect local government financial performance. These results align with Sesotyaningtyas (2012) and Masdiantini & Erawati (2016).

The provincial revenue does not affect the local government's utilizing central funds. This inability can be due to a lack of central government oversight when an allocation to bridge a fiscal gap is not utilized. The expenditure depends on DAU, which is expected to increase the local government's independence, even though inadequate.

Effect of BPK Audit Opinions

The significance value of the BPK audit opinion (OPN) is 0.0340, which is smaller than 0,05, and β_2 is positive. Therefore, the second hypothesis is accepted.

The audit opinion of BPK has a significant positive effect on the performance, supporting Masdiantini & Erawati (2016) and Suryaningsih &Sisdyani (2016). In this case, *opinion* relates to presenting the local government's financial statement under accounting standards and applicable legislation with the reasonableness of the information presented. For example, an opinion of WTP (one of the five possible opinions specified) indicates good management with only minor deviations from accounting standards and current regulations, avoiding misuse.

Another standard opinion, TMP, indicates irregularities against accepted accounting standards and legislation. As a result, local governments do not manage their local finances well with TMP's opinion.

Effect of Size on Local Government Financial Performance

The local government size variable (Ln_SIZE) is 0.0005 smaller than 0,05 while the coefficient β_3 is positive. Therefore, the third hypothesis is accepted.

Size significantly and positively affects the financial performance of local government. Therefore, the opinions of Mustikarini & Fitriasari (2012), Kusumawardani (2012), and Utomo (2015) are accepted.

These results show that the local government size results in better financial performance. This indicates that acquiring a higher total value of assets improves financial performance. In addition, local government with high total assets can operate better because it is more flexible in using assets to increase revenue.

CONCLUSION

This research discovers that the BPK audit opinion and size of local government has a significant positive effect, and central revenues do not affect the financial performance of district and city governments in Indonesia.

This research suggests that the central governments provide more intensive supervision on balancing funds because their use is not targeted correctly, and the main objective is not achieved. The local governments increase the total value of assets to improve their financial performance. This will promote economic growth to increase the local revenue. Furthermore, the local government is more conscientious about accounting and compliance.

FUTURE RESEARCH

1. Add several other variables that have a relationship to the government's financial performance, such as the level of local wealth, local expenditure, and legislative measures.
2. Use sample data of financial report areas more broadly.
3. Divide the research sample into several categories based on criteria such as *opinion* and regional status to increase relevance and reliability.

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