CHAPTER I

INTRODUCTION

A. Research Background

During the last decades, public sector and governmental accounting reforms have been adopted in many countries. Many of these reforms show a number of characteristics often summarized in terms of New Public Management (NPM) (Hood, 1991; and Osborne and Gaebler, 1992), and widely discussed and described for many countries (Lane, 1997; OECD, 1997; Pallot, 1999; Pollitt, 2000; Green-Pederson, 2002; Van Helden and Jansen, 2003; Schedler, 2003; and Reichard, 2003). In such reforms, traditional concepts and instruments are changed to businesslike tools and styles. According to Hood (1995), the emphasis of NPM lays on the diminution of the differences between the public and private sector and the shift from process accountability towards greater accountability in terms of results.

In Indonesia, accountability of financial reports can be obtained if the information presented in the financial statements meets the quality of financial reporting as set out in the SAP, which is relevant, reliable, comparable, and understandable. If all the characters are met in financial reporting process the high quality financial reporting is achieved. Ball (2005) suggests three reasons why high-quality financial reporting by government agencies, institutions and enterprises is desirable. The first relates to monitoring and managing their own performance: government organizations, just like large private enterprises, need timely and accurate financial information for this purpose. They shift large amounts of resources from the private to the public sector with the objective of improving the well-being of society, and if they do not operate efficiently and effectively, or invest funds wisely, this can represent a huge drain on the economy.

The second reason is that electors entrust governments with the management of assets and liabilities that have been accumulated over decades, and will affect the welfare of citizens for many more decades to come. They are entitled to information that allows them to hold governments accountable for their use of public resources, including information on the extent to which revenues are sufficient to pay for services being provided, and on the capacity of governments to meet their financial obligations and to withstand potential shocks.

The third reason, closely related to the second, is that a properly functioning democracy requires its constituents to have confidence in politicians and to be willing to take an interest in politics. This confidence is enhanced when governments fully inform their constituents, enabling them to exercise their votes on the basis of reliable financial information. Transparent financial reporting is one means by which politicians can engage constituents in the democratic process and engender confidence.

On the other hand, without an effective implementation of the reform, the accounting system could not provide relevant managerial information. The implementation of the reform is therefore extremely important. Without an adequate implementation, all the efforts made the presupposed goals of the reform and the created expectations will be lost. Also Lin, Baxter and Murphy (1993) emphasize the implementation stating that the compliance of a reform is very important since all the merits depend thereupon and because the compliance is not guaranteed. We should not assume that an appropriate standard-setting mechanism will naturally gain acceptance and thereby guarantee compliance.

While public sector reforms delivered through the introduction of accrual accounting is intended to realize greater efficiency and effectiveness in the delivery of public sector services, there is no guarantee that a government will be any more accountable for its achievements and that provision of goods and services will be any better. Jones and Puglisi (1997) highlight potential problems in adopting accrual accounting in the public sector context: the complexity and cost of designing and implementing the new accounting systems; difficulties in applying economics based definitions of assets, liabilities, expenses and revenues; and, importantly, managerial and political factors related to change management and resistance to change. Likewise, Guthrie (1998) argues that although the implementation of accrual accounting has tended to be seen as a 'good thing' in public administration, government bodies must consider many issues when adopting it, especially in developing countries. Hopwood (1983) notes that it is difficult to distinguish between the advance accounting for ritualistic, legitimizing and rationalizing reasons, and its advance from the belief that it can change and improve organizational performance. As suggested by Yamamoto (1999) the introduction of an accounting reform is not an end in itself; its value depends on the level of the user's understanding and its contribution to improved decision making. Therefore, to provide evidence of the links between broader changes in the public sector and changes in accounting techniques, it is important to (a) examine the political and economic context in which changes to financial reporting have taken place (Ryan, 1998) and (b) to assess the impact of these changes upon public sector management practices and performance.

Since 2000, to achieve accountability in the management of state finances, the government of Indonesia has made a strategic move to set up more detailed information on state finances in paragraph 5 of article 23 of Constitution Act 1945. This decision was followed by the enactment of three packages of the state finance law, the Law No. 17 of 2003 on Public Finance, Law no. 1 of 2004 on the State Treasury and the Law No. 15 of 2004 on the Investigation and Management of State Financial Responsibility. The law No. 1 of 2004 lays out the management of the state treasury both in central and local governments. It also initiates the establishment of the finance directorate within local governments as local treasurers. While the law no 17 of 2003 indicates that accounting systems in central and local governments will be regulated under new government accounting standards. The standard is enacted by Peraturan Pemerintah no. 24/2005 of Standar Akuntansi Pemerintah (SAP).

The establishment of the new accounting standard for local government in Peraturan Pemerintah no. 24/2005 (PP24) which straightens up about Standar Akuntansi Pemerintah is followed by the establishment of Permendagri no. 13/2006 (PM13) which straightens up about Pedoman Pengelolaan Keuangan Daerah. The implementation of these rules are not similar between one local government and another, both these rules are made the local government confused by many innovation that the government issued. This condition has made the implementation of good governance became complicated. Besides, there are some issues of human resources that hamper the success of good governance (LGSP, 2007). The difficulty caused by the complexity of laws will appear in the whole cycle of local government fund, start from the legalization of budget until the composition of financial report, the less of human resources, bad coordination, and insufficient technology they use.

To check compliance with standards of financial reporting and other regulatory audit process is required. This examination provided for in Law No. 15 of 2004 in which the law was declared that the state auditor is the Badan Pemeriksa Keuangan (BPK) in charge of examination and management of state financial responsibility by the state audit standard (SPKN). In doing audit, the auditor will produce examination report that must be accompanied by an audit opinion.

Audit opinion of the auditor is a professional statement about the fairness of the financial information presented in the financial statements that are based on criteria (i) compliance with standards governmental accounting, (ii) the adequacy of disclosure, (iii) compliance with laws and regulations, and (iv) the effectiveness of internal control systems. There are 4 (four) kinds of opinions to be given by the examiner, namely (i) an unqualified opinion (unqualified opinion), (ii) reasonable opinion with the exception of (qualified opinion), (iii) improper opinion (Adverse opinion), and (iv) a statement refusing to give an opinion (disclaimer of opinion).

Payamta (2006) which examined the effect of audit opinion on the quality of private company financial statements stating that the quality of financial reporting is the extent to which the financial statements show a true and honest information. Truth and honesty, according to the conceptual framework of financial reporting in SAP is one of the qualitative characteristics of financial information. The quality of financial reporting can be examined by looking at the accompanying audit opinion, if the opinion is issued then it could be said to be good quality financial statements are also good, and vice versa. As stated earlier, the government organization issued an audit opinion based on criteria (i) compliance with governmental accounting standards, (ii) the adequacy of disclosure, (iii) compliance with laws and regulations, and (iv) the effectiveness of internal control systems. So that if the audit opinion issued has a high quality, the information presented in financial statements also meet four criteria, one of which is compliance with accounting standards.

Related study on quality of financial reporting in local government has previously done by Christiaens (1999a), Christiaens and Van Peteghem (2007). They examine the quality of financial reports based on qualitative characteristics of financial statements as listed in the conceptual framework of financial reporting, among timelines, completeness, cut-off, classification, compensation, mechanical accuracy, disclosure, the formalistic requirements, adequacy and usefulness. All the qualitative characters of financial information are converted into quantitative by using a compliance index. If the character met, the local governments are considered in compliance with financial reporting standards.

While Cohen and Kaimenakis (2007) investigate the compliance of financial reporting based on one of these qualitative characteristics, accuracy, by using compliance index build by the accuracy in disclosing some account in financial statements of local government.

Some external and internal factors that have been tested in previous studies as having an influential role on the level of compliance with accounting standards the empirical results found in literature do not coincide. Those factors tested are the local governments' reliance on debt, municipal wealth, organization's size, and local government's accrual accounting experience on its compliance to accounting standards. More specifically, Ingram, (1984), Ingram and DeJong, (1987) and Christiaens (1999a) did not find any statistical relationship between the local governments' reliance on debt and compliance. On the contrary, the empirical evidence in the studies of Robbins and Austin (1986) and Cheng (1992) supported such a relationship. Ingram (1984) and Robbins and Austin (1986) assumed but they did not succeed in supporting with empirical evidence a positive relationship between compliance and municipal wealth. Also, the relevant literature remains inconclusive as to the effect of an organization's size on compliance with accounting standards. More specifically, even though Christiaens (1999a) revealed a positive relationship, Robbins and Austin (1986) and Ingram and DeJong (1987) did not find such a relationship. Finally, Christiaens and Van Peteghem (2007) who tested the effect of a local government's accrual accounting experience on its compliance to accounting standards were inconclusive regarding the effect of experience on compliance. However, Ryan et al. (2002) found a positive association between the years of accrual accounting experience and compliance.

B. Problem Statement

The enactment of new policy related with accounting in Indonesian local governments aimed at the improvement of accounting information provided to decision makers; this was expected to enhance fund management and improve accountability. However, for this to happen, the output of the accounting system should provide relevant and useful information. The present research study seeks to determine the quality of accounting information provided by Indonesian local governments' end-of-the-year 2007 financial statements. Therefore it will study the following research question: "Which factors exhibit an influential role on the level of compliance with the accrual accounting standards?"

C. Objectives

The purpose of this study is tried to give empirical evidence on factors that exhibit an influential role on the level of local governments' financial reporting compliance.

D. Research Contribution

This research will give a benefit for those who use the local government report to assess whether the local government has made the good quality report on the fund trusted to them, whether they has obeying the standard and rules set by the government. For the government itself, as a standard setter, can realize whether the standard they issued has made the quality of local government reporting improved or may be less than they expected. From this benefit, they can come up with a policy that really fit with the condition that local government face without ignoring the accountability and transparency of local government. For the government as a regulator, this study can help them to evaluate the obedience of the local government in preparing financial statement; this process will help them to set an act related to the violation of standard or rules they have set out before. For local government, this research can be an evaluation for preparing financial statements process. For local governments that have implemented this new standard, it can improve its application to improve compliance with governmental accounting standards, but for those who have not applied and have not complied with these standards can be more motivated to review their financial statements to comply and adhere to them more.