The Association between Poor Financial Reporting and Local Government Corruption: Evidence from Indonesia

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Abstract

This study investigates whether corruption is more (less) likely to occur in local governments with poor (good) financial reporting practices. Using logistic regressions for panel data with 5,917 financial statements of Indonesian local governments from 2007 to 2019, this study finds that mayors (i.e., the heads of local governments) are more likely to eventually become corruption suspects when financial reports during their tenure receive poor audit opinions from the Supreme Audit Board. Additionally, we find that corruption is more likely in larger and wealthier local governments and when mayors are relatively younger. This study contributes to the literature on corruption by providing empirical evidence that poor financial reporting practices open the door to corrupt activities. Policymakers interested in preventing and eradicating corruption can emphasize improving the quality of financial reporting in their governmental institutions.

Keywords: financial reporting quality, audit opinion, local government corruption, Indonesia.

1. Introduction

The United Nations estimates that $2.6 trillion, or five percent of the global domestic product, is lost to corruption annually (United Nations, 2018). Corruption increases business costs, impedes investments, slows economic growth, and makes public services less accessible, especially to the poor. The UN has made reducing corruption and bribery a major goal, as stated in the UN Sustainable Development Goal No. 16. While many countries have pursued various strategies to eradicate corrupt practices, combating corruption is challenging for governments worldwide as most anti-corruption efforts fail (Kuipers & Verhey, 2023).

Studies suggest critical factors in resisting corruption include transparency and accountability (Chen & Ganapati, 2023). As financial reporting quality is strongly associated with transparency and accountability (Rose, Mazza, Norman, & Rose, 2013), corruption is expected to decrease with improved financial reporting practices (Changwony & Paterson, 2019).

In a government setting, one way to improve the quality of financial reporting is through audits, where auditors render opinions on the financial reports prepared by government institutions. However, existing studies on the role of government audits in combating corruption provide mixed findings. Avis, Ferraz, and Finan (2018) find that government audits reduce the probability of future corruption among municipalities in Brazil. On the contrary, corrupt political elites can infiltrate supreme audit institutions to weaken audit findings so that public sector audits sustain, instead of fighting, corruption (Lino, Azevedo, Aquino, & Steccolini, 2022). Similarly, Lassou, Hopper, and Ntim (2021) argue that supreme audit institutions might facilitate instead of control corruption, especially in countries with corrupt political officials. Phiri and Guven-Uslu (2019) investigate accountability institutions in Zambia and find the presence of networks of a corrupt nature, including in the supreme audit institutions, which implies that audits might lose their effectiveness in curbing corruption.

This study investigates whether auditing affects corruption levels in the public sector. More specifically, this study examines whether the types of audit opinions on local governments' financial reports are associated with future corruption among local governments in Indonesia. We hypothesize that mayors whose financial reports during their tenure receive cleaner (poorer) audit opinions are less (more) likely to become corruption suspects in the future. A clean audit opinion indicates that a financial statement is free from material misstatements and is presented fairly based

on generally accepted accounting principles. We argue that a clean opinion on a local government financial report signals higher transparency and accountability, making corruption less likely.

Examining corruption in Indonesia is interesting because the country was listed as one of the most corrupt countries in the world, ranked 122 in the global corruption perceptions index in 2003 (*Corruption Perceptions Index*, 2003).[1] Since establishing the Indonesian Corruption Commission in 2004, hundreds of local government leaders have been arrested and served prison sentences for corruption (Tempo.co, 2023). Interestingly, public debate has arisen in Indonesia as anecdotal evidence shows that many local government heads became corruption suspects even when local governments received clean opinions on their financial reports. This begs the question of whether audit opinions provide signals of present or future corrupt practices among local governments in the country.

This study uses the logistic regression analysis for panel data with 5,917 observations from 2007 to 2019 as the sample. We find that receiving poor audit opinions on financial reports increases the likelihood of the mayors becoming corruption suspects. However, clean audit opinions on the reports are not significantly associated with a lower probability of mayors becoming corruption suspects. This finding confirms the anecdotal evidence that some mayors were arrested for corruption charges even when their financial reports received clean opinions. In our model, we believe that poor financial reporting practice induces corrupt activities, not vice versa, because, between 2007 and 2019, more mayors in Indonesia became corruption suspects in later years when more financial reports received clean opinions than in earlier years. Our control variables suggest that young mayors, those allocating a higher proportion of capital expenditure,

[1] In 2021, the corruption perceptions have improved, and the country ranked 96.

and those serving in larger and wealthier local governments are more likely to become corruption suspects.

Our study contributes to the literature by providing empirical evidence that poor financial reporting quality, as reflected by the disclaimer of opinion on financial reports, provides a breeding ground for corruption. This study offers insights to corruption-fighting agencies and policymakers that improving financial reporting practices is one way to prevent corruption among governmental institutions. With their limited resources, corruption-fighting agencies might want to focus on local governments with poor audit opinions on their financial reports in their surveillance to detect corruption.

2. Institutional Setting

Indonesia has been experiencing democratization and public reform since the toppling of President Soeharto in 1998, who managed to hold on to power for 32 years. The New Order regime under the President was seen as corrupt, nepotistic, and collusive. To combat corruption, governments implemented reforms in various areas, including accounting, budget, law, and politics. As part of government reform, Indonesia issued Act 28 of 1999 to promote a public administration that is clean and free from corruption. The country moved further by establishing a corruption-fighting agency in 2002 named Komisi Pemberantasan Korupsi or the KPK (i.e., the Commission for Corruption Eradication) to curb and battle corruption. Since the establishment of the KPK, corruption cases have been handled by three institutions: the KPK itself, the Police Forces, and the Attorney's Office. Following the establishment, the country's corruption perception index improved steadily from 20 in 2004 to 40 in 2019 (Transparency International, 2023).

Another part of the public reform was that government institutions (e.g., central, provincial, and local governments, ministries, etc.) were required to prepare financial statements since 2004. The Indonesian Supreme Audit Institution (i.e., the BPK) audits all financial reports of government institutions in the country, including those of local governments. The BPK comprises nine members selected by the House of Representatives to ensure its independence from the executive branch. The BPK audits and issues an audit opinion on each financial report. There are four types of audit opinion: unqualified, qualified, adverse, and a disclaimer of opinion. The provision of an audit opinion is based on whether there is a material misstatement and its conformity with governmental accounting standards and related regulations. An unqualified opinion is considered the cleanest, while an adverse or disclaimer represents the poorest opinion.

The proportion of financial reports receiving unqualified opinions from the BPK has increased significantly from only 7.3% in 2004 to 90% in 2020 and 91% in 2022 (BPK, 2023). However, there exists an expectation gap where, with a clean opinion, the public expects corruption not to occur. The literature supports the view that auditing should reduce corruption (Jeppesen, 2019). And yet, many local government heads in Indonesia committed corruption even when their financial reports consistently received clean opinions from the BPK. The BPK addresses the issue by arguing that their audits are not intended to detect corruption but instead to provide assurance that financial reports are prepared in accordance with the accounting standards and that there are no material misstatements in the reports.

3. Literature Review & Hypothesis Development

Accounting protects the public interest by enabling transparency and supporting accountability. Johnston (2015) argues that rigorous accounting techniques can become a powerful force to combat corruption. Through an experiment, Parra, Muñoz-Herrera, and Palacio (2021)

found that transparency decreases embezzlement. Similarly, Azfar and Nelson (2007) find that increasing the difficulty of hiding gains from corrupt activities reduces corruption. Cross-country studies find that financial reporting quality improves the corruption perception index (Houqe & Monem, 2016; Kimbro, 2002). Several countries have reformed public sector accounting by adopting an accrual accounting system to improve accountability and transparency. Adopting accrual accounting is expected to reduce corruption, although previous studies show that adopting accrual accounting can increase complexity and arbitrariness for users of financial statements (Bonollo, 2023).

The accounting process generates financial information verified through auditing as a central element of good government governance, where auditors express an audit opinion of the financial reports. Auditors will issue unqualified opinions when the financial statements are free from material misstatement (International Standard on Auditing 700, 2009). The lesser clean opinions include a qualified opinion, an adverse opinion, and a disclaimer of opinion.

An audit opinion can be used as an indication of whether the financial statements presented by an entity contain fraud, corruption, and irregularities. Research conducted by Hikam et al. (2020) found a strong relationship between auditor opinion and fraud in local governments. Their study was conducted on 28 local governments in West Java Province from 2012-2017. In their research, fraud was measured by the existence of fraud cases, the amount of state financial loss, and the amount of penalty or fine determined by a court with permanent legal force. However, the study conducted by Budiman and Amyar (2021) provided different results. Their research does not find a significant effect of audit opinion on corruption levels in the ministries and institutions in Indonesia.

Although research regarding the influence of audit opinions on fraud and corruption has not provided conclusive results, Liu and Lin (2012) show that audits significantly reduce corruption in the Chinese government. In the US, states use audited financial statements to conduct fiscal monitoring of municipal governments by regularly reviewing municipal financial reports, which increases financial reporting quality and reduces corruption (Nakhmurina, 2024). Using the framework of the fraud triangle theory, Malau, Ohalehi, Badr, and Yekini (2021) find evidence that repeated audit issues in the disclaimer audit opinion create opportunities for financial statement and financial transaction fraud in the public sector of the Solomon Islands. Based on the above arguments, this study predicts that the quality of financial reports, as reflected by the type of audit opinion, affects the level of corruption.

H1a: Mayors whose financial reports receive unqualified opinions during their tenure are less likely to become corruption suspects.

H1b: Mayors whose financial reports receive a disclaimer of opinion during their tenure are more likely to become corruption suspects.

4. Research Model

In this study, a financial report is considered high quality when it receives an unqualified opinion (*CLEAN*) from the BPK (Rakhman & Wijayana, 2019). On the contrary, a report is of poor quality when it obtains a disclaimer of opinion (*DISCLM*). Our models use local governments receiving qualified opinions as the control groups. We use logistic regression models for panel data to examine whether financial reporting quality is associated with the probability of corruption. The regression models are presented as follows:

Model 1:

$$CORSUS_{it} = \mu_0 + \mu_1 CLEAN_{it} + \mu_2 AGE_{it} + \mu_3 GNDR_{it} + \mu_4 JAVA_i + \mu_{5d} lnLOCREV_{it} + \mu_6 lnCAPEX_{it} + \mu_7 lnGRANT_{it} + \mu_8 lnSOCA_{it} + \mu_9 CAPEX\%_{it} + \mu_{10} GRANT\%_{it} + \mu_{11} SOCA_{it} + \mu_{12} MYS_{it} + \varepsilon \quad (1)$$

Model 2:

$$CORSUS_{it} = \partial_0 + \partial_1 DISCLM_{it} + \partial_2 AGE_{it} + \partial_3 GNDR_{it} + \partial_4 JAVA_{it} + \partial_5 lnLOCREV_{it} + \partial_6 lnCAPEX_{it} + \partial_7 lnGRANT_{it} + \partial_8 lnSOCA_{it} + \partial_9 CAPEX\%_{it} + \partial_{10} GRANT\%_{it} + \partial_{11} SOCA_{it} + \partial_{12} MYS_{it} + \varepsilon \quad (2)$$

where,

$CORSUS_{it}$ = a dummy variable set to 1 if the mayor of local government *i* at year *t* is eventually a corruption suspect.

$CLEAN_{it}$ = a dummy variable set to 1 if the financial report of local government *i* at year *t* receives a clean opinion.

$DISCLM_{it}$ = a dummy variable set to 1 if the financial report of local government *i* at year *t* receives a disclaimer of opinion.

AGE_{it} = the age of the mayor of local government *i* at year *t*.

$GNDR_{it}$ = a dummy variable set to 1 if the mayor of local government *i* at year *t* is a male and zero otherwise.

$JAVA_i$ = a dummy variable set to 1 if local government *i* is in Java Island and zero otherwise.

$lnLOCREV_{it}$ = the natural logarithm of local revenues of local government *i* at year *t*.

$lnCAPEX_{it}$ = the natural logarithm of the capital expenditure of local government *i* at year *t*.

$lnGRANT_{it}$ = the natural logarithm of the grant expenditure of local government *i* at year *t*.

$lnSOCA_{it}$ = the natural logarithm of the social assistance expenditure of local government *i* at year *t*.[2]

[2] Social assistance expenditure is designed to help individuals, families, or groups in a society prone to social risks to increase their welfare.

$CAPEX\%_{it}$ = the capital expenditure divided by the total expenditure of local government *i* at year *t*.

$GRANT\%_{it}$ = the grant expenditure divided by the total expenditure of local government *i* at year *t*.

$SOCA\%_{it}$ = the social assistance expenditure divided by the total expenditure of local government *i* at year *t*.

MYS_{it} = the mean years of schooling of the citizens in local government *i* at year *t*.

e = error term.

The parameters of interest in the models are μ_1 and ∂_1. If unqualified opinions (*CLEAN*) reduce the likelihood of mayors becoming corruption suspects, then it is expected that $\mu_1 < 0$. If a disclaimer of opinion (*DISCLM*) on financial reports increases the likelihood of mayors becoming corruption suspects, then it is expected that $\partial_1 > 0$. The models control for capital expenditures (*CAPEX*) as they are major sources of corruption (Csáki & Gelléri, 2005; Sikka & Lehman, 2015). Bastida, Guillamón, and Ríos (2022) find that total and capital expenditures of local governments are higher when corruption exists. Similarly, Pierskalla and Sacks (2018) find that increased capital expenditure may be accompanied by increased corruption. Our models control for the social assistance expenditures (*SOCA*) as such expenditures are considered one source of corruption in the country.[3] The country's Oversight Committee for Regional Autonomy was concerned that incumbents may capitalize on social assistance expenditure to gain support from voters (Anonymous, 2018).

[3] The Minister of Social Affairs, Juliari Batubara, was sentenced 12 years prison sentence in 2021 for corruption on social assistance.

The models also control for the geographic location (*JAVA*) as local governments on Java Island are closer to the capital city, Jakarta, where the KPK's headquarters is located, making corruption in these regions more easily detected and prosecuted by the Commission. We also control for local revenues (*LOCREV*) as citizens have greater incentives to monitor local government affairs when a greater amount of local government revenues is generated locally instead of transferred from the central government. We also control for the capital (*CAPEX%*), grant (*GRANT%*), and social assistance (*SOCA%*) expenditures as proportions to the total expenditures. Finally, our model controls for mean years of schooling (*MYS*) as greater educational achievement reduces corruption (Goel & Nelson, 2011). However, interestingly, Aidt, Hillman, and Qijun (2020) find that officials with more education take more bribes.

4.1. Data

The sample of this study is around 500 unique local governments in Indonesia from 2007 to 2019, with a total observation of 5,917 local government-years. We observed 160 mayors who became corruption suspects during the period. The sample period of this study begins in 2007, when local governments started reporting the grants and social assistance expenditures. In many cases, some corrupt mayors did not become corruption suspects until several years after completing their terms. The year 2019 was selected to ensure that the law enforcement offices have revealed all or at least most corruption suspects during the study period. Data on the types of audit opinions and financial information are obtained from the financial reports, while the mean years of schooling data are released annually by the Indonesian Bureau of Statistics. Data on corruption charges involving mayors were collected from various sources on the website.

5. Results and Discussions

Table 1 presents the descriptive statistics of the sample. The Table shows that 9.9 percent of the 5,917 observations are associated with mayors becoming corruption suspects. Further, 39.9 percent of financial reports received an unqualified opinion, whereas the rest received either a qualified (47.6%), an adverse (2.8%), or a disclaimer of opinion (10.7%).

Insert Table 1 here

We further examine the characteristics of local governments whose mayors became corruption suspects and compare them to those of non-suspect. Table 2 shows that financial reports prepared by mayors who eventually became corruption suspects have lower quality. The proportion of financial reports of corruption suspects obtaining unqualified opinions (25.25 percent) is lower than e that of non-suspects (41.54 percent). On the contrary, the proportion of reports of corruption suspects obtaining disclaimers of opinion (17.82 percent) was slightly higher than that of non-suspects (9.87 percent).

Mayors who became corruption suspects served in relatively larger local governments with greater amounts of total revenues, total assets, capital expenditures, and social assistance expenditures. This can be interpreted in two ways. Firstly, larger local governments have more financial resources, incentivizing mayors to commit to corrupt activities. Corruption provides greater "rewards" in larger local governments than in smaller ones. Secondly, corruption is rampant and occurs in local governments of all sizes. However, law enforcement officers (i.e., the attorney offices, police departments, and the Corruption Eradication Commission), due to their limited

resources, are more likely to prosecute corruption involving greater public funds and tend to ignore smaller-scale corruption.

Further, the Table shows that local governments whose mayors became corruption suspects have a higher proportion of local revenues (i.e., wealthier) and social assistance expenditures. Lastly, corruption suspects are relatively younger when they serve as mayors. As corruption is considered risky, this result is consistent with the upper-echelon theory, suggesting that younger mayors are more willing to take risks than older ones.

Insert Table 2 here

We conducted the Hausman test, suggesting that the fixed effect model is more appropriate for Model 1 and the random effect model is more suitable for Model 2. Table 3 presents the results of the regression analyses. Model 1 tests whether having a clean opinion on financial reports during a mayor's tenure is associated with a lower probability of becoming a corruption suspect. The result shows that clean audit opinions on financial reports (*CLEAN*) are not associated with the level of corruption (z= -1.39). More specifically, mayors whose financial reports received clean opinions during their tenure are not less likely to become corruption suspects. This finding aligns with the public suspicion that some local governments managed to “buy clean audit opinions" (Tempo.co, 2024). Further, mayors can pressure auditors to issue better audit opinions on financial reports, distorting auditors' judgment. These make some unqualified audit opinions on financial reports meaningless and create noise in our measure of clean audit opinion (*CLEAN*).

In Model 2, we find that mayors who received disclaimers of opinions (*DISCL*) on their reports during their tenure are more likely to become corruption suspects (z= 3.36).[4] A disclaimer of opinion represents a reporting environment with poor transparency and accountability where auditors are denied access to audit evidence or cannot complete audit procedures necessary to form an opinion. Our finding is consistent with the view that transparency is an effective means in reducing corruption (Hansen, Christensen, & Flyverbom, 2015) and that a poor financing reporting environment characterized by weaker transparency and accountability creates a breeding ground for corruption.

Insert Table 3 here

Our control variables suggest that younger mayors (*AGE*) are likelier to commit corruption (z= -4.06; -4.99). Corrupt practices are associated with risks, and younger managers are more willing to take risks than older ones (Hambrick & Mason, 1984). Further, mayors of local governments in Java Island (*JAVA*) are more likely to become corruption suspects (z= 6.92). As the headquarters of the KPK is located in Java, even though corruption is widespread in the country, corruption in Java is more likely to be detected, and the anti-corruption agency will arrest the suspects. Concerning capital expenditure, consistent with existing studies, mayors are more likely to commit corruption (z= 2.22; 1.68) when local governments allocate a higher proportion of capital expenditure (*CAPEX*). Male mayors (*GNDR*) are less likely to become corruption suspects (z=-

[4] We conducted an additional analysis where we set the variable *DISCL* to 1 when the financial report received either a disclaimer of opinion or an adverse opinion (not tabulated). This is because financial reports receiving an adverse opinion are also considered of poor quality. The result remains significant (z=2.99).

2.18; 1.34). Finally, corruption is less likely when the citizens of the local government are more highly educated (*MYS*) (z=-1.99; 0.70).

6. Conclusions

This study investigates the association between the cleanliness of audit opinion and corruption. Our study finds that poor financial reporting quality is associated with a higher probability of corruption among local governments. When local governments have poor transparency and accountability, as reflected in the disclaimer of opinions on the financial reports, their mayors are more likely to become corruption suspects. However, receiving clean opinions on financial reports is not necessarily associated with a reduced probability of mayors becoming corruption suspects. Our findings suggest that poor financial reporting practices create an environment where mayors are more likely to commit corruption.

Our study contributes to the literature on corruption by providing evidence that poor financial reporting quality is associated with an increased probability of corruption. This study offers insight to policymakers that preventing corruption can be accomplished by improving financial reporting quality (i.e., avoiding a disclaimer of audit opinion) among local governments and strengthening auditing as one pillar to combat corruption.

This study uses corruption suspects and not corruption convicts as the proxy for the presence of corrupt activities. It usually takes months or even years before a corruption suspect receives a final verdict, especially due to the long appeal processes to the higher judicial institutions. Some corruption suspects might not be eventually convicted in court, which becomes a limitation of this study. However, according to the statistics, the number of corruption suspects

who did not serve prison sentences is extremely low. Therefore, we believe our proxy for the presence of corrupt activities is still accurate.

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Table 1. Descriptive Statistics

Variables	N	Mean	Min	0.25	Med	0.75	Max	Std Dev
CORSUS	5,917	0.099	0	0	0	0	1	0.299
CLEAN	5,917	0.399	0	0	0	1	1	0.490
DISCL	5,917	0.107	0	0	0	0	1	0.309
AGE	5,917	52.870	27	48	53	58	76	8.044
GNDR	5,917	0.950	0	1	1	1	1	0.217
JAVA	5,917	0.237	0	0	0	0	1	0.425
LOCREV (Billion Rp)	5,917	128.24	.39	20.96	50.40	119.63	5,381.92	294.840
CAPEX (Billion Rp)	5,917	252.59	8.85	131.61	196.96	297.97	4,750.21	218.92
GRANT (Billion Rp)	5,917	30.63	0	6.93	17.94	40.32	956.91	41.616
SOCA (Billion Rp)	5,917	14.31	0	1.99	6.20	16.02	601.34	26.666
CAPEX%	5,917	0.252	0.038	0.186	0.238	0.305	0.775	0.094
GRANT%	5,917	0.027	0	0.010	0.021	0.038	0.222	0.024
SOCA%	5,917	0.016	0	0.002	0.008	0.021	0.382	0.024
MYS	5,917	7.712	0.255	6.751	7.550	8.630	11.361	1.612

Table 2. Mean Differences of Variables: Suspects vs Non-Suspects Mayors.

Variables	Corruption Suspects			Non-Suspects			*t*-test		
	N	Mean	Std Dev	N	Mean	Std Dev	Mean Diff.	*t*-stat	
CLEAN (%)	606	25.25	43.48	5,311	41.54	49.28	-16.29	-7.797	***
DISCLM (%)	606	17.82	38.30	5,311	9.87	34.30	7.96	6.024	***
CAPEX (billion Rp)	606	290.22	316.41	5,311	248.29	204.47	41.93	4.474	***
SOCA (billion Rp)	606	21.01	37.02	5,311	13.54	25.11	7.47	6.557	***
REV (billion Rp)	606	1,257.73	772.14	5,311	1088.80	772.14	168.93	4.877	***
ASSET (billion Rp)	606	3,317.21	4558.25	5,311	2,463.97	2,994.01	853.24	6.236	***
LOCREV (%)	606	10.04	9.03	5,311	8.76	8.18	1.28	3.601	***
SOCA (%)	606	2.14	2.93	5,311	1.56	2.28	0.59	5.821	***
AGE (years)	606	50.44	8.50	5,311	53.18	7.94	2.71	7.884	***
MYS (years)	606	7.84	1.53	5,311	7.70	1.62	0.15	2.132	**

Notes: *, **, and *** indicate significance at 10%, 5%, and 1% levels.

Table 3. Results of Regression Analyses

Variables	Predicted Sign	Model 1			Model 2		
		Coeff.	z-stat		Coeff.	z-stat	
Constant	?				2.061	0.83	
CLEAN	-	-0.275	-1.39		-	-	
DISCL	+				0.767	3.36	***
AGE	-	-0.039	-4.06	***	-0.047	-4.99	***
GNDR	-	-0.794	-2.18	**	-0.462	-1.34	
JAVA	+	omitted			3.408	6.92	***
lnLOCREV	-	-0.535	-2.57	***	-0.642	-3.48	***
lnCAPEX	+	-0.116	-0.30		0.007	0.02	
lnGRANT	+	-0.042	-1.00		-0.029	-0.73	
lnSOCA	+	-0.046	-1.28		-0.981	-0.76	
CAPEX%	+	4.797	2.22	**	3.099	1.68	*
GRANT%	+	-0.442	-0.11		-1.661	-0.42	
SOCA%	+	12.746	3.47	***	15.003	3.96	***
MYS	-	-0.355	-1.99	*	0.073	0.70	
N		5,917			5,917		
Wald chi2(12)		195.65			174.23		
Prob > chi2		0.0000			0.0000		

Notes: *, **, and *** indicate significance at 10%, 5%, and 1% levels.