“The relationship between organizational characteristics and the quality of local government financial statements”

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THE RELATIONSHIP BETWEEN ORGANIZATIONAL CHARACTERISTICS AND THE QUALITY OF LOCAL GOVERNMENT FINANCIAL STATEMENTS

Abstract

This study investigates the relationship between organizational characteristics and the quality of financial statements in Malaysian local government. Organizational characteristics, including status, size, financial stability, tax revenue collection efficiency, and level of competence, were examined to discern their impact on mandatory information disclosure in local government financial statements. Data were collected from 71 local governments in Peninsular Malaysia, representing nearly 74% of the total population, using a combination of secondary data from audited financial reports and official documents, as well as structured questionnaires. The results indicate that tax revenue collection efficiency and the level of competence had a significant positive relationship with financial statement quality. Conversely, organizational characteristics related to status, size, and financial stability did not significantly impact financial statement quality. This implies the greater significance of human resources, precisely tax revenue collection efficiency and account officers' competence, in shaping local government financial statement quality in Malaysia. These findings support the stewardship theory, confirming the connection between specific organizational characteristics and financial statement quality. However, limitations include relying solely on secondary data and facing certain data collection constraints. Future research can enhance these findings by exploring additional factors through in-depth qualitative or case studies.

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Keywords organizational characteristics, financial statement quality, local government, tax revenue collection efficiency, competence, stewardship theory

JEL Classification H11, H83, M41

INTRODUCTION

The reform initiatives undertaken by the Malaysian government have highlighted the importance of enhancing governance and strengthening the delivery of public services. These reforms have placed local authorities at the forefront of ensuring efficient and transparent service delivery. However, the operational challenges local authorities face, stemming from financial and capacity constraints, can hinder their ability to meet public expectations. It is crucial to empower local governments to overcome these challenges and achieve effective development outcomes.

In the context of these reforms, it is crucial to investigate the relationship between the quality of financial statements in Malaysian local government and various organizational characteristics, including status, size, financial stability, tax revenue collection efficiency, and level of competence. Understanding this relationship is paramount in the broader context of strengthening governance and improving service delivery. High-quality financial reporting is essential to meet legal requirements, particularly information disclosure requirements.

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The legal provisions, including Article 99 of the Federal Constitution (1957), Section 16 of the Financial Procedure Act (Malaysian Legislation, 1957), and section 54(2) of the Local Government Act (Malaysian Legislation, 1976), emphasize the importance of financial statements in the public sector. In light of these legal expectations, the study is framed by a fundamental scientific problem: How do specific organizational characteristics impact the quality of financial statements in Malaysian local government, and what implications does this hold for governance and service delivery?

1. LITERATURE REVIEW

Various theories have been proposed to explain the relationship between independent variables and the level of information disclosure. However, the suitability of a theory for explaining phenomena related to information disclosure levels depends on the perspective and operational environment of the organization under study (Tilling, 2004; Gray et al., 1995). Given that the subject of this study is a public sector organization with a primary focus on service efficiency, the paper chooses stewardship theory as the fundamental framework for elucidating the relationship between the organization's nature and the quality of information disclosure, as suggested by Jones and Pendlebury (2004) and Ryan et al. (2002).

Klein et al. (2005) and Slyke (2005) contend that compliance with information disclosure requirements is influenced by management's attitudes and incentives, which are a consequence of their actions. To explain this behavior concerning the quality of financial statements, two theories are presented: the psychological-sociological approach, which advocates stewardship theory, and the market-oriented approach, which employs agency theory to justify the relationship between organizational characteristics and information disclosure quality.

Stewardship theory (Donaldson & Davis, 1991) posits that management acts as trustees, with the board of directors representing the interests of the principal owner. In this model, managers are expected to adhere to stewardship principles, where individuals are assumed to be pro-organizational (organization-cantered), prioritize collective interests over individual ones, and value collaboration over individualism (Davis et al., 1997; Armstrong, 1997; Klein et al., 2005). Consequently, stewardship theory assumes that the trustee's behavior aligns with the organization's goals and the principal's interests, with no inherent conflict of interest between the two parties (Davis et al., 1997). Their primary objective is organizational performance, which maximizes performance when all parties involved operate within the framework of a principal-trustee relationship.

Within this context, based on stewardship theory, the nature of the organization, which includes the sector it operates in and its primary goals, is expected to correlate with organizational outcomes. Public sector organizations, in particular, aim to enhance efficiency and cost-effectiveness in delivering services to stakeholders (Armstrong, 1997; Frey, 2003; Klein et al., 2005; Frey & Benz, 2005).

Stewardship theory posits that both parties responsible for the organization mutually support one another (Donaldson & Davis, 1991; Armstrong, 1997). Consequently, the primary goal for both parties (trustee and principal) is the improvement of organizational achievements over individual ones. Thus, all involved parties strive to attain the organization's goals and subsequently enhance the organization's image and perception. In this context, the trustee refers to the management, composed of the President and all related staff, while the principal denotes the interest owner, represented by Council Members. Based on stewardship theory, organizational characteristics, including status, size, financial stability, tax revenue collection efficiency, and competence, are expected to influence the quality of financial statements in local government contexts.

Status denotes the official recognition granted to a local government entity by authorities, typically the District Council or the Municipal/City Council. The awarding of status is contingent on criteria such as total revenue and total population. However, final authority rests with state and federal governments, which issue status certifications through the National Council for Local

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Government. Consequently, even local governments failing to meet revenue or population requirements may still receive a higher status. Status carries significance in terms of administrative structure, autonomous power, development opportunities, and local government prestige.

Stewardship theory posits that individuals act as trustees, not agents. Trustees are expected to act following instructions, exhibit pro-organizational behavior, prioritize collective action over individual interests, and value cooperation over reluctance (Donaldson & Davis, 1991; Armstrong, 1997). Therefore, all organization members are anticipated to collaborate extensively to achieve goals and maintain the organization's image. Under these assumptions, organizations with higher status levels are expected to promote increased cooperation among all members and exhibit greater compliance with mandatory requirements to safeguard and bolster their image and prestige (Armstrong, 1997).

Prior research findings regarding the relationship between status and financial statement quality are inconclusive. Robbins and Austin (1986) and Giroux and McLelland (2003) suggest a positive correlation between local government status and the quality of financial statements, while Syed Soffian et al. (2002) and Ryan et al. (2002) indicate that status lacks a significant relationship with financial statement quality. Despite the disparate findings in previous studies, this study anticipates a positive relationship between status and financial statement quality, drawing upon stewardship theory.

The size of a local government pertains to its total assets or total revenue. Various metrics are used to measure size, including total revenue or total assets (Barton, 1999; Syed Soffian et al., 2002; Ryan et al., 2002; Khasharmeh & Aljifri, 2010; Keerasuntonpong et al., 2015; Firmansyah et al., 2022). The use of total assets as a measure of size is more prevalent for public sector organizations and corporate firms, aligning with the stewardship theory's assumption that all available resources are maximized to achieve organizational goals. Consequently, larger local governments possessing more resources are expected to produce higher-quality financial statements than smaller counterparts.

Ryan et al. (2002) and Syed Soffian et al. (2002) support the positive relationship between the size of an organization and its ability to allocate resources effectively, leading to higher-quality financial reports. This view is echoed by Laswad et al. (2005), Tilling (2004), Giroux and McLelland (2003), Mack et al. (2001), Taylor and Rosair (2000), and Firmansyah et al. (2022). However, Evans and Patton (1987) suggest a negative relationship between size and financial statement quality, while Evans and Patton (1983), Robbins and Austin (1986), Dixon et al. (1991), and Coy et al. (1993) find no significant correlation. Given the alignment of this study's measurement method (total assets) with previous research employing the same metric and in consonance with stewardship theory, a positive relationship between size and financial statement quality is anticipated.

Financial stability refers to the proportion of internal revenue to total revenue within a local government, as explained by Giroux and McLelland (2003), Christiaens (1999), and Robbins and Austin (1986). For local governments, internal revenue encompasses funds obtained through legal provisions or services offered to the community. Consequently, internal revenue consists of revenue generated under the provisions of section 39 (a), (b), and (c) of the 1976 Local Government Act (Malaysian Legislation, 1976), encompassing tax revenue and non-tax revenue, as specified in the Treasury Circular (No. 8/86) (Treasury of Malaysia, 1986). External revenue sources, including grants or assistance provided by state or federal governments, such as rate assistance contributions and balance grants, as well as donations or gifts from external entities, fall under the category of external revenue sources as outlined in the provisions of section 39 (d) of the 1976 Local Government Act (Malaysian Legislation, 1976).

Financial stability holds significance in distinguishing the level of autonomy of a local government. Insufficient financial resources can impede a local government's ability to deliver services and fulfill its functions (MAMPU, 2001; UN-Habitat, 2015). Jafri (2001) notes that nearly 60% of a local government's annual revenue is allocated for operational expenses. Azmi (2002) asserts that financial stability affects a local government's capacity to execute its functions and roles, ultimately influencing its autonomy level. Weaknesses in a financial position contribute to subpar financial statement quality (Nailah, 2001).

Financial stability is typically measured by assessing own revenue per capita, which gauges the ratio between total internal revenue and total revenue (per capita income) (Giroux & McLelland, 2003; Christiaens, 1999; Robbins & Austin, 1986). Previous studies, such as those by Christiaens (1999) and Giroux and McLelland (2003), establish a positive relationship between financial stability and financial statement quality. However, Robbins and Austin (1986) find no significant correlation between financial stability and the quality of financial statements. Given the varied results from prior research regarding the relationship between financial stability and financial statement quality, this study anticipates a positive relationship based on stewardship theory, which posits that the ability to possess resources aligns with compliance.

Tax revenue pertains to income generated by the law (Engku Ali et al., 2006). In the context of local government, it constitutes one of the primary sources of internal revenue and significantly contributes to a local government's financial resources. Therefore, the efficiency of tax revenue collection by a local government has repercussions on its financial position and subsequent financial performance. Better organizational performance leads to higher-quality disclosure statements as organizations seek to demonstrate improved accountability. This aligns with stewardship theory's assumption that all organizational parties strive to pool available resources and capabilities to achieve organizational goals (Armstrong, 1997).

Research findings concerning the relationship between organizational performance and the quality of financial statements are varied and inconsistent. Tayib (1998) suggests a positive correlation between information disclosure levels and the efficiency of tax revenue collection for local governments in Malaysia. Alesani et al. (2007) also propose a positive relationship between financial performance and information disclosure levels. Akhtaruddin (2005), in a study on firms in Bangladesh, concurs, finding a positive relationship between organizational performance and financial statement quality. Conversely, Singhvi and Desai (1971), Cooke (1989), and Rahman (1998) find no influence of organizational performance on the quality of financial reports published by corporate firms.

Despite the divergent findings from prior studies regarding the relationship between organizational performance and the quality of financial statements, this study anticipates a positive relationship between organizational performance measured by the efficiency of tax revenue collection and the quality of financial statements. This expectation draws from the assumptions of stewardship theory and aligns with past research findings.

Competence pertains to the level of proficiency a local government demonstrates in preparing financial statements as mandated by laws and regulations. This proficiency is measured by the academic qualifications held by the officer responsible for financial statement preparation, specifically whether they possess qualifications in accounting or equivalent fields. As Ahmed and Nicholls (1994) expound, preparers with qualifications in accounting or related fields, such as business and financial management, are more competent in preparing financial statements in accordance with legal or accounting standards. Such individuals have undergone professional training and successfully met the requirements, rendering them more capable than their non-qualified counterparts.

The Treasury Circular (No. 15/94) (Treasury of Malaysia, 1994) designates the financial officer or accountant as the individual responsible for preparing financial statements for a local government before presentation in the local government council meeting. Their role is pivotal in determining decisions related to information disclosure in financial statements. Thus, the role of this supervising accountant is underscored by the necessity for them to issue a letter acknowledging their responsibility as prescribed by the Treasury Circular (No. 15/94) (Treasury of Malaysia, 1994).

Prior studies examining the relationship between competence and the quality of financial statements yield diverse and inconsistent results. Research investigating the impact of staff competency on financial reporting quality in-

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dicates significant positive effects (Iskandar & Setiyawati, 2015; Afiah & Rahmatika, 2014). However, Kasim (2015) suggests that staff competency lacks a significant effect on financial reporting quality.

Drawing from stewardship theory, which assumes a positive orientation and emphasizes cooperation in achieving organizational objectives, and in alignment with the findings of previous research such as Ahmed and Nicholls (1994), which demonstrate a positive relationship between the competence of individuals responsible for financial statement preparation and financial statement quality, this study anticipates a positive relationship between competence, measured by the qualifications of supervisors responsible for financial statement preparation in local governments, and financial statement quality.

The objective of this study is to test whether organizational characteristics consisting of status, size, financial stability, tax revenue collection efficiency, and the level of competence of an entity have a relationship with the quality of mandatory information disclosure of local government financial statements in Malaysia.

Based on the literature review, the following hypotheses are formulated:

H1: The status of local government has a positive relationship with the level of financial statement quality.

H2: The size of local government has a positive relationship with the level of financial statement quality.

H3: The financial stability of a local government has a positive relationship with the level of financial statement quality.

H4: The level of tax revenue collection efficiency of a local government has a positive relationship with the level of financial statement quality.

H5: The level of competence of the local government's account officer has a positive relationship with the level of financial statement quality.

2. METHOD

This study focuses on local governments within Peninsular Malaysia that are under state government jurisdiction. The final sample for this study consists of 71 local governments, representing approximately 73.96% of the total population. Data collection involves a combination of secondary data methods, which include audited financial reports and official documents, and survey methods utilizing structured questionnaires. Information regarding the level of mandatory information disclosure by the study sample was primarily sourced through secondary data methods. Simultaneously, information on organizational characteristics was gathered through secondary data and structured questionnaires.

Table 1. Variables and measurement

Variables	Definition/measurement	Source
The quality of mandatory information disclosure of financial statements	Financial statements prepared based on the requirements of legislation and regulations as well as accounting standards related to aspects of mandatory information disclosure and measured using an unweighted disclosure index	Hooks et al. (2000), Coy and Dixon (2004), Tayib and Coombs (1997), Ahmed and Nicholls (1994)
Status	"1" for MC/ CC and "0" for DC (Dummy variable)	Laswad et al. (2001), Laswad et al. (2005), Giroux and McLelland (2003)
Size	Total assets ($\log_{10}$ total assets)	Syed Soffian et al. (2002), Ryan et al. (2002), Firmansyah et al. (2022)
Financial Stability	Per Capita Internal Revenue (The ratio between total internal revenue compared to total overall revenue)	Robbins and Austin (1986), Christiaens (1999), Giroux and McLelland (2003)
Current tax revenue collection efficiency	The ratio between the current year's total tax revenue compared to the total tax revenue	Tayib and Coombs (1997)
Level of competence	"1" when having at least a diploma in accounting or similar, "0" otherwise (Dummy variable)	McDaniel et al. (2002), Ahmed and Nicholls (1994)

All relevant variables are measured using appropriate measurement techniques, which can be dichotomous, continuous, or ratio-based. The measurement techniques for these variables vary; some are self-constructed (for dependent variables), while others draw upon measures proposed and employed by previous researchers. A summary of the variables and their sources is provided in Table 1.

This study employs Pearson correlation analysis and the VIF test to assess the relationships between variables for data analysis. Furthermore, regression analysis is conducted on various variables to quantitatively support the formulated hypotheses and, consequently, to fulfill the study's objectives.

3. RESULTS AND DISCUSSION

Pearson's correlation analysis was employed to examine the relationships among the independent variables in this study. High correlations among independent variables could lead to multicollinearity issues, which, in turn, might impact the coefficients of the variables. The results of the Pearson's correlation analysis are presented in Table 2.

Table 2 indicates that all independent variables exhibit a significant relationship at the 1% level with the quality of financial statements. All five independent variables demonstrate the anticipated positive relationship with financial statement quality. Notably, the highest coefficient value of 0.72 is observed between the STATUS and SIZE variables, while the lowest coefficient value of 0.127 exists between the EFFICIENT and COMPETENT variables. Notably, the study does not encounter serious multicollinearity issues among the variables, as the coefficient values between the variables remain below 0.80, in line with the criteria set by Hair et al. (1998). This finding is further corroborated by the Variance Inflation Factor (VIF) analysis, where the relationships between independent variables are below the maximum acceptable value of 5 (Hair et al., 1998). Furthermore, the Pearson correlation analysis results indicate that the STATUS variable has a positive and significant relationship with the SIZE, STABLE, and COMPETENT variables but demonstrates an insignificant relationship with the EFFICIENT variable.

Subsequently, a multivariate regression analysis was conducted to assess the relationship between the dependent variable (QUALITY) and all independent variables (STATUS, SIZE, STABLE, EFFICIENT, and COMPETENT). The results of the hypotheses testing using multivariate regression analysis and a model summary concerning financial statement quality and its association with organizational characteristics are presented in Table 3.

Table 3 presents the results of the multivariate regression analysis conducted in this study. This model exhibits a statistically significant F value of 8.974 at the p = 0.000 level. The unadjusted R2 and

Table 2. Pearson correlation analysis between independent and dependent variables

Variable	QUALITY	STATUS	SIZE	STABLE	EFFICIENT	COMPETENT
QUALITY significant	1	.494**	.491**	.331**	.367**	.527**
		.000	.000	.005	.002	.000
STATUS significant	–	1	.722**	.570**	.148	.685**
			.000	.000	.218	.000
SIZE significant	–	–	1	.593**	.177	.541**
				.000	.139	.000
STABLE significant	–	–	–	1	.175	.314**
					.143	.008
EFFICIENT significant	–	–	–	–	1	.127
						.290
COMPETENT significant	–	–	–	–	–	1

Note: ** significant at 0.01 level.

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Table 3. Multivariate regression analysis

Variable	Expected Relationship	B	t-Statistic	P-Value
constant	?	57.697	4.901	0.000
STATUS	+	0.821	0.447	0.656
SIZE	+	0.583	0.332	0.741
STABLE	+	–0.008	–0.315	0.754
EFFICIENT	+	0.075	2.371	0.021**
COMPETENT	+	3.799	2.586	0.012***
Model Summary				
R2	0.457	–		
Adjusted R2	0.406	–		
F-Statistic	8.974	–		
Significance of F	0.000	–		
Sample Size	71	–		

Note: *** significant at 0.01 level; ** significant at 0.05 level.

adjusted R2 values are 45.70% and 40.60%, respectively, indicating that the model explains 45.70% of the variance in financial statement quality. All of the independent variables tested demonstrate the expected relationships, except for the STABLE variable. However, only two variables, EFFICIENT and COMPETENT, exhibit a significant relationship at the 1% and 5% levels with financial statement quality, as indicated by the P-value and t-statistic values. These results support hypotheses 4 and 5, which postulate a positive influence on financial statement quality. A positive relationship implies that an increase in the EFFICIENT unit will improve financial statement quality, and an increase in the COMPETENT unit is associated with a higher likelihood of achieving better financial statement quality.

In the context of the results, this study explored five vital components related to organizational characteristics, delving into attributes tied to organizational performance and structure. The insights gleaned offer a nuanced perspective on the interplay between these characteristics and the quality of mandatory information disclosure. As per the results, two aspects, namely tax revenue collection efficiency and competence, emerged as influential drivers of higher-quality financial statements. Conversely, the study unveiled that the attributes associated with organizational structure, including status, size, and financial stability, did not significantly impact financial statement quality.

The significance of tax revenue collection efficiency came to the fore, reinforcing the formulated hypothesis. This finding highlights that organizations demonstrating greater efficiency in tax revenue collection tend to produce superior financial statements. This alignment with the stewardship theory emphasizes that all organizational stakeholders channel their efforts and expertise toward achieving the collective objectives. These results are consistent with previous research, echoing the established link between organizational performance and the depth of information disclosure, as highlighted by Rahman (1998) and Tayib (1998).

One of the primary goals of any organization is to enhance its performance, which extends to tax revenue collection – the primary contributor to its overall income. Consequently, heightened efficiency in tax revenue collection translates to heightened financial accountability within the organization. According to Treasury Instruction (AP 10) and Section 15A of the Financial Procedure Act 1957, accounting officers are responsible for ensuring the complete collection of all revenue sources. In pursuit of heightened accountability, organizations are inclined to provide more detailed disclosures, particularly regarding mandatory information, to underscore their commitment to stakeholders.

The study's findings validated the hypothesis that competence significantly influences financial statement quality. Organizations boasting competent financial officers are more likely to produce high-quality financial statements. These findings align with Ahmed and Nicholls (1994), and Ahmed (1996).

Nevertheless, contrary to the formulated hypothesis, the study's results challenged the conventional notion that organizational status significantly impacts financial statement quality. This outcome resonates with the findings of Robbins and Austin (1986), Syed Soffian et al. (2002), and Ryan et al. (2002). However, it contrasts Laswad et al. (2005). The divergence might be attributed to the Malaysian context, where local governments can potentially secure "Municipal/City" status even if they fall short of stipulated minimum requirements, provided they secure approvals from state and federal governments. This flexibility in status assignment might have contributed to the hypothesis's rejection.

Intriguingly, the study's examination of size, measured by total assets, failed to support the hypothesis, indicating that size does not significantly influence financial statement quality among Malaysian local governments. These findings diverge from international studies by Ingram (1984), Christiaens (1999), Ryan et al. (2002), and Syed Soffian et al. (2001) but align with the results reported by Lasward et al. (2005), Patton and Zelenka (1997), and Ahmed and Nicholls (1994). The discrepancy may be rooted in the unique nature of Malaysian local government, where size (total assets) may not adequately reflect management efficiency. Instead, it is influenced by many factors, including location, available resources, and the impact of federal and state government initiatives. Furthermore, the concept of size ought to encompass human resources, an aspect unaccounted for in this study. Hence, the non-significant relationship between size and financial statement quality could be resolved by integrating the human resource factor into size measurement, in line with the insights of Christiaens (1999).

Lastly, the study uncovered that financial stability bore no significant relationship with the quality of local government financial statements in Malaysia. These findings defy the conventional wisdom, as they diverge from earlier studies by Laswad et al. (2005), Robbins and Austin (1986), and Ingram (1984) but align with those of Giroux and McLelland (2003). Unlike prior studies, the study's rejection of the hypothesis may arise from variations in the legal environment and managerial practices concerning top management appointments within Malaysian local governments.

In summary, this discussion illuminates the intricate interplay between organizational characteristics and the quality of financial statement disclosure among Malaysian local governments. While some attributes, such as tax revenue collection efficiency and competence, emerge as potent drivers of financial statement quality, others, like status, size, and financial stability, yield less influence in this context. These findings contribute valuable insights for policymakers and practitioners to enhance financial accountability and transparency within local government entities.

CONCLUSION

This study explored the relationship between organizational characteristics and the quality of mandatory information disclosure in local government financial statements in Malaysia. The findings revealed that two components of organizational characteristics, namely the efficiency of tax revenue collection and the level of competence, exhibited a positive and significant association with the quality of financial statements. Conversely, council status, size, and financial stability did not align with the initial hypotheses. These results highlight the relevance of the stewardship theory in explaining the connection between the studied independent and dependent variables. They also emphasize the pivotal role played by tax revenue collection efficiency and the competence of account officers in shaping financial statement quality. In contrast, factors linked to council status, size, and financial stability, which provide insights into local government financial structure, did not significantly impact financial statement quality. This emphasizes the importance of human resources over physical resources in influencing the quality of local government financial statements in Malaysia.

While this study contributes to the expanding literature, certain limitations should be acknowledged. The reliance on secondary data collection methods, utilizing audited financial statements and struc-

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tured questionnaires, encountered various constraints, including administrative, legal, attitudinal, and logistical issues. Additionally, measuring local government size based on total assets may benefit from further exploration, considering the common use of the total population as an alternative size indicator in prior local government studies. Future research endeavors may investigate additional factors, such as environmental influences, enforcement levels, and geographic variables within the study model. Furthermore, qualitative or case studies can provide in-depth insights to complement and fortify the findings presented in this study.

AUTHOR CONTRIBUTIONS

Conceptualization: Siti Zabedah Saidin, Engku Ismail Engku Ali.
Data curation: Siti Zabedah Saidin, Engku Ismail Engku Ali.
Formal analysis: Siti Zabedah Saidin, Engku Ismail Engku Ali.
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Writing – original draft: Siti Zabedah Saidin, Engku Ismail Engku Ali.
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