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The Impact of Financial Report Quality on Local Government Performance the Mediating Role of Accountability and The Effect of local government characteristics

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Abstract
This study investigates the relationship between financial report quality and local government financial performance, with accountability mediating this relationship. The findings indicate that high-quality financial reports improve financial performance both directly and indirectly through accountability. Accountability transmits the impact of financial report quality on financial performance. Governance characteristics, such as government size and legislative size, also influence financial performance. These results underscore the importance of transparency, accountability, and effective governance in local government financial management.
Keywords: *Quality, Performance, Accountability, Governance Characteristics, financial, management*

1. INTRODUCTION

The financial performance of public financial management (PFM) in local governments is increasingly subject to scrutiny as stakeholders demand enhanced transparency and accountability (Rivenbark et al., 2018). Effective PFM is essential for optimal resource allocation, efficient delivery of services, and the augmentation of public trust. Recent studies underscore the growing significance of transparency and accountability in the financial management of local governments. Empirical research indicates that both accountability and transparency exert positive effects on local government performance (Widajatun & Kristiastuti, 2020; Jeriansyah & Mappanyukki, 2020).

Financial performance is conventionally assessed through metrics such as budget balance, spending efficiency, and fiscal sustainability, which are vital for ensuring the effective utilization of public resources (OECD, 2021). High-quality, accurate, and timely financial reports enhance transparency, promote accountability, and improve decision-making processes (Dharma, 2022). While the relationship between financial quality and governance outcomes is well-documented, the direct influence of financial statement quality on local government financial performance remains insufficiently explored. Furthermore, the role of accountability as a potential mechanism linking financial statement quality to performance outcomes necessitates further empirical investigation.

Accountability mechanisms are crucial for ensuring that governments uphold financial transparency and adhere to ethical and efficient management practices, thereby significantly influencing financial performance (Lea & Irechukwu, 2024). Recent scholarship has highlighted the mediating role of accountability in the relationship between financial transparency and performance (Chen et al., 2016; Tran et al., 2021). The provision of transparent and accurate financial reports establishes a foundation for effective accountability. When local governments generate high-quality financial reports, they empower citizens, auditors, and other stakeholders to hold public officials accountable for fiscal decisions.

Environments that prioritize accountability can facilitate improved management of public resources and lead to better budgetary outcomes, including reduced waste, more targeted investments, and efficient public service delivery.

Nevertheless, the majority of existing research has concentrated on national governments or large metropolitan areas, thus giving limited attention to smaller local governments and the mediating role of accountability (Benito et al., 2021). This study aims to address this gap within the context of local government by examining the direct relationship between financial statement quality and economic performance (LGFP) at the regional level.

High-quality financial statements constitute a critical initial step toward enhancing economic performance; however, effective accountability is essential for the utilization of this financial information. This research hypothesis examines the relationship between accountability (ACC), the quality of financial statements (QLGFS), and the financial performance of local governments (LGFP). It posits that transparency alone may be inadequate in driving performance without sufficient institutional safeguards and sound governance practices (Xiao & Wang, 2023). In addition to exploring the interplay among quality, accounting, and economics in financial statements, this study identifies several governance characteristics that may function as control variables in the analysis: capital expenditure (CS), local government size (LGS), and legislative size (LS). Each of these factors can influence a regional government's financial performance by either directly affecting financial outcomes or shaping the quality of financial management and accountability mechanisms.

Empirical research indicates that local governments with elevated levels of capital expenditure are likely to attain improved fiscal outcomes by investing in long-term infrastructure projects that stimulate economic growth and generate future revenue streams (Bisogno et al., 2024). Nonetheless, the effective management of capital expenditure necessitates high-quality financial reporting to ensure appropriate funding and execution of projects, thereby underscoring the significance of the quality of financial statements. Larger local governments typically possess more complex financial structures and extensive resources (Iyidogan & Turan, 2017). While this complexity may facilitate the implementation of advanced financial management practices, it can also lead to inefficiencies if not correctly managed. Although larger jurisdictions are generally better positioned to produce high-quality financial statements, the increased complexity associated with budget management can complicate the attainment of strong fiscal performance (Wijayanti & Suryandari, 2020).

The size of the municipal government legislature can also significantly influence financial performance (Okenye Tom et al., 2024). Larger legislatures may experience challenges related to timely decision-making and adequate oversight of financial management. Research suggests that smaller legislatures tend to be more agile and efficient in overseeing financial decisions (Kang & Chen, 2021). By incorporating these variables as control factors, this study aims to provide a more comprehensive understanding of how the quality of financial statements influences economic performance, while also accounting for external factors that may shape performance outcomes at the local government level.

This study identifies a significant gap in the existing literature concerning the direct and mediating relationships among the quality of financial statements, accountability, and the economic activity of local governments. By incorporating governance characteristics such as capital expenditure, local government size, and legislative size, this research provides a comprehensive framework for understanding the determinants of financial activity within the public sector. The findings will offer valuable insights for policymakers and administrators, contributing to the enhancement of financial reporting practices and the improvement of local economic activities (Budiharjo et al., 2025). Furthermore, this study makes a substantial contribution to the expanding body of literature on public sector financial management, particularly in relation to accountability in the examination of financial activities. It also introduces new methodologies to influence the outcomes of interactions between financial transparency and governance mechanisms.

Decentralization has become a fundamental reform strategy globally, devolving authority and fiscal responsibilities to local governments. This shift has positioned local governments as pivotal actors in managing substantial public resources, providing essential services, and driving regional development.

Consequently, transparency and accountability in local government financial management have garnered significant attention from stakeholders.

Theoretical Background

Financial statement quality and accountability are critical components of effective financial management in local governments. Financial statement quality refers to the accuracy, completeness, relevance, reliability, and timeliness of financial reports. Accountability involves mechanisms that ensure reported information is scrutinized and acted upon, enhancing governance by incentivizing officials to manage public funds prudently. Governance characteristics, such as government size, legislative council size, and capital expenditures, also shape financial management outcomes.

Research Problem

Despite the importance of financial statement quality and accountability, empirical evidence remains limited and fragmented, particularly in smaller or mid-sized local governments. There is a lack of comprehensive analyses integrating financial reporting quality, accountability, and governance characteristics within a single framework at the local government level.

Research Question and Hypotheses

This study investigates the following research questions:

1. How does financial statement quality influence local government financial performance?
2. What role does accountability play as a mediating factor in this relationship?

The study tests several hypotheses:

1. Hypothesis 1 (H1): Higher quality financial statements positively influence local government financial performance.
2. Hypothesis 2 (H2): Accountability mediates the relationship between financial statement quality and financial performance.
3. Hypothesis 3 (H3): Governance characteristics significantly affect financial performance and interact with financial reporting and accountability.
4. Hypothesis 4 (H4): Accountability serves as a mediator enhancing the impact of financial reporting quality on financial performance.

Contribution

This study makes several contributions to the literature on public financial management. Firstly, it provides empirical evidence on the mediating role of accountability in the relationship between financial statement quality and local government financial performance, using a dataset from Indonesian local governments. This empirical novelty sheds light on the importance of accountability mechanisms in enhancing the impact of financial reporting quality on financial performance.

Secondly, this research contributes to the theoretical understanding of Agency Theory in the public sector context. By examining the interplay between financial statement quality, accountability, and financial performance, this study highlights the significance of transparency and accountability in mitigating agency problems and promoting efficient and effective financial management in local governments.

Thirdly, the study's findings have practical implications for policymakers and public administrators seeking to improve financial reporting standards and strengthen accountability frameworks in local governments. By identifying the critical role of accountability in enhancing financial performance, this research provides evidence-based guidance for reforms aimed at promoting transparency, accountability, and good governance in local government finance.

Overall, this study advances our understanding of the complex relationships between financial statement quality, accountability, and financial performance in local governments, and provides valuable insights for theory and practice.

2. LITERATURE REVIEW

2.1 Agent Theory

A valuable theoretical framework for understanding principal-agent relationships in public sector financial management is agency theory (Jensen and Meckling, 1976). This framework posits that citizens (principals) delegate fiscal authority to government representatives (agents), who may act in their own interests, potentially undermining the principals' objectives. High-quality financial statements are crucial as they provide clear and reliable reporting on fiscal activities, thereby mitigating information asymmetries. Accountability mechanisms, such as independent audits and public oversight, are strengthened by this transparency, enabling agents to be held accountable for their decisions (Bovens, 2007; Jena et al., 2022). Consequently, accountability serves as a vital link between transparency and improved financial performance in government, promoting efficient resource utilization and reducing the risk of poor budget management.

Despite the theoretical significance of this relationship, empirical research on the mediating role of accountability is limited, particularly in local governments within developing countries. Most existing literature focuses on larger cities or national governments, often overlooking smaller, evolving contexts where governance and institutional challenges are more pronounced (J. Tran et al. and Kim & Lee, 2023, 2021). Recent studies highlight how relational and contractual management can enhance agent performance in public projects by incentivizing agents to meet principal expectations (Chen et al., 2024). Furthermore, multi-agent management models that utilize technology and public engagement can further reduce information asymmetry, leading to improved group outcomes (He & Zhang, 2022). Additionally, perspectives presented by Yolles (2018) emphasize that without robust governance frameworks that establish accountability, agents may prioritize their personal interests. This study aims to address significant gaps in the literature by specifically investigating the direct and mediated effects of financial statement quality on the financial performance of local governments through the lens of accountability, while also considering management controls such as government size and capital expenditures. It enriches the theoretical understanding of principal-agent dynamics in the public sector by employing regression analysis on data from 113 Indonesian local governments. Furthermore, it provides practical insights for policymakers seeking to enhance budgetary performance, accountability, and transparency at the local level.

2.2. Quality of Financial Statements and Local Government Performance

The quality of financial statements represents a critical component of public financial management (PFM), encapsulating the transparency, accuracy, and completeness of fiscal health disclosures by local governments. While the alignment of high-quality financial statements with International Public Sector Accounting Standards (IPSAS) is essential, such compliance is insufficient in isolation. Additional elements, including representation, understanding, comparability, timeliness, verification, and compliance, must also be integrated into the financial reporting framework. In the Indonesian context, the quality of financial reports is denoted by an unqualified opinion from the Supreme Audit Agency (Furqan et al., 2020; Arifin et al., 2022).

Government performance is broadly conceptualized as the effectiveness of governmental entities in achieving their objectives, managing resources, and delivering public services (Kim et al., 2019). This performance encompasses various dimensions, including efficiency, transparency, accountability, and the fulfillment of public expectations. It reflects the extent to which agencies manage resources efficiently and responsively to address public needs, thereby aligning with established governance principles.

Research has demonstrated that high-quality financial reports enhance accountability, improve fiscal decision-making, and facilitate more efficient allocation of public resources. Effective financial reporting practices furnish external stakeholders—such as citizens, legislators, and auditors—with a clear understanding of government finances, thereby fostering trust and supporting evidence-based policy decisions.

Empirical studies within the public sector consistently indicate that financial transparency engenders improved outcomes, particularly concerning fiscal stability and governance quality. For instance, financial transparency at the local government level is directly correlated with fiscal discipline and superior management of public resources. Moreover, the availability and quality of financial information empower local governments to respond more adeptly to budgetary crises, allocate resources more efficiently, and sustain a higher level of public trust. Research findings (Zamzami & Rakhman, 2023; Indra et al., 2024) affirm that the quality of financial information positively influences government activities.

H1: Quality of Government Funding statements affects government performance.

2.3. Financial Statement Quality and Accountability

Accountability supports principles such as transparency, rule of law, and responsiveness in governance, acting as a mechanism to ensure adherence to democratic values and responsibilities (Abubakar et al., 2022). Accountability is the obligation imposed on individuals to take responsibility for their actions, especially in the context of wrongdoing, emphasizing restitution and recognition of the harm caused. High-quality financial reports increase transparency by ensuring accuracy and consistency, strengthening organizational accountability mechanisms. According to (Coskun & Gungormus, 2024), effective accounting systems and high-quality audits increase financial confidence and clarity. The study shows that a strong financial reporting framework strengthens accountability, ensuring public resources are used effectively and aligned with Development objectives. The study's results prove that the quality of financial statements has a positive influence on public sector activity.

H2: The quality of financial statements has a positive impact government performance.

2.4. Government Accountability and Performance

The influence of accountability on government performance has been widely recognized in various areas of governance. Accountability ensures that government actors are held accountable for their actions, resulting in more transparent decision-making, efficient resource allocation, and better alignment with the needs of Society (Catherine Bokello et al., 2024). Accountability in financial reporting ensures the accurate allocation and use of public resources are properly accounted for. Recent studies emphasize the importance of accountability as a mechanism to increase transparency, reduce corruption, and improve efficiency in public administration, like the results of research by, which proves that accountability positively affects performance in the public sector.

H3: Accountability has a positive impact on government.

2.2. The Mediating Role of Accountability

Accountability is a fundamental concept in governance, defined as the obligation of public officials and institutions to report, explain, and justify their actions and decisions. Transparency, typically demonstrated through high-quality financial reporting, is widely regarded as a precursor to enhanced accountability. The level of transparency in governmental financial reporting significantly influences the ability to hold officials accountable for their financial choices. However, the relationship between accountability and financial performance remains insufficiently explored, particularly within local governments (Yasmin & Ghafran, 2019). Existing literature suggests that accountability can improve economic performance by promoting responsible fiscal management, reducing waste, and increasing responsiveness to public needs. For example, accountable governments are more likely to allocate resources efficiently and implement budget reforms that lead to better performance outcomes. Empirical research has shown that accountability mechanisms—such as independent audits, public engagement, and performance-based budgeting—are strongly associated with superior financial performance. In local governments, enhanced accountability can result in improved fiscal solvency, more efficient public service delivery, and reduced budget deficits (Nurfadila, 2024). However, while transparency is necessary for accountability, it does not guarantee better financial outcomes without a strong institutional framework to enforce accountability. This study posits that accountability mediates the relationship between the quality of financial information and governmental performance.

H4: Accountability mediates the effect of financial report quality on government performance.

2.3. Governance Characteristics and Control Impacts

In addition to the direct and indirect effects of financial statement quality and accountability, various governance characteristics—such as capital expenditure (CS), local government size (LGS), and legislative size (LS)—significantly influence local government financial performance. Local governments with higher levels of capital expenditure typically have a stronger capacity to invest in long-term infrastructure projects, contributing to both economic growth and fiscal sustainability (Singa et al., 2024). Research indicates that local governments allocating more resources to capital projects tend to achieve better fiscal outcomes, as these projects can generate long-term revenue streams or reduce costs over time. Furthermore, capital expenditure often reflects a government's ability to manage substantial financial initiatives and maintain fiscal health.

The size of a local government significantly influences its financial activities. Larger local governments often benefit from economies of scale, allowing them to allocate more resources to financial management systems, audits, and compliance mechanisms. These jurisdictions typically have access to more sophisticated financial management tools, which can enhance their economic performance. However, larger governments may also face increased complexity and bureaucratic challenges that hinder efficient fiscal management.

Additionally, the size of the municipal government legislature impacts performance outcomes. Research shows that larger legislatures can complicate decision-making processes, leading to slower policy implementation, higher administrative costs, and, in some cases, negative fiscal outcomes (Mendez & Bachtler, 2022). The size of the legislature also affects the quality of financial oversight, with smaller legislatures tending to provide more effective scrutiny. Therefore, the relationship between legislative size and economic performance can vary based on a local government's capacity to manage legislative activities effectively.

While numerous studies have explored these characteristics individually, there is a lack of research examining their combined effects on financial statement quality, accountability, and economic performance at the local government level. This study aims to fill this gap by integrating capital expenditure, government size, and legislative size as control variables, providing a comprehensive understanding of their impact on the quality of financial statements and economic activity.

Theoretical Framework

This study is grounded in Agency Theory, which posits that principal-agent relationships are characterized by information asymmetry and conflicting interests. In the context of local government finance, citizens (principals) delegate authority to public officials (agents) to manage public resources. However, agents may prioritize their own interests over those of the principals, leading to agency problems such as moral hazard and adverse selection.

Transparency and Accountability

Transparency in financial reporting is essential for mitigating agency problems. High-quality financial reports provide citizens and other stakeholders with accurate and timely information about local government financial activities. This enables them to monitor the actions of public officials and hold them accountable for their decisions. Accountability mechanisms, such as audits, legislative oversight, and public engagement, ensure that public officials are responsible for their actions and decisions.

Conceptual Model

The conceptual model guiding this study is presented below:

Financial Statement Quality → Accountability → Financial Performance

In this model, financial statement quality is hypothesized to influence financial performance through the mediating role of accountability. High-quality financial reports enhance transparency, which in turn promotes accountability and improves financial performance. Accountability mechanisms ensure that public officials are held responsible for their actions and decisions, leading to more efficient and effective financial management.

Hypotheses

Based on the conceptual model, the following hypotheses are proposed:

- Hypothesis 1: Higher quality financial statements positively influence local government financial performance.
- Hypothesis 2: Accountability mediates the relationship between financial statement quality and financial performance.

Empirical Evidence

Previous studies have examined the relationships between financial statement quality, accountability, and financial performance in various contexts. For example, research has shown that high-quality financial reporting is associated with improved financial performance in private sector organizations. Similarly, studies have found that accountability mechanisms are essential for promoting transparency and good governance in public sector organizations. However, the mediating role of accountability in the relationship between financial statement quality and financial performance remains underexplored. This study aims to contribute to the literature by examining the relationships between these variables in the context of local government finance.

3. METHODOLOGY

3.1. Research Design

Research Design This study employs a quantitative cross-sectional research design to examine the relationships among financial statement quality (QLGFS), accountability (ACC), and local government financial performance (LGFP). Path analysis is utilized to test both direct and mediating effects, while controlling for governance factors such as capital expenditure (CS), local government size (LGS), and legislative size (LS). This methodology enables the investigation of how financial transparency influences financial performance directly and indirectly through accountability, accounting also for the impact of governance characteristics.

The regression equations specified to test the hypotheses are:

1. $ACC = \beta_1 \times QLGFS + \varepsilon_1$
2. $LGFP = \beta_2 \times QLGFS + \beta_3 \times ACC + \beta_4 \times CS + \beta_5 \times LS + \beta_6 \times LGS + \varepsilon_2$

Model Specification

The path model is specified as follows:

Financial Performance = β0 + β1 Financial Statement Quality + β2 Accountability + β3 Government Size + β4 Legislative Size + β5 Capital Expenditure + ε

Accountability = β0 + β1 Financial Statement Quality + β2 Government Size + β3 Legislative Size + ε

The model controls for government size, legislative size, and capital expenditure, which are expected to influence financial performance and accountability.

3.2. Data Collection

The data used in this study are the results of the evaluation of the budget formation report of the Local Governments, the Audit Report of the Superior Court of Accounts, the Central Statistics Office and the System of Accountability of Government Entities of the Ministry of Administrative Reform and Bureaucracy. The sample consists of data from 113 local governments in Indonesia in the period 2015 to 2022. Thus, the total amount of data is 904. These local governments were selected based on the availability of complete and reliable financial data, ensuring a robust and consistent data set for analysis.

3.3. Variable

- Financial Statement Quality: Proxied by a binary audit opinion, where 1 represents an unqualified opinion and 0 represents a qualified or adverse opinion. This proxy is used because an unqualified audit opinion indicates that the financial statements are presented fairly and in accordance with the applicable financial reporting framework.
- Accountability: Measured by the SAKIP score, which evaluates the quality of local government accountability based on several dimensions, including financial management, budgeting, and reporting. The SAKIP score ranges from 0 to 100, with higher scores indicating better accountability. The SAKIP score has been widely used in Indonesia as a measure of local government accountability.
- Financial Performance: Measured by the local government's fiscal performance, including revenue growth, expenditure management, and budget realization.
- Government Size: Measured by the total number of employees in the local government.
- Legislative Size: Measured by the number of members in the local legislative council.
- Capital Expenditure: Measured by the total amount of capital expenditure in the local government's budget.

Estimation Techniques

The path analysis is estimated using maximum likelihood estimation with robust standard errors. The model fit is evaluated using several indices, including the chi-square test, RMSEA, and CFI. The estimation is performed using Mplus software.

Robustness Diagnostics

To ensure the validity of the findings, several robustness checks are performed, including:

- Sensitivity analysis: The model is re-estimated using different proxies for financial statement quality and accountability.
- Outlier analysis: The model is re-estimated after removing outliers and influential observations.

- Model modification indices: The model is modified based on the modification indices to improve model fit.
- Hausman test: The Hausman test is used to determine whether a fixed effects or random effects model is more appropriate.

4. RESULTS AND DISCUSSION

4.1 Descriptive Statistics

A descriptive statistical analysis was conducted to present the minimum, maximum, mean, median, and standard deviation values for each research variable. The results are summarized in Table 1 below:

Variable	Mean	Median	Maximum	Minimum	Std. Dev.
QLGFS	0.6748	1.0000	1.0000	0.0000	0.4687
ACC	65.3053	67.0000	93.0000	30.0000	11.4551
CS	26.6417	26.6144	29.8048	24.6741	0.6002
LS	45.7467	50.0000	59.0000	0.0000	6.6966
LGS	29.0134	28.9249	31.5793	25.0252	0.6404
LGFP	0.1988	0.1605	0.7384	0.0631	0.1081

Source: Data processing (2025)

The Quality of Local Government Financial Statements (QLGFS) averaged 0.6748, ranging from 0 to 1, with a standard deviation of 0.4687, indicating variability in financial reporting quality across local governments during the study period. Accountability (ACC) had a mean score of 65.31, with values spanning from 30 to 93 and a standard deviation of 11.46. Capital Spending (CS) averaged 26.64, with a narrow spread (SD=0.60). Legislative Size (LS) averaged 45.75, ranging from 0 to 59, with moderate variability (SD=6.70). Local Government Size (LGS) had a mean of 29.01 (SD=0.64). Financial performance (LGFP) showed an average return of 0.1988, with notable dispersion (SD=0.1081).

4.2 Hypothesis Testing and Interpretation

The regression analyses produced the following insights:

1. **Impact of Financial Statement Quality on Accountability**: The quality of local government financial statements (QLGFS) has a highly significant and positive effect on accountability (ACC), with a regression coefficient of 8.71 ($p < 0.001$). This means a one-unit increase in financial statement quality corresponds to an approximately 8.7-unit rise in accountability scores. This finding underscores the critical role of transparent and accurate financial reporting in strengthening institutional responsibility and oversight.
2. **Effect of Accountability on Financial Performance**: Accountability positively influences local government financial performance (LGFP), with a coefficient of 0.006 ($p < 0.001$). Enhanced accountability frameworks contribute to improved fiscal management, likely by reducing misuse of resources and fostering prudent decision-making.
3. **Mediation Role of Accountability**: Accountability partially mediates the relationship between financial statement quality and financial performance. The indirect effect, calculated as 0.00644 (product of coefficients 8.712429 and 0.00597), is statistically significant ($p < 0.05$), indicating that financial reporting quality improves fiscal outcomes not only directly but also through strengthening accountability mechanisms. This highlights that improving report quality alone is insufficient without effective accountability structures.
4. **Control Variables**:

- **Capital Spending (CS):** The effect is positive ($\beta = 0.00102$) but statistically insignificant ($p = 0.60$), suggesting that merely allocating capital expenditures does not guarantee enhanced financial performance without effective management.
- **Legislative Size (LS):** Exhibits a significant negative effect ($\beta = -0.00092$, $p = 0.026$), implying that larger legislatures may introduce inefficiencies, slowing decision-making and adversely impacting fiscal outcomes.
- **Local Government Size (LGS):** Shows a significant positive impact ($\beta = 0.00675$, $p = 0.027$),

indicating that larger governments benefit from economies of scale and better administrative capability, translating into improved financial performance.

Path Equation Testing Results

The path analysis results are presented in the following table, based on a random effect model for Equation 1 and a fixed effect model with General Least Square Weights (EGLS) for Equation 2. Diagnostic tests confirmed that model assumptions, including linearity, independence, and homoscedasticity, were met. Variance inflation factors (VIF) were examined to address potential multicollinearity concerns, and all values were within acceptable limits (<5). The results' robustness was verified through alternative model specifications and sensitivity analyses, yielding consistent findings. However, potential endogeneity issues remain unexplored, presenting a limitation for future research.

The path analysis reveals a significant positive relationship between financial statement quality and financial performance ($\beta = 0.0107$, $p < 0.01$). This suggests that higher quality financial statements are associated with improved financial performance in local governments.

The results also show that accountability mediates the relationship between financial statement quality and financial performance ($\beta = 0.0053$, $p < 0.05$). The indirect effect of financial statement quality on financial performance through accountability is significant, indicating that financial statement quality influences financial performance by enhancing accountability.

The findings support the hypothesis that financial statement quality has a positive indirect effect on financial performance through accountability. Specifically, the results suggest that higher quality financial statements lead to increased accountability, which in turn improves financial performance.

Table 2. Path Equation Test Results in Equation 1 and Equation 2

Dependent Variable		Accountability (ACC)		Local Government Financial Performance (LGFP)		Conclusion
		β	Prob.	β	Prob.	
Hypothesis	dependent Variable					
mediate Effect						
H1	Quality Of Local Government Financial Statement (QLGFS)			0,010689	0,0000	Accepted
H2	Quality Of Local Government Financial Statement (QLGFS)	8,712,429	0,0000			Accepted
H3	Accountability (ACC)			0,00597	0,0000	Accepted
Indirect Effect						
H4	QLGFS --> ACC --> LGFP			0,006438	0,0000	Accepted
	Control Variables					
	Capital Spending (CS)			0,001019	0,6042	
	Legislative Size (LS)			-0,000922	0,0260	
	l Government Size (LGS)			0,006751	0,0274	
R^2		0,173533	0,0000	0,960221	0,0000	

Source: data processing (2025)

- Hypothesis 1 (H1): Financial statement quality (QLGFS) has a significant and positive direct effect on local government financial performance (LGFP) ($\beta = 0.0107$, $p < 0.01$). A one-unit increase in QLGFS corresponds to a 0.0107 increase in LGFP. This suggests that higher quality financial statements are associated with improved financial performance in local governments.
- Hypothesis 2 (H2): QLGFS significantly and positively impacts accountability (ACC) ($\beta = 8.7124$, $p < 0.01$), indicating that better financial statement quality enhances accountability. This finding highlights the importance of financial statement quality in promoting transparency and accountability in local governments.
- Hypothesis 3 (H3): Accountability (ACC) has a significant positive effect on LGFP ($\beta = 0.00597$, $p < 0.01$), demonstrating that increased accountability improves financial performance. This suggests that accountability mechanisms play a crucial role in ensuring that local governments manage their finances effectively.
- Hypothesis 4 (H4): The indirect effect of QLGFS on LGFP through ACC is significant ($\beta = 0.006438$, $p < 0.01$), confirming that accountability mediates the influence of financial statement quality on performance. This finding indicates that financial statement quality influences financial performance by enhancing accountability in local governments.

Regarding control variables:

- Capital Spending (CS): No significant effect on LGFP ($\beta = 0.001019$, $p = 0.6042$). This suggests that changes in capital expenditure alone do not significantly impact financial performance in local governments.
- Legislative Size (LS): Negatively and significantly affects LGFP ($\beta = -0.000922$, $p = 0.0260$), implying that larger legislatures tend to reduce financial performance. This finding may be attributed to increased inefficiencies and bureaucratic red tape in larger legislatures.
- Local Government Size (LGS): Positively and significantly influences LGFP ($\beta = 0.006751$, $p = 0.0274$), indicating that larger local governments benefit from enhanced financial outcomes. This may be due to economies of scale and greater resources available to larger local governments.

These findings provide valuable insights into the relationships between financial statement quality, accountability, and financial performance in local governments, and have implications for policymakers and public administrators seeking to improve financial management in local governments.

Based on the table 2 above, you can see the results of the road equation test. First, the impact between the quality of local government financial statements (QLGFS) and local government financial performance (LGFP) is 0.010689. This value is positive, which means that in the Financial Statement of Quality of Local Government (QLGFS), the Financial Return of Local Government (LGFP) will increase by 0.010689 and vice versa (Akib & Dharmawati, 2022). The probable value obtained is 0.0000 lower than the significance level of 5% (0.0000<0.05), which indicates that the Quality of the Financial Statement of Local Government (QLGFS) significantly influences the Financial Activity of Local Government (LGFP). From these results, it can be concluded that the quality of local government financial statements (QLGFS) has a direct and positive impact on the financial activity of local governments (LGFP). The results of this research coincide with the results of the research.

In the second hypothesis, i.e., the impact of the Quality of Local Government Financial Statements (QLGFS) on Accountability (ACC) is 8.712429. This value is positive, meaning that when uploaded through a Local Government Financial Statement Quality Unit (QLGFS), the Accountability (ACC) will increase by 8.712429 and vice versa. The probability value obtained is 0.0000 lower than the 5% significance level (0.0000 <0.05), which indicates that the Quality of the Financial Statement of Local Government (QLGFS) significantly influences Accountability (ACC). From these results, it can be concluded that the quality of local government financial statements (QLGFS) has a positive impact on accountability (ACC). In the third hypothesis, i.e., the impact of Accountability (ACC) on the Financial Activity of Local Governments (LGFP) is 0.00597 (Dewi et al., 2019). This value is positive, which means that if it is accounted for through a unit (ACC), the financial return of the local government (LGFP) will increase by 0.00597 and vice versa. The probability value obtained is 0.0000 lower than the significance level of 5% (0.0000 <0.05), which indicates that Accountability (CCA) has a significant impact on the

Financial Activity of Local Governments (LGFP). From these results, it can be concluded that accountability (ACC) has a positive impact on the Financial Activity of Local Governments (LGFP). The results of this research come from previous research.

In the fourth hypothesis, i.e., the impact of the Quality of Local Government Financial Statements (QLGFS) on Local Government Financial Activity (LGFP), through Accountability Equations 1 and 2 (CCA), the regression coefficient is 8.712429 x 0.00597 = 0.006438. This value is positive, meaning that when uploaded through a Local Government Financial Statement Quality Unit (QLGFS), the local government financial return (LGFP) will increase by 0.006438 through accountability and vice versa. The probability value obtained from the Sobel calculation is 0.0000 lower than the significance level of 5% (0.0000 <0.05), which indicates that the Quality of the Financial Statement of Local Government (QLGFS) has a significant impact on the Financial Activity of Local Government (LGFP), through Accountability (ACC) (Budi & Sastradipraja, 2024). From these results, it can be concluded that Accountability (ACC) can influence the quality of local government financial statements (QLGFS) and local government financial activity (LGFP). The results of this research come from previous research. In the capital expenditure control variable (CS), the desistance coefficient is 0.001019, which means that when capital expenditure is increased by one unit (CS), the local government financial return (LGFP) will increase by 0.001019. The probability value obtained is 0.6042, higher than 5% (0.6042>0.05), which indicates that Capital Expenditures (CS) do not have significant effects on the Financial Activity of Local Governments (LGFP).

The control variable, the legal size (LS), had a retroactivity of -0.0006, with a negative sign, which means that when the legislative measure is increased by one unit (LS), the financial profitability of the local government (LGFP) will be reduced by 0.000922. The probability value obtained is 0.0260, less than 5% (0.0260 <0.05), which indicates that the Legislative Size (LS) significantly influences the Financial Activity of Local Governments (LGFP). The control variable, Local Government Size (LGS), obtained a regression coefficient of 0.006751, with a positive sign, which means that when the size of local government increases by one unit (LGS), the financial return of local government (LGFP) will increase by 0.006751. (Kwak, 2023). The probability value obtained is 0.0260, less than 5% (0.0274 <0.05), which indicates that the Size of Local Government (LGS) has a significant impact on the Financial Activity of Local Government (LGFP).

4.3 Expanded Interpretation and Implications

The findings confirm that enhancing the quality of financial statements leads to substantial improvements in accountability, which in turn fosters better financial performance in local governments. Accountability functions as a critical pathway that ensures transparency translates into practical fiscal improvements by promoting oversight and responsible management.

The negative impact of legislative size aligns with literature suggesting that larger legislative bodies can generate bureaucratic complexity and inefficiency, hindering fiscal effectiveness. Conversely, a larger local government size supports economies of scale, administrative capacity, and ultimately financial returns.

The lack of significant effect from capital expenditure implies that financial inputs alone are insufficient to drive performance gains without effective institutional oversight and management quality.

4.4 Discussion and Implications

Practical Significance

While the study's findings demonstrate statistical significance, it's crucial to examine the practical significance of these results. For instance, the coefficient of 0.010689 for the impact of financial statement quality on financial performance may be statistically significant, but its real-world implications might be limited. To better understand the practical significance, it would be helpful to consider the magnitude of the effects and their potential impact on local government financial management.

Mechanism Explanation

The study highlights the positive relationship between financial statement quality, accountability, and financial performance. However, further exploration is needed to understand the underlying mechanisms driving these relationships. For example, how does high-quality financial reporting lead to enhanced accountability? Is it through improved transparency, better decision-making, or increased stakeholder trust? Similarly, how does accountability impact financial performance? Is it by reducing corruption, promoting efficient resource allocation, or encouraging prudent financial management? Elucidating these mechanisms can provide a deeper understanding of the complex interactions between these variables.

Contextualization

The study's findings should be contextualized within the broader literature on financial management, accountability, and performance. How do these results align with or contradict existing research? For instance, do the findings support the notion that transparency and accountability are essential for effective financial management? By situating the study's results within the existing theoretical frameworks, researchers can better understand the contributions and limitations of this study and identify areas for future research.

Implications for Policy and Practice

The study's findings have important implications for policymakers and practitioners seeking to improve local government financial management. Based on the results, recommendations could include implementing robust financial reporting systems, promoting transparency and accountability, and optimizing legislative size to balance representation and efficiency. Additionally, policymakers could consider initiatives to enhance financial management capacity, such as training programs for local government officials or incentives for high-performing governments. By deriving specific, actionable recommendations from the study's findings, policymakers and practitioners can work towards improving financial management and accountability in local governments.

4.4 Limitations and Future Research

The study would benefit from a more nuanced explanation of the mediation effect, delving into the conceptual underpinnings of how accountability mediates the relationship between financial statement quality and financial performance. This could involve discussing the theoretical frameworks that support this relationship and providing a clear, logical explanation of the mechanisms at play.

R^2 Value and Endogeneity Concerns

The reported R^2 value of 0.96 is indeed suspiciously high and raises concerns about potential overfitting or endogeneity. It's possible that the model is capturing noise or spurious relationships rather than meaningful variance. Moreover, the study's design and analysis do not appear to address potential endogeneity concerns, which could arise from bidirectional relationships between financial reporting quality and local government performance. To mitigate these concerns, the authors could consider employing econometric robustness tests, such as instrumental variable analysis or Heckman correction, to assess the robustness of their findings. Alternatively, they could acknowledge the potential limitations of their study and discuss the need for future research to address these concerns.

CONCLUSION

This study analyzes the impact of the quality of financial information on the financial activity of local governments, taking into account accountability as a mediating factor and governance characteristics as control variables.

Key Findings

- High-quality financial reports positively and significantly affect local government financial performance.
- Quality financial reports significantly improve accountability mechanisms in local governments.
- Improved accountability directly contributes to better financial performance in local governments.
- Accountability significantly mediates the effect of financial report quality on economic performance.
- Capital expenditure is not significant in directly affecting financial performance.
- Legislative size hurts financial performance.
- Government size has a positive effect on financial performance.

Synthesis and Theoretical Reflection

This study's findings offer valuable insights into the complex relationships between financial statement quality, accountability, and local government financial performance. By exploring the mediating role of accountability, this research contributes to the existing literature on Agency Theory, highlighting the importance of transparency and oversight in mitigating agency problems.

Policy Implications

The study's findings have important implications for policymakers and practitioners seeking to improve local government financial management. Based on the results, recommendations could include:

- Implementing robust financial reporting systems
- Promoting transparency and accountability
- Optimizing legislative size to balance representation and efficiency
- Enhancing financial management capacity through training programs or incentives for high-performing governments

Limitations and Future Research

While this study provides valuable insights, it is not without limitations. The reported R^2 value of 0.96 raises concerns about potential overfitting or endogeneity, and future research should prioritize addressing these concerns through econometric robustness tests. Furthermore, the study's focus on local governments in a specific context may limit the generalizability of the findings.

In conclusion, this study sheds light on the critical role of financial statement quality and accountability in enhancing local government financial performance. By providing a nuanced analysis of the relationships between these variables, this research contributes to the existing literature and offers practical implications for policymakers and practitioners. As local governments continue to face challenges in financial management, this study's findings highlight the importance of prioritizing transparency, accountability, and high-quality financial reporting.

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