

# The Effect of Local Government Characteristics and the Examination Result of Indonesian Supreme Audit Institution on Economic Growth, with Financial Performance as Intervening Variable in District and City Government of Lampung Province

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## Abstract

The importance of utilization local potential effectively and efficient resources use, is the motivation of writer to conduct this research. The aim of this research is to examine empirically on the effect of local government characteristics and the examination result of Indonesian Supreme Audit Institution on economic growth in district/city/province government of Lampung. This research uses population of all districts/cities in the Province of Lampung, Indonesia. The secondary data are tested statistically by using multiple regression to prove the hypothesis. The result of this research proves that characteristics of local government can affect financial performance especially the ratio of effectiveness, but do not affect the ratio of efficiency and the ratio of autonomy. The result of audit examination (audit opinion and audit findings) does not affect financial performance. Then, financial performance does not affect economic growth. The lack of fund source potential use effectiveness and the lack of fund source use efficiency may cause financial performance has not been able to increase economic growth. Financial performance can be improved through local governance characteristic, but is not affected by audit opinion and audit findings.

**Keywords:** characteristics of local government, audit opinion, audit findings, financial performance, economic growth.

## 1. Introduction

Local management done economically, efficiently, and effectively or fulfilling value for money as well as participation, transparency, accountability, and justice will boost economic growth. The economic growth shows the extent to which economic activity can produce addition income of community in a certain period (Sukirno, 2006:423). Federalism fiscal theory states that economic growth will be achieved with fiscal decentralization through local autonomy implementation. Fiscal decentralization is delegation of authority related to decision making to lower local government that functionates to increase the efficiency long term public sector (Akai and Sakata, 2002).

Financial performance is a performance measurement that is measured by using financial indicator. Financial performance of local government can be measured among others by using effectiveness ratio and efficiency ratio. Effectiveness ratio is the ability of local government in PAD realization that has been planned and compared to the determined target based on local real potential (Halim, 2007:234). Efficiency ratio is a ratio that describes the comparison of spending realization (expense) and local income realization (Halim, 2007:234). Hamzah (2008) describes that high discrepancy occurs in financial performance in each different region. The difference of performance is caused by the existence of ability difference in each region in increasing its local income potential. Therefore, automatically there is ability difference occurring between one region and other regions in increasing their economic growth. Sularso and Restianto (2011), in their research, it shows the result that financial performance affects economic growth.

Based on the data of Lampung Province financial bureau, Local Government Proposed Budget (RABPD) for Local Real Income (Pendapatan Asli Daerah/PAD) in 2013 was 50% and it was realized as much as 45%, it shows that effective ratio of 90% meaning that financial performance of Lampung Province local government is quite effective because income from RRI (PAD) has been realized as much as 90%, but is still needs to be improved its effectiveness in order to be able to fulfill budgeting target and goal wanted to be achieved in order to fulfill the needs of community. Based on Lampung Province Financial Bureau in 2013, the realization of Lampung Province spending or expense in the end of budgeting year in 2013 was Rp 3.880,02 billions, while the realization of its income was Rp 3.896,47 billions. It shows that efficiency ratio for financial performance of Lampung local government was 95.56% that is included in the category of less efficient, because the total spending realization is almost the same as its income realization. The previous research stating that this financial performance is affected by the characteristics of local government, among others are the researches from Patrick (2007), Mustikarini and Fitriyani (2012), Virgasari (2009) and Indrarti (2011), but there are still some other researches that give inconsistent results.

Based on the phenomena, theory and previous researches, the writer is interested in proving whether or

not financial performance of local government is affected by the characteristics of local government and the examination result of BPK (Supreme Audit Institution), so it will affect economic growth. The result of this research is expected to be able to solve the problems of efficiency and effectiveness of local government financial performance by focusing on factors of local government characteristics that affect, so it is expected to increase economic growth.

## 2. Literature Review

Patrick (2007) has investigated on local characteristic applied on local government of Pennsylvania. Mustikarini and Fitriarsari (2012) use size of region (size), local asset level, dependency level on central government, and local expense in explaining characteristic of local government. Mustikarini and Fitriarsari (2012), Virgasari (2009) and Indrarti (2011) use audit opinion in explaining the result of BPK (Supreme Audit Institution) audit. This research uses variable of the examination result of BPK audit in measuring the relation of financial performance of local government. Characteristic of local government in this research uses corporate size (total assets) and local expense. Bigger assets of local government and local expense are expected that the resource is bigger in order to give better performance of the local government to community (Mustikarini dan Fitriarsari, 2012). Next, Sumarjo (2010) stated that the size of local government positively affects financial performance of district/city local government in Indonesia. The type of BPK audit examination consists of: financial audit, performance audit, and investigative audit (Bastian, 2006). More audit findings show that financial management of local government is poor, so it affects performance (Mustikarini and Fitriarsari, 2012; Virgasari, 2009; Indrarti, 2011). Audit opinion can be a pressure for local government in organizing good government in order to create good performance as well.

In governmental organization, to measure financial performance, there are some performance measurements, which are dependency ratio, effectiveness ratio, efficiency ratio, growth ratio, and suitability ratio. In public sector, an activity is said to be effective if the activity has great effect on the ability to provide public service that is a target determined previously. Effectiveness ratio describes the ability of local government in realizing PAD planned that is compared to the target determined based on local real potential. When PAD income realization is bigger than PAD income target, then, it can be said to be more effective, and vice versa. Effectiveness value is obtained from the comparison as has been mentioned above, and it is measured by evaluation criteria of financial performance (Medi, 1996 in Budiarto, 2007). If percentage of financial performance is above 100%, it can be said to be very effective, 90% - 100% is effective, 80% - 90% is fairly effective, 60% - 80% is less effective and less than 60% is not effective. Efficiency ratio is a ration describing the comparison between output and input or expense realization and income realization of local government. The smaller ratio, the more efficient, and vice versa. An activity is said having been done efficiently if the work implementation has achieved result (output) with the lowest cost (input) or with minimal cost, desired outcome is obtained. By knowing the result of comparison between expense realization and income realization by using the efficiency measurement, financial performance evaluation can be determined (Medi, 1966 dalam Budiarto, 2007). If financial performance is above 100%, it can be said to be not efficient, 90% - 100% is less efficient, 80% - 90% is fairly efficient, 60% - 80% is efficient, and below 60% is very efficient. Ratio of local financial independence or commonly known as fiscal autonomy, shows the ability of a region in self financing government activity, development, and service for community that has tax and retribution as income source needed by the region. This ratio also describes dependency of local government on external funding source. If is this ratio is higher, then, the dependency level of the region on external party is lower, and vice versa. In this research, autonomy ratio is measured by comparing Local Real Income and Total Income.

In general, economic growth can be defined as developing activity in economy causing good and service produced in community is rising and public welfare is increasing. The economic growth can be defined as the increase of Gross Domestic Product (GDP) or Gross National Product (GNP) regardless whether the increase is bigger or smaller than the growth of population or whether the change of economic structure is occurring or not (Arsyad, 1999).

### **The Effect of Region Size on Financial Performance of Local Government**

The size of region is marked by the amount of total assets of local government. When the asset of local government and local expense is bigger, it is expected that the resource they have is bigger in order to give good performance of the local government to community (Mustikarini and Fitriarsari, 2012). Next, Sumarjo (2010) stated that the size of local government positively affects financial performance of district/city local government in Indonesia. Therefore, hypotheses in this research are:

H1a. The size of region positively affects financial performance of local government (effectiveness ratio).

H1b. The size of region negatively affects financial performance of local government (efficiency ratio).

H1c. The size of region positively affects financial performance of local government (autonomy ratio).

### **The Effect of Local Expense on Financial Performance of Local Government**

According to UU No. 32/2004 Pasal 167 ayat 1, local expense is used to protect and increase community life quality. Therefore, the higher expense of local government should reflect the higher service level given to

community so that the performance of local government is increasing. The research from Purba (2006) proves that development expense positively affects macro economic performance in The District of Simalungun, it is in line with Rustiono (2008) stating that government expense positively affects macro economic performance in The Province of Central Java. Sjoberg (2003) found that there is positive relationship between government expense on consumption and investment and macro economic performance in Sweden for period of 1960-2001. From the above explanation, then, hypotheses in this research are:

- H2a: Local expense positively affects financial performance of local government (effectiveness ratio)
- H2b: Local expense negatively affects financial performance of local government (efficiency ratio)
- H2c: Local expense positively affects financial performance of local government (autonomy ratio)

#### **The Effect of BPK (Supreme Audit Institution) Examination Result (Audit Findings and Audit Opinion) on Financial Performance of Local Government**

Audit finding of BPK is the result of BPK examination on government financial report disclosing the existence of internal control system weakness and violation on disobedience on legal provision. This disobedience on legal provision can cause state/local loss, state/local loss potential, lack of income, administration weakness, lack of frugality, inefficiency, and ineffectiveness. The research that relates audit finding and local government performance has been done by Mustikarini and Fitriasari (2012) resulting that the more number of BPK audit findings on a local government, then, the lower local government performance will be. Based on the above explanation, then, hypotheses that can be developed are:

- H3a. The result of BPK examination (audit finding) negatively affects financial performance of local government (effectiveness ratio)
- H3b. The result of BPK examination (audit finding) positively affects financial performance of local government (efficiency ratio)
- H3c. The result of BPK examination (audit finding) negatively affects financial performance of local government (autonomy ratio)

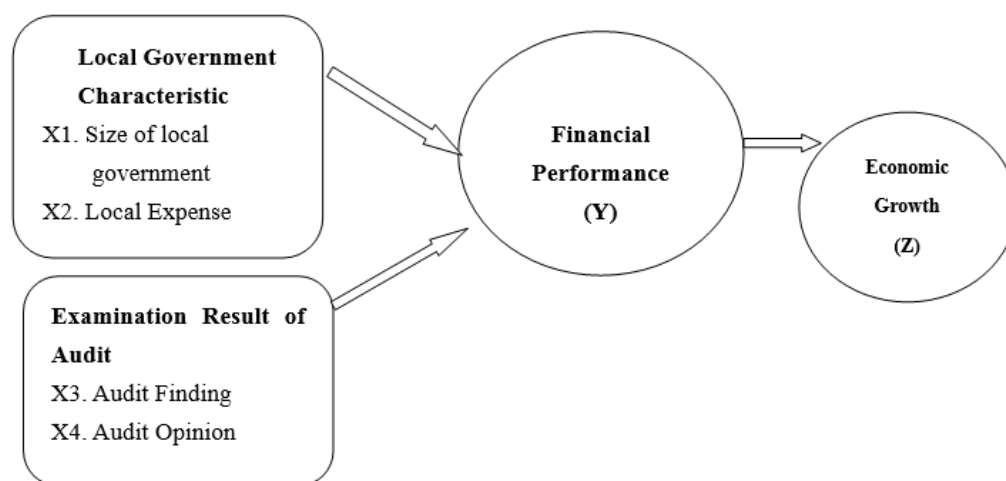
Opinion is a professional statement as a summary of examiner on the fairness level of information that presented in financial report. BPK opinion can be benchmark (indicator) to evaluate accountability of government entity. This opinion can increase or decrease the trust level of stakeholders on report presented by audited party (auditee), in this matter is the entity of local government. In other words, the more reasonable opinion of BPK audit should show the higher performance of a local government. The researches from Virgasari (2009) and Indrarti (2011) showed that there is relationship between opinion of BPK audit and financial performance of local government. From the explanation, hypotheses that can be developed are:

- H4a. The result of BPK examination (audit opinion) positively affects financial performance of local government (effectiveness ratio)
- H4b. The result of BPK examination (audit opinion) negatively affects financial performance of local government (efficiency ratio)
- H4c. The result of BPK examination (audit opinion) positively affects financial performance of local government (autonomy ratio)

#### **The Effect of Financial Performance of Local Government on Economic Growth**

The autonomy and management economically, effectively, and efficiently of a region or area will be able to boost economic growth of the region. Local officials are able to manage a region by initiative and creative in order to boost the growth of the region. Todaro (1997) specifically stated that there are three main factors or components of economic growth, which are capital accumulation, population growth, and matters related to the increase of the number of workforce that is considered positively to stimulate economic growth. Based on the explanation above, hypotheses proposed in this research are:

- H5a. Financial performance of local government (effectiveness ratio) positively affects economic growth.
- H5b. Financial performance of local government (efficiency ratio) negatively affects economic growth.
- H5c. Financial performance of local government (autonomy ratio) positively affects economic growth.



**Theoretical Framework Model**

### 3. RESEARCH METHOD

Hypothesis testing is done by analysis method of multiple regression quantitative data. The source of data in this research is secondary data obtained from related agency such as BPK / Supreme Audit Institution of Lampung Province and Central Statistic Bureau, and from related websites such as [www.BPK.go.id](http://www.BPK.go.id) and [www.BPS.go.id](http://www.BPS.go.id). The data include quantitative data among others balance financial report, Local Government Proposed Budget and its realization, and data of economic growth.

Table 1. Variables in Research and Indicators

Notation	Variable	Indicator
<b>Characteristic of Local Government</b>		
X1	Size of Local Government	Total Assest of Local Government
X2	Local Expense	Total Realization of Local Expense
<b>Examination Result of BPK Audit</b>		
X3	Audit Finding	Audit Finding
X4	Audit Opinion	Audit Opinion Given
<b>Financial Performance</b>		
Y1	Effectiveness Ratio	$\frac{\text{Realization of PAD Income}}{\text{Target of PAD Income}}$
Y2	Efficiency Ratio	$\frac{\text{Realization of Expense}}{\text{Realization of Income}}$
Y3	Autonomy Ratio	$\frac{\text{Total Local Real Income (PAD)}}{\text{Total Local Income}}$
<b>Economic Growth</b>		
Z	The Change of Gross Local Domestic Income	$\frac{\text{PDRB } t - \text{PDRB } t-1}{\text{PDRB } t}$

The population is local government of district/city in Lampung Province. Sample taking is by purposive sampling, with criteria of the sampling taking as the following:

1. Local government of district/city in Lampung Province having all complete financial report data for 3 years in a row.
2. Sampel has data of BPK audit examination result report for obtaining the number of audit findings and audit opinion taken from Examination Result Summary on BPK official site (<http://www.bpk.go.id>);

#### Analysis Design/Hypothesis Testing Design

$$Y1_{it} = \alpha + \beta_1 X1_{it} + \beta_2 X2_{it} - \beta_3 X3_{it} + \beta_4 X4_{it} + e$$

$$Y2_{it} = \alpha - \beta_1 X1_{it} - \beta_2 X2_{it} + \beta_3 X3_{it} - \beta_4 X4_{it} + e$$

$$Y3_{it} = \alpha + \beta_1 X1_{it} + \beta_2 X2_{it} - \beta_3 X3_{it} + \beta_4 X4_{it} + e$$

$$Z_{it} = \alpha + \beta_5 Y1_{it} - \beta_6 Y2_{it} + \beta_7 Y3_{it} + e$$

Y1 = Financial Performance of Local Government (Effectiveness Ratio)

Y2 = Financial Performance of Local Government (Efficiency Ratio)

Y3 = Financial Performance of Local Government (Autonomy Ratio)

X1 = The size of Local Government

X2 = Local Expense

- X3 = Audit Finding
- X4 = Audit Opinion
- Z = Economic Growth
- $\alpha$  = Constan
- $\beta 1, \dots, \beta 7$  = Coefficient of independent variable
- e = Error

#### 4. RESULT AND DISCUSSION

##### The Effect of Region Size, Local Expense, Audit Finding and Audit Opinion on Effectiveness Ratio

Table 2. Testing result of hypotheses 1

Model	Unstandardized Coefficients	t	Sig.	Result
(Constant)	2,467	4,142	,000	
X1	,000	-1,703	,097**	Ha accepted
X2	5,047E-007	1,912	,064**	Ha accepted
X3	-,580	-1,299	,202	Ha not accepted
X4	-,613	-1,603	,118	Ha not accepted

\*\* significant at alpha 10%

$$Y1 = 2,467 + 0,00 X1 + 5,047E-007 X2 - 0,580 X3 - 0,613 X4 + e$$

Variable X1 (the size of local government) and X2 (Local Expense) significantly affect financial performance of local government (effectiveness ratio), it means that the bigger the size of local government, the higher effectiveness ratio of the region. The more assets of a local government, the larger level of the local government ability in realizing planned PAD compared to the determined target based on local real potential. The result of this research is in line with the research from Sumarjo (2010) that concluded that the size of local government positively significantly affects financial performance of district/city local government in Indonesia. It is also in line with the research from Lin *et al.* (2010) that investigated on the effect of local assets on the index of economic performance in China. As well as variable X2 (Local Expense) affects financial performance of local government that is represented by effectiveness ratio. It means that the larger local expense, the higher effectiveness ratio of the region. It indicates that Local Government Proposed Budget has been realized for the use of performance improvement to a better direction. This research result is in line with the research from Purba (2006) and Rustiono (2008). Next, variable X3 (BPK audit finding) negatively, but not significantly, affects financial performance of local government that is represented by effectiveness ratio, meaning that the more number of BPK audit findings, the lower effectiveness ratio of the local government. However, this result is not significant, and is in line with the research from Mustikarini and Fitriarsari (2012). Similarly, the next research result shows that the effect between BPK audit opinions (X4) on financial performance of local government that is represented by efficiency ratio does not have significant effect. It is not in line with the research result from Virgasari (2009) and Indrarti (2011). Audit opinion does not affect financial performance that is because in giving audit opinion, BPK as governmental auditor emphasizes more on financial report fairness based on internal control system, accounts checking, and accountancy notes (Indrarti, 2011). The aim of the examination is useful for detecting the existence of fraud in reporting whether it is in accordance with Financial Accountancy Standard, and is not based on the number or nominal of the financial data (Indrarti, 2011).

##### The Effect of Region Size, Local Expense, Audit Finding and Audit Opinion on Efficiency Ratio

Table 3. Testing result of hypotheses 2

Model	Unstandardized Coefficients	t	Sig.	Result
(Constant)	-,025	-,648	,521	
X1	2,816E-006	,203	,841	Ha not accepted
X2	5,632E-009	,323	,748	Ha not accepted
X3	,018	,615	,542	Ha not accepted
X4	-,025	-,974	,337	Ha not accepted

$$Y2 = -0,025 + 2,816E-006 X1 + 5,632E-009 X2 + 0,018 X3 - 0,025 X4 + e$$

From Table 3, it can be seen that all independent variables which are X1 (Size of Local Government), X2 (Local Expense), X3 (Opinion), X4 (Finding) do not have significant effect on financial performance of local government that is represented by efficiency ratio. The total assets do not affect financial performance (efficiency ratio) of local government, indicating that the total assets, local expense, finding and opinion, have not had role in improving efficiency ratio of local government. Local governments both city and district in Lampung have not been efficient, the expense is still bigger than income. Local Governments have not used existing assets to maximize local income, and the local expense has not been used efficiently either.



**The Effect of Region Size, Local Expense, Audit Finding and Audit Opinion on Autonomy Ratio**

Table 4. Testing result of hypotheses 3

Model	Unstandardized Coefficients	t	Sig.	Result
(Constant)	-2,726	-8,155	,000	
X1	,000	1,009	,320	Ha not accepted
X2	4,845E-007	3,269	,002*	Ha accepted
X3	,382	1,522	,137	Ha not accepted
X4	,397	1,850	,072**	Ha accepted

\* significant at alpha 5%

\*\* significant at alpha 10%

$$Y3 = -2,726 - 0,000 X1 + 4,845E-007 X2 + 0,382 X3 + 0,397 X4 + e$$

From Table 4, it is seen that variable X2 (Local Expense) has significant effect on autonomy ratio (significant at alpha 5%). The bigger local expense, the more independent local government is, or more able to fund governmental activity, development, and service for community. The result of this research supports the hypothesis and research result from Kusumawardani (2012), Sumardjo (2010), Mustikarini and Fitriyani (2012). Similarly, X4 (opinion) significantly affects autonomy ratio (significant at alpha 10%), meaning that the better opinion obtained, the more independent local government is, or more able to fund governmental activity because PAD value that its portion is quite big compared to Total Income. This research result is in line with the research from Virgasari (2009) showing correlation between audit opinion on local government financial report and financial performance. However, X1 (size of region) and X3 (finding) do not affect autonomy ratio.

**The Effect of Financial Performance (Effectiveness Ratio, Efficiency Ratio, Autonomy Ratio) on Economic Growth**

Table 5. Testing result of hypotheses 4

Model	Unstandardized Coefficients	t	Sig.	Result
(Constant)	6,650		,000	
X1	,049	,035	,824	Ha not accepted
X2	-5,728	-,245	,125	Ha not accepted
X3	,505	,249	,118	Ha not accepted

$$Z.PE = 6,650 + 0,049 Y1 - 5,728 Y2 + 0,505 Y3 + e$$

On Table 5, it can be seen that all independent variables which are financial performance (effectiveness ratio, efficiency ratio, and autonomy ratio) do not have significant effect on economic growth. Effectiveness ratio does not significantly affect economic growth because income realization of local government that is because income realization of local government can not fulfill the income target of local government. Income realization of local government that is compared to the target does not fulfill economic, efficiency, and effectiveness (value for money). There are still some districts that cannot achieve determined PAD target, then, the effectiveness ratio is less able to boost the occurrence of economic growth. This research result is in line with the research from Hamzah (2008) stating that effectiveness ratio does not affect economic growth.

The effect of variable efficiency ratio on economic growth shows negative value, but not significant, meaning that the lower efficiency ratio (meaning that financial performance is more efficient) will not increase economic growth. It is because efficiency ratio in Local Government of Lampung is still inefficient. The realization of government expense for obtaining bigger income than the realization of its income, causing weakness and cannot be allocated for other expenses (public), it cannot boost economic growth.

The effect of variable autonomy ratio on economic growth shows positive value, but is not significant. Autonomy ratio does not affect economic growth because Local Governments in Lampung have autonomy ratio that is considered very poor so that PAD is not the main factor that can increase economic growth.

**Conclusion**

1. Financial performance of local government (effectiveness ratio) is affected significantly by the characteristics of local government (size of region and local expense), but it is not affected by the result of audit examination (number of findings and audit opinion).
2. Financial performance of local government (efficiency ratio) is not affected by government characteristics (size of region, local expense), and the result of audit examination (number of findings and audit opinion).
3. Financial performance of local government (autonomy ratio) is affected significantly by local expense and opinion, but it is not affected by size of region and number of findings.
4. Financial performance of local government (effectiveness ratio, efficiency ratio, and autonomy ratio) does not affect significantly on economic growth. It is because financial performance of Lampung district/city local

government has not been efficient enough (expense that is spent has not been in accordance with allocation and planning) and still less autonomous (financing still depends on central, PAD/RRI is still not maximum, so it has not been factor that affects economic growth significantly).

### **Suggestion / implementation**

1. Local government is expected to be able to increase PAD by developing more on existing potential in order to be more autonomous in financing government activity, and able to use PAD as good as possible.
2. Government should use local expense more efficiently and effectively so that the use of local expense is in accordance with planning and in order to achieve the objective of public welfare service.
3. Government should try to increase opinion from Supreme Audit Institution so that financial performance of local government increases, through the process of financial report making that is reasonable, and meets the standard applicable standard.

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