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# Developing Mandatory Disclosure Index (MDI) of Financial Statement in Malaysian Local Government

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## Abstract

The objective of this study is to develop a mandatory disclosure index (MDI) of financial statements for local government in Malaysia. The method for developing the MDI is based on the legal and regulatory requirements and related literature. This study adopted the procedure suggested by Gore (2002), Hooks et al. (2003) and Coy and Dixon (2004) in developing the index. The MDI is a simple index using a list of items that has been identified. This study presents 63 items considered as mandatory disclosure requirements based on three main sources consisting of law which includes the Local Government Act (1976), the Statutory Bodies (1980) and Audit Act (1957); rules and guidelines outlined in TC No. 15/1994; and Malaysian Accounting Standards Board (MASB). The study is limited by the incomplete financial statements supplied which caused it to be removed from the sample. Further study could be done regarding the measurement of financial statements quality based on the method of disclosure index, the assessment on the level of quality of financial statements, the determination of the quality of published financial statements and factors that influence the quality of local governments' financial statements in Malaysia.

**Keywords:** Mandatory disclosure index, information disclosure, voluntary disclosure, financial statement, Local Government, Malaysia.

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## 1. INTRODUCTION

In general, the concept of information disclosure has various meanings and definitions as included in the relevant literature. For example Parker (1992, in excerpts Azhar, 1998) defines information disclosure as a report on the financial and non-financial information to users, and it can be based on legislative requirements or standards or may be voluntary. Cooke (1992) refers information disclosure as both mandatory disclosure and voluntary disclosure in the financial statements, including notes to the accounts and analysis by the management on the business operations. Based on the above definition of information disclosure, it can be concluded that the concept of information disclosure is extensive and covers all the disclosure in various forms of media. However, the scope of this study is focused on aspects of information disclosure in the financial statements only, hence the definition of disclosure of information used is related to disclosures in the financial statements only as defined by Treasury Circular (TC) no. 15/1994. Treasury Circular No. 15/1994 states that financial statements consist of balance sheet; profit and loss statement or income and expenditure statement; statement of changes in financial position; cash flow statement; the notes to the accounts; certificates of declarations of the Chairman and a member of the Board Director; recognition by the officer primarily responsible for the financial management; audit certificates and observations, if any, by the Auditor General on the financial statements; and other related statements.

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In practical terms, the mandatory disclosure index can serve as a guide and benchmark for all local governments in Peninsular Malaysia. By having this benchmark, it can be a basis for the authority bodies and interested parties in making a decision on matters such as the distribution of funds or assistance, awards and rewards, and others. In addition it will also increase the competition among local governments in improving the quality of their services and promote their image. By having an index of mandatory information disclosure, it also can be used to measure the quality of financial statements. Thus, the objective of this study is to develop a mandatory disclosure index of financial statements for local government in Malaysia. Following the introduction section one, the remainder of the paper is organized in sequence order. The second section reviews previous literature on disclosure information. Section 3 explains the mandatory disclosure index, while Section 4 presents the development of mandatory disclosure index. Finally, section 5 concludes the paper.

## **2. LITERATURE REVIEW**

Based on the literature, a study on disclosure of information can be divided into three categories; aggregate disclosure, mandatory disclosure and voluntary disclosure (Azhar, 1998; Cooke, 1989). Aggregate disclosure covers all items required to be disclosed by the organization whether an item is classified as mandatory or voluntary information. Studies related to aggregate disclosure on corporate firm was done by Azhar (1998) and Cooke (1989). Several studies on voluntary disclosure include Aitken, Hooper and Pickering (1997), Deegan (2002), Entwistle (1999), Haniffa and Cooke (2002), Ho and Wong (2001), Leftwich, Watts and Zimmerman (1981), Patton and Zelenka (1997), and Prencipe (2004). Other researchers such as Ahmed and Nicholls (1994), Akhtaruddin (2005) and Hilwani, Hasnah, Akhtaruddin, and Hanem Hafizah (2006) studied on mandatory information disclosure. In addition, there are few studies associated with the disclosure of information on public sector organizations such as Copeland, Ingram and Gann (1981), Christiaens (1999), Collin, Keenan and Lapsley (1991), Coy, Tower and Dixon (1993), Daniels and Daniels (1991), Giroux (1989), Giroux and McLelland (2003), Lasward, et al. (2005), Robbins and Austin (1986) and Ryan et al. (2002).

While in the Malaysian public sector environment, previous studies are more focused on local government as compared to the other public sector organizations. Mahamad and Coombs (1997) studied on the mandatory information disclosure practices for five samples of local governments in Malaysia and the United Kingdom, while Smilin and Asmah (2002), examined the quality of local governments' financial statements by looking at the type of audit certificate issued to the selected local government. Azhar Mohamed et al. (2004) and Syed Soffian et al. (2001) studied local governments within the state of Kedah using the financial statement's publication period and type of audit certificates as a method of quality measurement. In general, previous studies related to local government are relatively quite limited and focused on the level of general disclosure of financial information or mandatory disclosure (Collin et al., 1991; Copeland et al., 1981; Coy et al., 1993; Daniels & Daniels, 1991; Ryan et al., 2002). While the study on this matter in the Malaysian environment, in particular, the study of local government, is very limited and only focused on the issue of the disclosure of information only (Smilin & Asmah, 2002; Mahamad & Coombs, 1997; Mohamed Azhar et al., 2004).

## **3. MANDATORY DISCLOSURE INDEX**

There are two methods for developing the mandatory disclosure index. These are (1) based on the legal and regulatory requirements (legal requirement) and related literature; and (2) through adoption or modification of the index that has been established by previous studies (Meek et al., 1995; Hooks, et al., 2003; Coy and Dixon, 2004; and Coy et al., 1997). This study uses the first method in developing the mandatory disclosure index which is based on the statutory disclosure requirements as required by the Act, Treasury circular, and accounting standards. The first method is chosen because, according to the literature, no specific index has been developed for local government in the Malaysian context. The index developed is known as mandatory disclosure index (MDI).

## **4. DEVELOPMENT OF MANDATORY DISCLOSURE INDEX**

In developing a disclosure index, some basic matters have to be decided in advance. These include how to establish and develop a new index and the type of index that is used (simple or weighted). The MDI is a simple index using a list of items that has been identified. The simple index is adopted as compared to the weighted index because all the elements included in the index are mandatory items to be disclosed and considered to have the same interests, while the purpose of the weighted index is to recognize an item which is more important than the less valuable items. Furthermore, a study by Mahamad and Coombs (1997) and Firth (1980, in excerpts Mahamad & Coombs, 1997) show that the use of the simple index and weighted index does not have a

significant impact in many situations. This view was also agreed by Marston and Shrides (1991), which recommends score without weights should be calculated in advance if the weighted index is used.

Since this study focuses on a specific organization and has its unique characteristics, procedures as suggested by Gore (2002), Hooks et al. (2003) and Coy and Dixon (2004) is adopted in developing the MDI. Hooks et al. explained that the process of formulating new index should include three phases. These are (1) identifying the potential items to be included in checklists and source of reference, (2) developing draft index and (3) establishing the final index.

#### **4.1 Identify potential items and source of reference**

In this process, the determination of the number of items that should be included in the checklist relied on the type or purpose of an index and source of reference used (Hooks et al., 2003; Coy and Dixon, 2004). According to Hooks et al. (2003), the source of reference refers to a literature review that includes laws, regulations, accounting standards applicable and bonded an organization. Types of index refer to mandatory disclosure index, or voluntary disclosure index, or overall disclosure index (mandatory and voluntary).

The number of items that make up an index is different from one study to another, depending on several factors such as the objective of the index, type of index and sector or organization where it operates. Thus the number of items proposed by previous researchers are varied, but a whole range of items that make up the index is between 17 items (Barrett, 1977) up to 224 items (Cooke, 1989). However, previous studies on corporate firms such as Hossain et al. (1994), Meek et al. (1995), Azhar (1998) and Akhtaruddin (2005) include more than 70 items in their list of indices. Previous studies found that the number of items in the index for public sector organizations is smaller than in the corporate sector where the average number of items is less than 70 items. For example Coy and Dixon (2004) presents only 58 items in their index while Hooks et al. (2003) present 67 items in their accountability index. For the local government in Malaysia, Mahamad and Coombs (1997) suggests only 55 items in the statutory and non-statutory disclosure index.

In this study, the process of identifying the items which should be included in the checklist as mandatory disclosure requirements are based on three main sources of reference for local government in Malaysia. These resources comprise (1) laws that include Local Government Act (1976), Statutory Bodies Act (1980) and Audit Act (1957); (2) rules and guidelines issued by the Treasury that include Treasury Circular (TC) No. 15/1986 and Treasury Circular (TC) No. 15/1994; and (3) Malaysian Accounting Standards Board (MASB).

#### **4.2 Developing draft index**

The second stage in the process of building the index as suggested by Hooks et al. (2003) is developing the draft index. At this juncture, the processes involved are (1) identify the number of items that form the index, and (2) conduct reliability test for each item. Based on the source of reference established in the previous section, a total of 67 items has been designated as items that are considered mandatory disclosure by the local governments. In this case, an item is considered as mandatory disclosure when explicitly stated in the source of reference used. Items are categorized into six sections as shown in Table 1.

**Table 1.** Number of disclosure items by category

Category	No. of Item	%
A. Content of Financial Statements	7	11
B. Items in Balance Sheet	21	32
C. Items in Statement of Income and Expenses	23	34
D. Items in Cash Flow Statement	4	6
E. Item in the Notes	9	13
F. Items in Other Disclosure Requirement	3	4
<b>TOTAL</b>	<b>67</b>	<b>100</b>

After identifying each item for the draft index, the next process is to verify the items by a panel of experts. The purpose of verification is to ensure that all items that have been identified are in line with legal requirements and reflects actual practice. This validation process is based on the analysis of the expert panel's opinion that has been identified in advance where they are a group of users that are knowledgeable and experienced in preparing the financial statements of local government. In this study, the selection of a panel of experts is based on two main criteria, namely the level of expertise and knowledge relating to the preparation of financial statements of local government as suggested by Hooks et al. (2003).

### 4.3 Establishing the final index

In this process, the final index is produced after analyzing the expert panel's opinion and subsequently, modifications are made to the number of items produced. The final index has taken into consideration all the references, interpretation, and opinion of the expert panel. Through a rigorous process of forming this index, it is considered that the index may be able to be used as the basis for measuring the quality of local government financial statements.

In considering whether to retain or drop an item that has been proposed in the draft index, the concept of "rule of thumb" is used by setting the majority of two-thirds or 67 percent as the basis for maintaining the item which has been applied by Mohd Herry, Shahifol Arbi and Azhar (2002). This means that the decision on whether to maintain or remove an item in the draft index after analyzing the expert panel's opinion was made based on this principle since the literature does not explain the criteria to be followed in maintaining or removing items that were listed in the draft index.

Based on the 67 items listed in the checklist, analysis on the expert panel's opinion found that 64 items or 95.52 percent met these criteria, and 3 items representing 4.48 percent did not meet the criteria. Out of the 64 items, an item in section F (ending balance accounts of the Council) is overlapped with an item in section B (accounts of the Council), hence, these items have been combined into "Accounts of the Council." In summary, the range of scores for each item proposed in the draft index based on the expert panel's opinion is between 30 to 100 percent

Table 2 shows the score for each item listed in the draft index according to the group of experts' opinion. Out of the 67 items listed in the draft index, 25 items or 37.3 percent have the maximum score of 100 percent. The maximum score means that all experts panel agreed that the item should be made as mandatory disclosure in the financial statements. A total of 12 items (17.9 percent) had a score of 95 percent and 7 items, or 10.4 percent of all items scored 90 percent, 8 items or 11.9 percent scored 85 percent, 4 items got 80 percent, 2 items scored 75 percent, 6 items scored 70 percent, and each 1 item scored 55 percent, 35 percent, and 30 percent respectively.

Table 2. Score for each item in the checklist

Score (%)	Frequency	(%)	Item Position
100	25	(37.3)	7 items from section A 4 items from section B 9 items from section C 3 items from section D 1 item from section E 1 item from section F
95	12	(17.9)	8 items from section B 1 item from section C 1 item from section D 2 items from section E
90	7	(10.4)	5 items from section B 1 item from section C 1 item from section E
85	8	(11.9)	1 item from section B 3 items from section C 3 items from section E 1 item from section F
80	4	(5.97)	1 item from section B 2 items from section C 1 item from section F
75	2	(2.99)	2 items from section C
70	6	(8.96)	5 items from section C 1 item from section E
55	1	(1.49)	1 item from section E
35	1	(1.49)	1 item from section B
30	1	(1.49)	1 item from section B
<b>TOTAL</b>	<b>67</b>		

As shown in Table 2, there are three items in which one item from section E (Item No. 61, Recognition methods for work in progress) and two items from section B (Item No.27, Development service fund; Item No. 28 Deferred government assistance fund) scored less than 67 percent. Hence, they were removed from the final list of the index due to not meeting the standard criteria.

Before the decision to drop all the three items was made, further review is done to determine whether errors occur in interpreting the requirements. From the review, it was found that item no. 61: recognition methods for work in progress is a requirement specified in MASB 1, while two items in section B, that are, Item No.27, Development service fund and Item No. 28, Deferred government assistance fund are a general and implicit requirement as described in Annex B, TC No. 15/1994. Thus, as the majority of the panel of experts interpreted these items as voluntary disclosures, the decision was made to drop them. The final number of items that constitute the mandatory disclosure index (MDI) by Category is represented in Table 3.

**Table 3. Number of items in final mandatory disclosure index by category**

Category	No. of Item	%
A. Content of Financial Statements	7	11
B. Items in Balance Sheet	19	30
C. Items in Statement of Income and Expenses	23	37
D. Items in Cash Flow Statement	4	6
E. Item in the Notes	7	11
F. Other Disclosure Requirement Items	3	5
<b>TOTAL</b>	<b>63</b>	<b>100</b>

## 5. CONCLUSION

This study presents 63 items considered as mandatory disclosure requirements based on three main sources consisting of law which includes the Local Government Act (1976), the Statutory Bodies (1980) and Audit Act (1957); rules and guidelines outlined in TC No. 15/1994; and Malaysian Accounting Standards Board (MASB). The study only focused on developing mandatory disclosure index for local government in Malaysia that can be used to measure the quality of financial statements. This is because the financial statements are the main instruments used to disclose the financial accountability of the management as a trustee to the stakeholders, especially the public society. Given the published financial statements can influence the perception and image of local governments to the public as a whole, it is necessary to explore this issue scientifically so that a true picture may be granted.

Contributions and implications of this study on the aspects of policy and practice can be assessed through the development of the mandatory disclosure index which can be used by the authority bodies as the basis for the standardization and harmonization of the local governments' financial statements. This is because by identifying and listing all items that are classified as mandatory for disclosure of information, the local government's financial statements will be more uniform, and thus, can be understood and used for comparisons and decision making. The study is limited by the incomplete financial statements supplied which caused it to be removed from the sample. Further study could be done regarding the measurement of financial statements quality based on the method of disclosure index, the assessment on the level of quality of financial statements, the determination of the quality of published financial statements and factors that influence the quality of local governments' financial statements in Malaysia.

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