

# Improving Quality of Financial Reporting Through Good Government Governance and Effectiveness of Internal Audit

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## Improving Quality of Financial Reporting Through Good Government Governance and Effectiveness of Internal Audit

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### ABSTRACT

Issue that has arisen today in the management of public administration is good governance. Good governance can enhance organizational leadership, management and supervision, produce more effective interventions, and ultimately lead to better outcomes with improved community life. One of the forms of government governance is financial statement accountability. The purpose of this study is to provide empirical evidence regarding the effects of government governance and the effectiveness of internal audits on quality of financial statements. Sources of data obtained through field research conducted through observation, interviews and questionnaires and literature study. Data collection was conducted from March to July 2019 at the offices of regional work units in 8 districts/cities in the province of North Sulawesi, Indonesia. Returns the questionnaire at 58% of the amount distributed. Data collected were analyzed using structural equation modeling with the path analysis method approach. The results showed that with an error rate of 0.05, good governance partially had a positive effect on the quality of the financial statements, the effectiveness of internal audit had a positive effect on the financial statements. Simultaneously good governance and the effectiveness of internal audit have a positive effect on the quality of local government financial reports.

**Keywords:** Good Governance, Internal Audit, Quality of Financial Reporting

**JEL Classifications:** M41, H70, G38

### 1. INTRODUCTION

Government reforms have begun since the Law No. 32 of 2004 regarding changes in the administration of government which initially adopted a centralized pattern turned into decentralization. Regions are given the widest possible authority to manage and utilize the potential of the regions that they have with real responsibility and require government agencies to make financial reports in every responsibility for implementing the budget. In reality, after more than a decade the implementation of decentralization shows a variety of phenomena. On the one hand shows positive results compared to the era before decentralization such as increasing regional economic growth, transparency and empowerment of the region politically, administratively and economically (Hadi and Priyo, 2005). But on the other hand, mass media coverage indicates an increase in abuse of authority

in the regions after decentralization. Decentralization is carried out with the authority to allocate the budget in accordance with the full discretion of each region but this pattern makes the implementation not in accordance with what was previously aspired. The emergence of the practice of dynastic rulers in the regions and the rampant corrupt behavior of public officials makes fiscal decentralization and regional autonomy nothing but merely removing negative externalities from the government. Conducted by the Corruption Eradication Commission. The results of the Public Integrity Survey show the average value of the regional government integration index is below the central agency, which is 6.82 while the central agency is 7.37 (Indonesian Corruption Eradication Commission, 2013). Likewise in the regional government financial reports, weaknesses in the internal control system were still found and findings of non-compliance with statutory provisions, which resulted in indications of losses,

potential losses and lack of revenue. In the summary report on the results of the audit the findings of the weaknesses in the internal control system and non-compliance with legislation have not shown any meaningful improvement (Indonesia Supreme Audit Agency, 2017). The lack of maximum governance, raises public awareness of the importance of governance, transparency and accountability (Ichsan et al., 2014).

One form of government transparency in the management of public finances is the management of the preparation of financial statements. From the audit report of the Supreme Audit Agency, North Sulawesi Province there are still weaknesses in the management of regional finances, including in the internal control system, non-compliance with legislation, and management of regional assets. There are still regional governments that get a fair opinion with an exception. The specific research objective is to provide a model for developing the quality of local government financial reporting in terms of the implementation of good governance government and the effectiveness of the internal audit function (study of local government in North Sulawesi Province, Indonesia). In addition, it can contribute to the development of local government financial reporting quality science as a scientific justification for research that links the variables of good government governance and the effectiveness of the internal audit function.

## 2. LITERATURE REVIEW

### 2.1. Good Government

Good governance is the most prominent issue in the management of public administration. Governance focuses on governance mechanisms that refer to the processes of formal and institutional institutions that operate to facilitate collective action and maintain public order. The concept of governance also refers to the creation of structures or rules both internally and externally as a result of the interaction of many actors regulating one another (Stoker, 1998).

The United Nations Development Program (UNDP) in 1997 formulated the principles of government governance as capable, responsive, inclusive, and transparent. According to UNDP, good or democratic governance requires participation. Improvements in governance must include many people who have a voice in decision making. United nations explained the principle of good governance is promotes equity, participation, pluralism, transparency, accountability and the rule of law. The most recent definition of good governance for the public sector was put forward by the International Federation of Accountants/IFAC (2014) namely governance comprises the arrangements put in place to ensure that the intended outcomes for stakeholders are defined and achieved.

Good governance is characterized by strong supervision, improved public sector performance and handling of corruption. Good governance can improve organizational leadership, management and oversight, produce more effective interventions, and ultimately lead to better outcomes with improved community life (IFAC, 2014). The International Federation of Accountants in the International Framework: Good Governance in Public Sector

states that Good Governance in the public sector encourages better use of information and helps long-term decision making. Good governance enhances organizational leadership, management and oversight, by making interventions more effective and better output (International Federation of Accountant, 2010).

The principles of Good Governance are (IFAC, 2014)

1. Behaving with integrity, demonstrating strong commitment to ethical values, and respecting the rule of law
2. Ensuring openness and comprehensive stakeholder engagement
3. Defining outcomes in terms of sustainable economic, social, and environmental benefits
4. Determining the interventions necessary to optimize the achievement of the intended outcomes
5. Developing the entity's capacity, including the capability of its leadership and the individuals within it Managing risks and performance through robust internal control and strong public financial management
7. Implementing good practices in transparency, reporting, and audit, to deliver effective accountability.

### 2.2. Effectiveness of the Internal Audit Function

Furthermore Sawyers et al. (2003) defines internal audit as follows: "Internal auditing is a systematic objective appraisal by Internal Auditors of the diverse operations and controls within an organization" Internal audit use to determine: (1) financial and operating information is accurate and reliable; (2) risks to the enterprise are identified and minimized; (3) external regulations and acceptable internal policies and procedures are followed; (4) satisfactory operating criteria are met; (5) resources are used efficiently and economically; and (6) the organization's objectives are effectively achieved-all for the purpose of assisting members of the organization in the effective discharge of their responsibilities. "According to Arens et al. (2014) and Boynton et al. (2006), Auditing is a process of gathering and evaluating evidence about measurable information, regarding an economic entity carried out by a competent and independent person to determine and report the suitability of information, with established criteria. More specifically, The Internal Auditor Professional (Moeller, 2010) states an internal audit: "Internal auditing is an independent appraisal function established within an organization to examine and evaluate its activities as a service to the organization."

According to the International Standard on Auditing (ISA) 610 (2009), "Using the Work of Auditor Internals", the goals/objectives of the Internal Audit Function vary in breadth depending on the size and structure of an entity and management needs.

According to Tugiman, 2004 an effective internal audit function must have independent characteristics, have competent staff, and be supported by adequate resources. According to Hermanson, et al. (2008), internal audit works effectively if:

1. There is something new that can be learned from the internal audit report
2. Internal auditors as the main actors in giving advice to the organization

3. Internal auditor's findings and recommendations have been communicated to management in a timely manner and can be understood and provide added value to changes in the organization
4. The head of internal audit communicates well with the audit committee, respected by management and external auditors
5. Internal auditors work to increase understanding of the organization, internal control and risk
6. Internal auditors are responsive to audit committee requests to work in certain areas that are at risk.

### 2.3. Quality of Financial Statements

According to Kieso et al. (2012: 4) financial reporting can be defined as the accuracy of financial statements in conveying information about the company's operations, specifically on the expected cash flow, so that investors can make investment decisions. Suwardjono (2010) states that financial reporting is the provision of management information that is to be conveyed through financial statements, because the information must be disclosed to meet the law, and government regulations (mandatory), or because of customs and because management itself considers the information useful for outsiders and willing to express it voluntarily.

Some definitions of the quality of financial reporting are broadly stated in the objectives of each study. Verdi (2006) states the quality of financial reporting as "the precision with which financial reports convey information about the firm's operations, in particular its cash flows, in order to inform equity investors." Other researchers define the quality of financial reporting as "the extent to which the financial statements provide true and fair information about the underlying performance and financial position", (Tang et al., 2008). However, the generally accepted definition is provided by Jonas and Blanchet (2000), which states that "... quality financial reporting is full and transparent financial information that is not designed to obfuscate or mislead users". The International Accounting Standards Boards (2010) issued the International Financial Reporting Standard (IFRS) which explains the Conceptual Framework For Financial Reporting. The purpose of financial reporting based on the Conceptual Framework For Financial Reporting is: "The objective of general purpose financial reporting is to provide financial information about the reporting entity that is useful to existing and potential investors, lenders and other creditors in making decisions about providing resources to the entity. Those decisions involve buying, selling or holding equity and debt instruments, and providing or settling loans and other forms of credit."

According to IASB (2010), the purpose of financial reporting is to provide financial information about the reported entity, which is useful for investors and creditors in making decisions regarding the allocation of resources for that entity. Furthermore, according to the international public sector accounting standards board (IPSASB) published by IFAC (2014), the objectives of financial reporting by public sector entities are to provide information about the entity that is useful to users for accountability purposes and for decision-making purposes.

Based on International Public Sector Accounting Standard Board / IPSASB (2010), the purpose of financial reporting by public

sector entities is to provide information about the entity, which is useful for Government Accounting Standards that have adapted to the International Public Sector Accounting Standards, stating that the purpose of government financial reporting is to provide useful information to users in assessing accountability and making decisions both economic, social and political decisions. Based on the definitions above, it can be concluded that quality financial reporting is financial reporting that produces information that is useful for its users, complete, transparent and not misleading, and meets the characteristics of quality financial information that is relevant, reliable, comparable, and understandable.

Quality characteristics of information referred to in the general purpose of financial reporting, as contained in the conceptual framework for general purpose financial reporting issued by the international public sector accounting standards board (2010). It has been adopted in the Republic of Indonesia government regulation No. 71 of 2010 concerning government accounting standards that have been adapted to the international public sector accounting standards (IPSAS), stating that the purpose of government financial reporting is to present useful information for users in assessing accountability and making good decisions economic, social and political. The dimensions of quality financial reporting based on the Republic of Indonesia Government Accounting Standards are as follows:

#### 1. Relevant

Financial statements can be said to be relevant if the information contained therein can influence users' decisions by helping them evaluate past or present events, and predict the future, and confirm or correct the results of their evaluations in the past.

#### 2. Reliable

Reliable, means that the information in financial statements is free from misleading notions and material errors, honestly presents every fact, and can be verified. Information may be relevant, but if the nature or presentation is not reliable then the use of the information can potentially be misleading.

#### 3. Comparability

Can be compared, meaning that the information contained in the financial statements will be more useful if it can be compared with the financial statements of the previous period or the financial statements of other reporting entities in general.

#### 4. Understandability

Understandability, meaning that the information presented in the financial statements can be understood by users and expressed in terms and terms that are tailored to the limits of the user's understanding.

Research on how to measure the quality of financial reporting has many variations and developments. Empirical assessment of the quality of financial reporting is also carried out in the context of specificity and preferences among several assessments (Dechow et al., 1996). The quality of financial reporting is examined indirectly by focusing on attributes that are believed to influence the quality of financial statements, such as earnings management, financial restatement, and timeliness (Cohen and Sayag, 2010).

Other researchers link the quality of financial reporting and corporate governance, internal control, revenue manipulation and fraud, and poor governance and internal control reduce the quality of financial reporting (McMullen, 1996).

### 3. METHODOLOGY

The object of research or also known as a unit of observation is a research variable or something construct that can produce characteristics and variables that will be the center of attention of researchers (Sekaran and Roger, 2013). The objects in this study are governance, internal audit effectiveness and the quality of financial statements. The unit of analysis in this study consisted of 8 districts/cities in North Sulawesi. The observation unit is the regional government inspectorate office and regional work units in 8 city districts in North Sulawesi. Data collection for this field research was carried out for 5 months through observation and interviews and provided a list of questions to respondents. The questionnaire was given to 112 respondents with a return rate of 58% or as many as 65.

The first test is to test the validity of the questions. Validity shows how far a test or set of operations measures what should be measured (Jogiyanto and Abdillah, 2009). Validity is related to the accuracy of the measuring instrument to achieve its goals. Validity test is used to measure the validity or validity of a questionnaire. A questionnaire is said to be valid if the questions on the questionnaire are able to reveal something that will be measured by the questionnaire (Ghozali, 2006). The validity test of this research uses the product moment correlation formula proposed by Pearson.

The reliability test of this research data used the Cronbach's coefficient Alpha formula. Cronbach's alpha coefficient is the reliability coefficient that is most often used because this coefficient describes the variance of items as well as evaluating internal consistency, with the formula (Riduwan, 2008). The most commonly accepted benchmark is the form of indicators that have a coefficient greater than 0.70, which is stated to be reliable, even though this number is not a fixed number. This means, if the research conducted is explanatory, then a value below 0.70 is actually still acceptable, as long as it is accompanied by empirical reasons that are seen in the exploration process.

The first data analysis is done changing data from ordinal to intervals using the method of successive interval (MSI). To measure how much influence the governance and effectiveness of internal audits have on the quality of financial statements, the test is carried out with a path analysis test. Path analysis is used with the consideration that the pattern of relationships between variables in the study is correlative and causality.

### 4. RESULTS AND DISCUSSION

#### 4.1. Research Results

To answer the research hypotheses regarding the effects of governance and the effectiveness of internal audit on the quality

of financial statements, path analysis is used. Research data for the studied variables were collected through distributing questionnaires with an ordinal measurement scale. So as to satisfy the data requirements used in the calculation of path analysis, at least they have interval measurement levels. Data on the responses of respondents through the research questionnaire were first transformed into interval measuring scales using the MSI. Governance variables and internal audit effectiveness in this study as causal variables (exogenous variables) and financial statement quality variables as effect variables (endogenous variables). From the research results obtained by the calculation of the path coefficient as shown in the following path structure equation  $Y = 0.821 X1 + 0.632 X2 + \epsilon$ .

Figure 1 show the path coefficient for the effect of governance (x1) on the quality of financial statements (Y) is positive with a value of 0.821. The path coefficient for the effect of the effectiveness of internal audit on the quality of financial statements (Pyx2) is positive with a value of 0.632. From the above equation it can be interpreted that each improvement of governance by one unit, it will improve the quality of financial statements by 0.821 units. Each increase in the effectiveness of internal audit by one unit, it will increase the effectiveness of internal audit by 0.632 units.

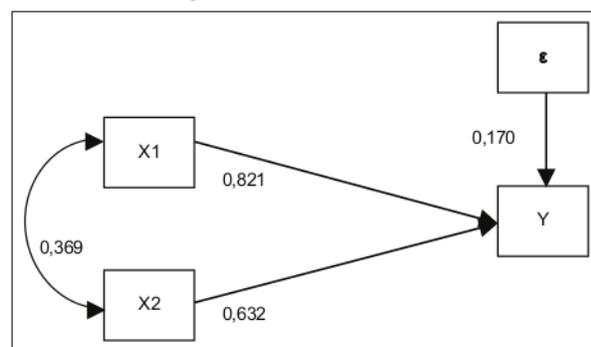
#### 4.1.1. Simultaneous path coefficient testing

The hypothesis testing is carried out through the F test statistics. Determination of the test results (acceptance of H1 or rejection of H0) can be done by comparing the Fcount. H0 is rejected; there is an effect of governance and internal audit effectiveness together on the quality of financial statements. So based on the test results it can be concluded that there is a significant (real) effect jointly between governance and internal audit effectiveness together on the quality of financial statements.

#### 4.1.2. Partial path coefficient testing

After the simultaneous testing procedure H0 is rejected, and it is concluded that there is a joint effect, then a partial test is performed to see the significance (significance) of the effect of X1, X2 partially on Y. The test is performed using t-test statistics. T<sub>count</sub> value is obtained from the calculation results with the help of SPSS 2 software. Hypothesis testing is done by looking at the comparison of t<sub>count</sub> with t<sub>table</sub> values. Ho is rejected if the t-value is greater than the table value. Table t values for error rates of 5%

Figure 1: Path coefficient results



and free degrees are 1,671. The results of the comparison between  $t_{count}$  with  $t_{table}$ .

4.1.3. Hypothesis 1 testing

Partial effect of governance (X1) on the quality of financial statements (Y).

The effect of partial governance on the quality of financial statements is shown by the path coefficient  $p_{yx1}$  of 0.821. The calculation results obtained  $t_{count}$  of 8.446. Empirical test results state the rejection of  $H_0$  or in other words the test is significant and means the hypothesis  $H_1$  is accepted. This decision was taken because it was obtained  $t_{count} = 8.446 > t_{table} = 1.671$  and the significance value for X1 was smaller than 0.05. From the results of partial hypothesis testing for variable X1, it can be stated that there is a significant positive effect of governance on the quality of financial statements.

The effect of partial effectiveness of internal audit on the quality of financial statements is shown by the path coefficient  $p_{yx2}$  of 0.632. The calculation results obtained  $t_{count}$  of 6.756. Empirical test results state the rejection of  $H_0$  or in other words the test is significant and means the hypothesis  $H_1$  is accepted. This decision was taken because it was obtained  $t_{count} = 6.757 > t_{table} = 1.671$ . From the results of partial hypothesis testing for variable X2, it can be stated that there is a significant positive effect of the effectiveness of internal audit on the quality of financial statements.

The magnitude of the simultaneous influence of governance and the effectiveness of internal audit on the quality of financial statements is indicated by the value of R-square ( $R^2$ ) which is equal to 0.624 or 62.4%.

Table 1 shows that effect of governance variables and internal audit effectiveness is 0.624 or 62.4%, while the influence of other factors on the quality of financial statements is indicated by the value of 0.376 or 37.6%. In other words, the variable quality of financial statements is 62.4% by the variables of governance and internal audit effectiveness. The remaining 37.6% of the variable quality of financial statements by other variables not examined.

4.1.4. Partial influence of governance on the quality of financial statements

The results showed that governance affects the quality of financial statements partially. Based on the correlation values and path coefficients obtained, it can be seen the magnitude of the direct and indirect effects of governance on the quality of financial statements as in the Table 2:

Table 2 shows that the results obtained when viewed directly in the absence of other variables indicate that governance affects the quality of financial statements by 67.4% and the value of the indirect effect of the effectiveness of internal audit is 19.1%. Through the effectiveness of internal audit, the total effect of partial governance on the quality of financial statements is 86.8%.

4.1.5. Effect of effectiveness of internal audit on the quality of financial statements

The results showed the effect of internal audit effectiveness on the quality of financial statements partially. Based on the correlation

values and path coefficients obtained, it can be seen the magnitude of the direct and indirect effects of the effectiveness of internal audit on the quality of financial statements in the Table 3.

Table 3 shows that the results obtained when seen directly in the absence of other variables indicate the effectiveness of internal audit affects the quality of financial statements by 39.9%. Through governance, the total effect partially on the effectiveness of internal audit on the quality of financial statements is 54.7%.

4.2. Discussion

The magnitude of the coefficient of determination (R-Square) of 62.4%, while other factors that influence are at 37.6%. This means that governance variables and internal audit effectiveness simultaneously influence the quality of financial statements. While the influence of other variables not examined was 37.6%, such as organizational commitment, decentralization, and other factors.

Governance is hypothesized to have a positive influence on the quality of financial statements. The path coefficient of the governance variable on the quality of the financial statements is 0.821. Furthermore, the  $t_{count}$  of the path coefficient of the governance variable on the quality of the financial statements is 8,446. Because the value of  $t_{count}$  is greater than the  $t_{table}$ , it is concluded that governance has a significant effect on the quality of financial statements.

The results showed that governance affects the quality of financial reports in district/city SKPD in North Sulawesi Province. This means that the higher the governance, the better

Table 1: Magnitude of the path coefficient

Variable	Path coefficient	Simul-taneously effect	Effect of residue
Good government (X1)	$P_{yx1}=0.821$	0.624	0.376
Effectiveness of internal audit (X2)	$P_{yx2}=0.632$		

Source: Research result, 2019

Table 2: Effect of Variable X1 on Y

Effect	Number of contributions
The direct effect of X1 on Y ( $0.821 \times 0.821$ )	0.674 or 67,4%
The indirect effect of X1 on Y through X2 ( $0.821 \times 0.369 \times 0,632$ )	0.191 or 19,1%
Total effect	86,8%

Table 3: Effect of variable X2 on Y

Effect	Number of contributions
The direct effect of X2 on Y ( $0.632 \times 0.632$ )	0.399 or 39,9%
The indirect effect of X2 on Y through X1 ( $0.632 \times 0.369 \times 0,632$ )	0.148 or 14,8%
Total effect	54,7%

Source: Research result, 2019

the quality of financial statements. Based on the test results obtained that the application of government governance has a direct positive effect on the quality of financial reporting. The results of this study support the hypotheses that have been built and provide empirical evidence that the better the implementation of government governance is implemented, the better the quality of financial statements will be. So it can be concluded that the better implementation of governance will improve the quality of financial reporting. The results of this study reinforce the Governance theory from Koimann (1993), Stoker (1998); Osborne (2010) as a process of managing activities properly and correctly in the public sector by providing strong services to the public clearly and clearly so that in the administration of the government so that it can organize a government free from corrupt, collusion and nepotism practices. Good governance is also characterized by strong supervision, which places important pressure on improving public sector performance handling corruption (IFAC, 2014).

#### 4.2.1. Effect of effectiveness of internal audit on the quality of financial statements

The effectiveness of internal audit is hypothesized to have a positive influence on the quality of financial statements. The magnitude of the path coefficient of the internal audit effectiveness variable on the quality of financial statements is 0.632. The path coefficient marked positive indicates that the more effective internal audit will make the quality of financial statements better. Furthermore, the  $t_{count}$  value of the path coefficient of the internal audit effectiveness variable on the quality of financial statements is 6,757. Because the value of  $t_{value}$  is greater than  $t_{table}$ , then it is concluded that the effectiveness of internal audit has a significant effect on the quality of financial statements.

The results showed that the effectiveness of internal audit affects the quality of financial reports of district/city work units in North Sulawesi Province. Based on the test results obtained that the effectiveness of the internal audit function has an indirect positive effect on the quality of financial reporting through the level of fraud with the strength of influence of 0.373. The results of this study support the hypotheses that have been built and provide empirical evidence that the better the effectiveness of the internal audit function, the lower the level of fraud. The lower the level of fraud, the more it can improve the quality of financial reporting. So it can be concluded the better the effectiveness of the internal audit function will increase the quality of financial reporting.

The above statement is in accordance with the theory that internal audit is a systematic and objective assessment by internal auditors of different operations and controls in an organization, among others, to determine whether financial and operating information is accurate and reliable (Sawyer, 2003). Arens and Loebbecke (2014) also revealed that an effective internal audit function (with independent, competent, and trained internal auditors), would achieve quality financial reporting. Arens and Loebbecke (2014) also stated that in an internal audit, the internal auditor is responsible for evaluating whether the financial statements have been presented fairly.

## 5. CONCLUSION

Referring to the testing of hypotheses, the results of the analysis of the discussion and the findings of the research results, the conclusions of the research can be put forward as follows:

1. Partially governance and effectiveness of internal audit have a positive effect on the quality of the financial statements of regional work units in the regency/city government in North Sulawesi Province. This can be interpreted by the application of good governance is the implementation of a solid and responsible government, as well as efficient and effective, by maintaining the synergy of constructive interaction between government domains, the private sector, and the interconnected community and the implementation of principle principles governance will improve the quality of financial statements. The better the effectiveness of the internal audit function, the lower the level of fraud, the more it can improve the quality of financial reporting. So it can be concluded the better the effectiveness of the internal audit function will increase the quality of financial reporting
2. Implementation of governance and internal audit effectiveness simultaneously have a positive effect on the quality of financial statements. The application of good governance indirectly has a positive effect on the quality of financial reporting through the effectiveness of internal audit. Application of principles in good governance will reduce fraud. The number of findings of irregularities and fraud in the examination of financial statements, can reduce the quality of government financial statements. So that the application of governance affects the quality of financial reporting. The effectiveness of the internal audit function has a positive effect on the quality of reporting. An effective internal audit function that is demonstrated by good audit quality, professional ability of internal audit, organizational arrangements and the added value contribution of internal audit, can detect fraud. The more effective the implementation of internal audit, the better the quality of local government financial reporting.

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