

# The Impact of Internal Audit Function Effectiveness on Quality of Financial Reporting and its Implications on Good Government Governance Research on Local Government Indonesia

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## Abstract

The purpose of this research is to examine the impact of Internal Audit Function Effectiveness on the Quality of Financial Reporting and Its Implications on Good Government Governance. The research conducted on 70 working unit area device on 7 District Local Government in eks Karesidenan Pekalongan Indonesia uses survey methods. The data is primary data collected through questionnaire. The samples selection uses proportionate stratified random sampling method. The data was processed using structural equation modeling (Partial Least Square). The results of this research show that: (1) From the results of test Kruskal Wallis, there are no significant differences between the effectiveness of the internal audit, quality financial reporting and the good government governance in 7 local government (2) the effectiveness of the internal audit function has significant effect on the quality of financial reporting. 3) Internal audit function has significant effect on Good Government Governance Application, 4) Quality of financial reporting has significant effect on Good Government Governance Application

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

## 1. INTRODUCTION

The management of good governance is one of the interesting topics that are often discussed. Good governance is a clean and respectable government (clean government) and a corruption-free. (Minister of State for Administrative Reform Taufiq Effendi, 2007). The survey of Transparency International Indonesia (TII) (2010) in its Annual Report reported that the triggering factors of corruption (corruption driver) of parameters bureaucratic process speed (Speed Up Process Beureucratic) happens, very prominent in Indonesia. Booz Allen and Hamilton in TII (2010) stated that the higher the level of corruption demonstrate accountability were not fully completed. According SPKN (2010), reflecting the high level of corruption is bad bureaucracy, which means also that the implementation of good governance is still far from expectations. Measurement Corruption Perception Index (CPI) which is conducted by Transparency International (TI) in 2013 resulted in that Indonesia ranks to 114 out of 177 countries, the CPI is used to compare the condition of corruption in a country against another country. ([www.ti.or.id](http://www.ti.or.id), 2013)

Implementation of good governance in the field of financial management, one of which is through the imposition of an obligation to the entire head area to prepare Local Government Finance Report (LKPD). From the results of the examination opinion not all local governments to prepare financial statements in accordance with Government Accounting Standards(SAP) and other regulations which has prevailed. Some findings show weakness that occurs in the making of financial statements so that upon inspection only 27% percent that gets LKPD WTP of 415 entities, BPK Chairman Hadi Purnomo (2011) claimed as many as 326 local governments, or 91% of the 358 local government whose financial statements are audited by the State Audit Board Finance awarded worse, only 32 local governments that received an unqualified opinion. He also stated that the internal audit function in Indonesia have not been effective because of the findings of an audit of LKPD. These findings are in the form of non-compliance with laws and regulations, fraud, and non-compliance in financial reporting that should be detected early by the inspectorate. With the number of audit findings by the BPK audit showed that the quality inspectorate officials are still relatively low. ([www.bpk.go.id](http://www.bpk.go.id)). According to Minister of State for Administrative Reform and Bureaucratic Reform Azwar Abubakar (2010), the Government requested the holding of Finance and Development Supervisory Agency (BPK) to achieve good financial governance in their respective governments. Because the financial management system in the area is poor.

LKPD examination results 2013 district / city revealed 5,405 cases worth Rp 2.07 trillion as a result of non-compliance with statutory provisions. Of the total audit findings on LKPD districts / cities, as many as 2,976 cases a finding that the financial impact of non-compliance findings against the statutory provisions which result in loss, potential loss, and the lack of acceptance Rp1,63 trillion worth. As for the rest of the findings of administrative irregularities, non effecient, and ineffectiveness as many as 2,429 cases worth Rp442,29 billion.

Based on the description that has been presented, the authors considered it important to do some

research as outlined by research the influence Effectiveness of Internal Audit Function on the Quality of Financial Reporting and Its Implications on Good Government Governance. The purpose of this study was to determine and obtain empirical evidence and get an answer how much influence the effectiveness of the internal audit function on the quality of financial reporting and its implication on Good Government Governance.

## **2.LITERATURE REVIEW**

### **2.1. Effectiveness of Internal Audit Function**

According to Etzioni, et al., (1985: 54-55); Mardiasmo (2002: 134) state that Effectiveness as the level of success of the organization in an effort to achieve the objectives and goals. Mauzt & Sharaf (1993) stated about the origin of the word auditing. Auditing is derived from the word "audire" which means to hear or pay attention, it is heard or considered is the financial responsibility submitted by the person in charge of financial (management). Auditing is a process of collecting and evaluating evidence about the information that can be measured, on an economic entity that is performed by a competent and independent to determine the suitability of the information and reporting, with the criteria set (Arens et.al, (2010) ; Boynton (2006)).

Internal auditing is an independent, objective assurance and consulting activity designed to add value and improve an organization's operations. (Spencer, 2010). It helps an organization accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control and governance processes. The Internal Auditor Professional (Moeller, 2010) defines internal auditing as follows: "Internal auditing is an independent appraisal function established within an organization to examine and evaluate its activities as a service to the organization". Internal quality audits according to Moeller include: 1). The level of compliance with IIA standards 2). The ability to audit plan 3). Execute audit findings 4). communicate audit findings

Definition of internal audit also noted by Carl Geffken (2004) in the Internal Compliance Audits, Internal auditing is a sure way to identify key staff responsibilities to assess how procedures are documented, to confirm how well staff and workers are trained in their assigned tasks, and to determine where significant control points are needed to assure your product quality by meeting written specifications. A well designed audit should address all the critical steps and opportunities for process flow from beginning to end. It should also identify how, where and when necessary corrections will be made, as well as how any specified and acceptable target conditions are controlled and documented. Furthermore Sawyers (2003: 10) defines a broad internal audit as follows: "Internal auditing is a systematic objective appraisal by Internal Auditors of the diverse operation and controls within an organization to determine whether: (1) financial and operating information is accurate and reliable; (2) risk to the enterprise are identified and minimized; (3) external regulations and acceptable internal policies and procedure 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."

The International Federation of Accountants (IFAC) in 2010 in the Handbook of International Public Sector Accounting pronouncements that formulate an effective internal audit function covers review implemented systematically, assessing and reporting on the reliability and effectiveness of internal control systems, financial, and operational control budgeting. According to Hiro Tugiman (2006) "Internal auditing is an independent appraisal function within an Organization for a test and evaluate the activities of the organization are carried out". Qualification internal audit is included independence, professional proficiency, scope of work, inspection activities and the management of internal audit.

### **2.2. Quality of Financial Reporting**

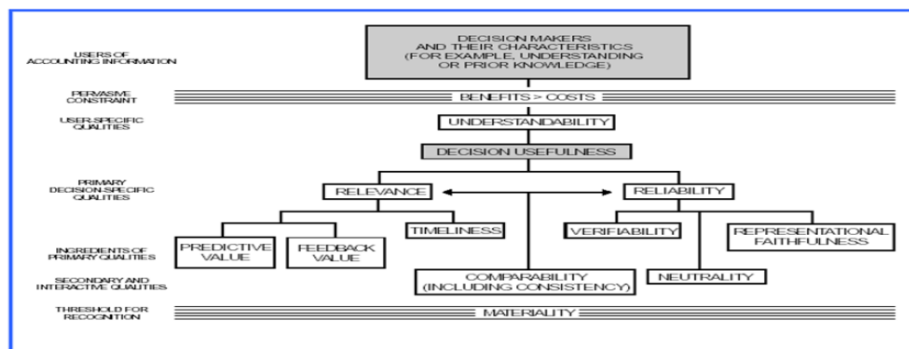
The definition of quality according to the Office Of Government Commerce ( 2009: 48) is degree to which a set of inherent characteristics fulfills requirements. Quality is generally defined as the totality of features and inherent or assigned characteristics of a product, person, process, service and/or system that bear on its ability to show that it meets expectations or satisfies stated needs, requirements or specification. According to Hall (2011) in Accounting Information system, the dimensions of information quality Consist of relevant, timeliness, accuracy, completeness and summarizing. According Gellinas (2005) in Accounting Information systems mentioned Dimensions of the quality of informations are accurate, timely, relative, and completeness.

The financial statements are a statement in the reporting entity's financial statements components, is a form of financial management accountability country / region over a period. The financial statements of the public sector is basically a form of government accountable to the people for the management of public funds either from taxes, fees or other transaction. (Masmudi, 2003). There are two public sector financial reporting purposes, the general and specific objectives. Common purpose to provide useful information and meet the needs of the user. Specific objectives to identify resources obtained and used in accordance with the approval of DPR / DPRD; provides information on resource allocation, financing, commitments and liabilities, financial condition, and changes in public sector organizations, the information to evaluate the performance of public sector

organizations. (Public Sector Committee - International Federation of Accounting Committee, 2010). The components of the public sector report in the International Public Sector Accounting Standards (IPSAS, 2010) consists of: Statement of Financial Position, Statement of Financial Performance, Statement of Changes in Equity, Cash Flow Statement, Accounting Policies and Notes to Financial Statements, whereas in SAP 2005 LKPD least consist of Budget Realization Report, Balance Sheet, Cash Flows and Notes to the Financial Statement .

Statement of Financial Accounting (SFAC) No. 2 sets of qualitative characteristics of accounting information as follows: Relevance, Timeliness, Reliable, Consistency. According to Azhar Susanto (2004: 40), a quality information must have the characteristics of (1). Accurate. It means that information must reflect the actual situation. (2). Timely. It means that information must be available or exist on when the information is required. (3). Relevant. It means the information-provided must be in accordance with the required one. (4) Completeness. It means information should be given in completes.

**Figure 1 Hierarchy of Accounting Quality**



Qualitative characteristics of financial statements useful in convincing financial information useful in making economic decisions (FASB, 1980).

## 2.3. Application of the Principles Good Government Governance

### 2.3.1. Understanding Good Government Governance

The issue of corporate governance (CG) coincided with the development of the corporate system in the UK, Europe, and the United States around the 1840s (Tjager, Alijoyo, Djemat, Soembodo, 2003). Cadbury Report itself defines CG as "the system by which organisations are directed and controlled". Asian Development Bank (ADB) (1995) defines governance. The United Nations Development Programme (UNDP) (1997) defines governance as "the exercise of political, economic and administrative authority to manage a nation's affairs at all levels". Based on the definition of governance according to UNDP, it is known that governance has three legs (legs tree), namely politics, economic, and administrative

Kooiman (1993), argued that good governance is a process of social and political interaction between government and private entities in a variety of fields related to public interests and government intervention on these interests. Furthermore, according to Lembaga Administrasi Negara/LAN (2000), good governance is a solid state governance and responsible, as well as efficient and effective, to maintain the unity of constructive interaction between domains of government, the private sector, and society are interconnected and perform its functions respectively. Good governance is often defined as good governance. Good governance in the sense of containing two (BPK, 2002: 6), namely

- (1) the values that uphold the desire of the people, and the values that can improve people's ability to achieve the national goal of self-reliance, sustainable development and social justice;
- (2) the functional aspects of an efficient and effective government in the execution of their duties to achieve these goals.

Based on the results of the Asian Development Bank (1999), concluded that there is a positive correlation between good governance to development outcomes. In addition, the practice of good governance can also improve the climate of openness, participation, and accountability in accordance with the basic principles of good governance in the public sector

### 2.3.2 Characteristics of Good Governance

According to UNDP (LAN & BPK, 2000), the principles of good governance are: Participation, Rule of Law, Transparency, Responsiveness. ADB explained that good corporate governance contains four core values namely, accountability, transparency, predictability and partisipation. According Mardiasmo (2002: 25) of the criteria of good governance is transparency, accountability and value there are four important principles of good governance: Transparency, accountability, predictability is the same as the rule of law and participation.

From some of the characteristics described above, can be taken three pillars of the basic elements that

for money (economy, efficiency and effectiveness). According to the Organization for Economic Cooperation and Development (OECD) good governance criteria consisted of: fairness, transparency, accountability, responsibility (Sukrisno Agoes, 2004). According to the World Bank (Tjokroamidjojo, 2000) are interrelated to each other and realize good Governance (Osborne and Geabler, 1992, OECD and World Bank, 2000, LAN and BPK, 2000; Bappenas, 2003) are as follows:

1. Transparency, namely openness in government management, environmental, economic and social.
2. Participation, namely the application of democratic decision-making and recognition of human rights, press freedom and freedom of expression / aspirations of the people.
3. Accountability, namely the obligation to report and answer of the mandate entrusted to account for success or failure, which gave the mandate to be satisfied and if not satisfied can be subject to sanctions.

### **3. Theoretical Framework**

#### **3.1. Influence of Internal Audit Function on the Quality of Financial Reporting**

Research by Mohammed Al-Shetwi etc (2011) states that a weak relationship between the internal audit function and the financial statements in Saudi Arabia. Cagle, Corey S in audit and report compilation timeliness in local Governments stated that the government audit and financial statements must be relevant, prepared and shown to the public periodically. This study also discusses the influence of an audit into the compilation report on the government's delay.

Diamond (2002) states is an important component in the government, financial management, and tools to improve government performance. Another study presented by Angus Okechukwu Unegbu. Mohammed Isa Kida. (2011) shows the internal audit effectively in detecting fraud and fraudulent activity in Kano State. In another study experienced that the Internal Audit Function improve the control environment will be reflected in the quality of financial reporting in terms of reducing error reporting (Gordon and Smith, 1992) blocking financial reporting irregularities (Schneider and Wilner, 1990) and increase investor confidence in the effectiveness of corporate control and the reliability of financial reporting (Holt and DeZoort, 2009).

From some of the research can be with the implementation of public sector audit conducted by the inspectorate at the local level resulted in better quality of financial statements. Public sector audit is done by using a financial audit, performance audit and investigative will make financial statements are prepared is better because it will be always so supervised and inspected regularly by auditors. The function and role of government auditors is also very important because they are monitoring and overseeing the entity's results of operations.

#### **3.2. Influence of Internal Audit Function on Good Government Governance**

Research conducted between internal audit and Good Government Governance has been done in some countries. Khemakhe (2001) in Tunisia expressed the need for public sector audit and the auditor's role in supporting the Good National Governance with a new auditing approach is called the Integral Audit. In Nepal, Satyal (2006) studied the Audit Profile: Office of the Auditor General of Nepal, recommends that the role of the auditor in auditing to improve good governance through accountability and transparency in the public sector. Felix (1978) in New York in the writing of the Public sector auditing: New opportunities for CPAs recommend that the need for public sector audit conducted by the Office of the Public Accountant in the private sector to create better governance and transparency.

Research in Pakistan by Hussain (2001) on "the role of Pakistan's national SAIs in promoting good governance", the role of auditors recommend in favor of good governance. Agung Rai (2008), in "The Role of Indonesia's Supreme Audit Institution (SAI) in Improving National Good Governance and Control" in Indonesia, also recommends the auditor's role in supporting good governance. I Gusti (2008) which states the role of internal audit of the National Good Governance. Gramling, et al (2004) and Leung, Philomena, et.al (2009) also stated the influence of the internal audit function to Good Governance.

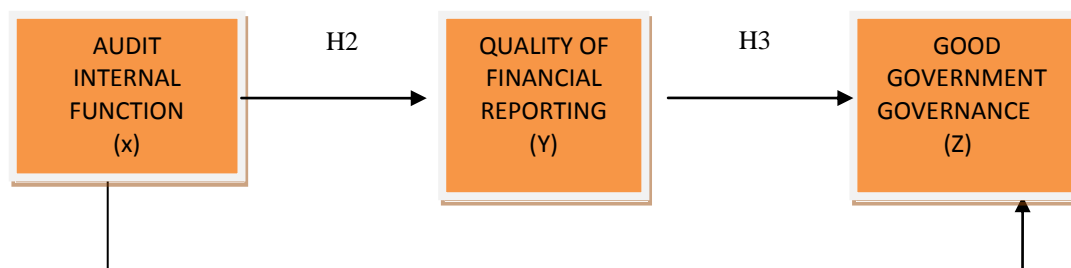
#### **3.3. Influence Quality of Financial Reporting on Good Government Governance**

Reporting form LKPD made by each local government must satisfy the qualitative characteristics of financial statements. Qualitative characteristics of financial statements is normative measures that need to be realized in the accounting information so that it can fulfill its purpose. These four characteristics as normative preconditions necessary for the financial statements of the government can meet the desired quality is relevant, reliable, understandable, and comparable (PP 24, 2005).

Yousef Shahwan (2008) which revealed that in order to be useful in decision making, the financial statements must be relevant and reliable. In general, the qualitative characteristics can be met if the proficiency level and the preparation of financial reporting is based entirely on the Government Accounting Standards. Robert Bushman, (2004) states limited transparency of firms operations to outside investors increases demands on governance systems to alleviate moral hazard problem. Reck, JL (2001) stated financial information and non-

financial effect on performance evaluation (compliance and financial accountability) and non-financial performance (accountability efficiency and effectiveness). Research by Burnaby et al. (1994) reported that the Governmental Accounting Standards Board (GASB) has initiated research as a way to enhance the reporting capabilities.

Frameworks in this study shown in Figure 2 below



#### IV. HYPOTHESIS

H4

A hypothesis is a tentative conclusion that should be tested or proven to be true (Sekaran, 2003). Based on the research problem, and a framework that has been stated previously, the research hypothesis can be formulated as follows: 1. There is a difference between the effectiveness of the internal audit function, the quality of financial reporting and the implementation of Good Government Governance in seven local government. 2. The effectiveness of the internal audit function affect quality of financial reporting 3) the effectiveness of the internal audit function affect good government governance 4) Quality of financial reporting affect good government governance

#### V. RESEARCH DESIGN

The research method used in this research is research that is the explanatory research, because it is a study that explains the causal relationship among the variables (Cooper and Schindler, 2006: 154). The unit of analysis in this study is 70 the Regional Working Units (SKPD) in 7 Local Government eks Karesidenan Pekalongan, Indonesia. The respondents are the Local Government Unit Leader, and Treasurer of each section on education. This research was carried out early in 2014.

#### VI. RESEARCH RESULTS

Variability of test results for each district using the Kruskal-Wallis test. This test is used to see whether there are differences in the effectiveness of the internal audit function, financial reporting quality and goodgovernment governance in each district. From the test results obtained probability value of 0.894 for the internal audit, 0.527 for the quality of financial reporting, and 0.871 for the implementation of Good Government Governance. This means that of the three variables, there were no significant differences between districts / cities in the former residency of Pekalongan. The dimensions of the variable effectiveness of internal audit, an independent gets the lowest value of 4.12. Lowest dimension of the variable quality of financial reporting is that it can be understood by 4,258. Of good government governance, transparency dimension is the lowest received sufficient assessment of 3,977.

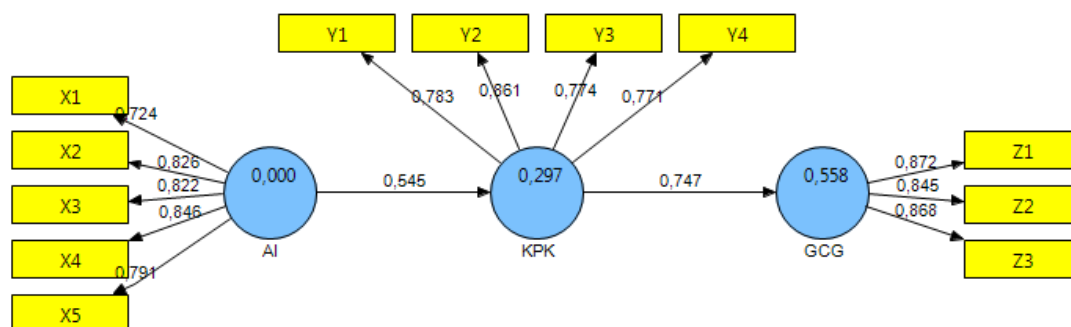
#### **The effectiveness of the internal audit function influence on the Quality of local government financial reporting And Its Implications On Good Government Governance**

The data was processed using structural equation modeling (SEM), the data must first be converted into ordinal scale intervals through the method of successive intervals are then processed using structural equation modeling with variance component-based or famous partial least square alternative method.

#### **Measurement Model**

Measurements using Partial Least Square estimation method, obtained full path diagram models, influence the effectiveness of the internal audit function of the quality of local government financial reporting and its implications on Good Government Governance application

**Figure 3 Coefficient Standards Structural Modeling**



**Weighting factor variable effectiveness of the internal audit function**

Variabel Manifest	Loading factor	Measurement model	R <sup>2</sup>	t <sub>hitung</sub>
Independence	0,724	AI = 0,724 X <sub>1</sub> + 0,476	0,524	15,211
professional capabilities	0,826	AI = 0,826 X <sub>2</sub> + 0,318	0,682	13,690
scope of the assignment	0,822	AI = 0,822 X <sub>3</sub> + 0,324	0,676	39,213
implementation of examination	0,846	AI = 0,846 X <sub>4</sub> + 0,284	0,716	25,882
Management of the audit	0,791	AI = 0,791 X <sub>5</sub> + 0,375	0,625	15,571
<b>Composite reliability(CR) = 0,900</b>				
<b>Average Variance Extracted(AVE) = 0,645</b>				

**Weighting factor variable quality of financial reporting**

Variabel Manifest	Loading factor	Measurement model	R <sup>2</sup>	t <sub>hitung</sub>
Relevant	0,783	KPK = 0,783 Y <sub>1</sub> + 0,388	0,612	9,419
Reliable	0,861	KPK = 0,861 Y <sub>2</sub> + 0,260	0,740	36,165
Comparability	0,774	KPK = 0,774 Y <sub>3</sub> + 0,401	0,599	21,888
Understanding	0,771	KPK = 0,771 Y <sub>4</sub> + 0,405	0,595	15,395
<b>Composite reliability(CR) = 0,875</b>				
<b>Average Variance Extracted(AVE) = 0,637</b>				

**Weighting factor variable Good Governance Government**

Variabel Manifest	Loading factor	Measurement model	R <sup>2</sup>	t <sub>hitung</sub>
Transparancy	0,872	KUB = 0,872 Z <sub>1</sub> + 0,239	0,761	47,404
Participation	0,845	KUB = 0,845 Z <sub>2</sub> + 0,286	0,714	30,230
Accountability	0,868	KUB = 0,868 Z <sub>3</sub> + 0,247	0,753	33,050
<b>Composite reliability(CR) = 0,897</b>				
<b>Average Variance Extracted(AVE) = 0,743</b>				

**Structural Models.**

**Statistics Summary Test Results**

Sub Structure	Path	Coefficient	T <sub>test</sub> *	R-Square
Pertama	AI → KPK	0,545	5,253	0,297
Kedua	AI → GCG	0,407	5,217	0,165
Ketiga	KPK → GCG	0,747	19,441	0,558

\*t<sub>kritis</sub> = 1,96

The effectiveness of the internal audit function by 29.7% effect on the quality of financial reporting of local government, while the remaining 70.3% is the influence of other factors not examined. The effectiveness of

the internal audit function gives the effect of 16.5% against the good government governance, while the remaining 83.5% is the influence of other factors not examined. Then the quality of financial reporting by local governments to give effect to the application of the 55.8% of the principles of Good Government, Governance while the remaining 44.2% is the influence of other factors not examined. Hypothesis test to prove whether there is influence effectiveness of the internal audit function of the quality of local government financial reporting and the implications on the application of the principles of Good Government Governance.

**a) Influence Effectiveness of internal audit function on the Quality of financial reporting**  
 Structural Equation Influence Effectiveness of internal audit function on the Quality of financial reporting

Endogenous Constructs	Exogenous Constructs		Error variance
	AI		
KPK	0,545 (5,253)		0,703

Partially effectiveness of the internal audit function by 29.7% effect on the quality of financial reporting. While the remaining 70.3% is the influence of factors other than the exogenous variables researched.

**b) Influence Effectiveness of internal audit function on the Good Government Governance**

Endogenous Constructs	Exogenous Constructs		Error variance
	AI		
GCG	0,407 (5,217)		0,835

Partially, the internal audit function by 16.5 to give effect to the application of the principles of Good Government Government Governance. While the remaining 83.5% is the influence of factors other than the two exogenous variables researched.

**c) Influence of quality financial reporting on Good Government Governance**

Endogenous Constructs	Exogenous Constructs		Error variance
	KPK		
GCG	0,747 (19,441)		0,442

Partially, the quality of financial reporting or local governments contributed 55.8% to the effect of the application of the principles of Good Government Governance, district in Central Java. While the remaining 44.2% is the influence of factors other than the two exogenous variables researched.

Based on the test results can be seen in the value of t test Effectiveness of internal audit function (5.253) is greater than t critical (1.96). Since the value of t is greater than the t critical, then the error rate of 5% was decided to reject Ho, so Ha is accepted. So based on the test results it can be concluded that the effectiveness of the internal audit function is partially an effect on the quality of financial reporting on the local government districts in the former residency of Pekalongan city. This is in line with research conducted by Cagle, Corey S (2012), Diamond (2002), Angus Unegbu Okechukwu (2011). Gordon and Smith, (1992) and Schneider and Wilner, (1990) and DeZoort T (2009).

The effectiveness of the internal audit function is weak positive effect of 29.7% on the quality of financial reporting of local government, while the remaining 70.3% is the influence of other factors not examined. In addition to the internal audit, there are other factors that may affect the quality of financial reporting, including the commitment of the organization, accounting information systems, organizational culture, budgeting and so on. Judging from the size of the effect of the internal audit function in line with Mohammed Al-Shetwi etc (2011) which states the internal audit function has a weak influence on the quality of financial reporting (FRQ)

Adams (1994) illustrates that the agency theory help explain the existence of internal audit within the company. Internal audit monitoring to reduce information asymmetry. According Lepto Spira and Page (2003), internal audit can add value by helping organizations achieve economy, efficiency and effectiveness (Al-Twaijry et al, 2003) through management consulting and assist in the management of the organization According to Sawyer (2003: 35), a professional internal auditor should have the independence to fulfill their professional obligations; give opinions, not biased, and not be restricted; and report the problem for what it is, not as you wish to report executive or agency. Internal auditors should be free of obstacles in carrying out his job as an auditor. Only the so-called internal auditors can work with professional duties.

The phenomenon that the quality of internal audit conducted by the local government needs to be improved. This is consistent with the results of research conducted that of indicators of internal audit, an independent who got the lowest score. This is because as far as the internal audit inspectorate colleagues assess the auditee so that it could be possible in a less independent examination. This resulted in a lack of intensive monitoring of the financial statements.

Based on the results of data processing can be seen t test variable quality of financial reporting of local government (5,217) is greater than t critical (1.96). Because t test greater than t critical, then the error rate of 5% was decided to reject  $H_0$ , so  $H_a$  is accepted. Based on the test results it can be concluded that the effectiveness of the internal audit function partially affect the application of the principles of Good Government Government district municipalities in the former residency of Pekalongan. Internal audit function partially contribute or very weak positive effect of 16.5% against the application of the principles of Good Government Government government's former city district residency of Pekalongan

Why internal audit relationship is very small, this is because the internal auditor has been assessed by the institution possess standards and norms to check. Nevertheless, the lack of independent auditors less area can make to local governments in managing government more transparent and accountable.

The research results support the research results of Khemakhe (2001), Agung Rai (2008), which states that there are significant public sector audit of the implementation of good government governance. Satyal (2006) recommends that the role of the auditor in auditing to improve good governance through accountability and transparency in the public sector. This research is also a matching of the results of research conducted by Felix (1978) in the United States, Hussain (2001) in Pakistan. Agung Rai (2008) Gramling, et al (2004) and Leung, Philomena, et.al (2009)

Based on the test results can be seen t test variable quality of financial reporting of local government (19,441) is greater than t critical(1.96). Because t test greater than t critical, then the error rate of 5% so it was decided to reject  $H_0$ ,  $H_a$  received. So based on the test results it can be concluded that the quality of local government financial reporting is partially affect the application of the principles of Good Government Governance on local government in the former residency of Pekalongan city. This is in line with research conducted by Yousef Shahwan (2008), Robert Bushman, (2004) and Reck, JL (2001).

From the results of this research is the quality of financial reporting local authorities have a positive influence enough for 55.8% of the application of the principles of Good Government Government, while the remaining 44.2% is the influence of other factors not examined.

This is in accordance with the facts on the ground that the studied SKPDs aware of the people's demands for good governance Improvement of transparency and accountability of fiscal or financial state is the most important part of the enforcement of governance or good governance. The audit of public sector that produces good quality financial reporting to help local governments more transparent and accountable.

Guthrie and Parker (1990) stated that the political economy perspective perceives accounting reports as a document that social, political and economic. They make it as a tool to build, support, and legitimize economic and political negotiations, institutions, and ideologies which it has contributed to the personal interests of the company. Disclosure that the capacity to convey the intent of social, political and economic for a pluralistic unity for report recipients. Factors participatory budgeting and political economy factors can be used as variables for further research studies that may explain the epsilon of 44.2%. The quality of financial reports of local governments in 7 local government in residency pekalongan also shown to have a strong positive effect on the application of the principles of governance as indicated by the magnitude of the effect was 55.8%. With the increasing quality of the financial reports of local government within the government can improve the application of the principles of good governance. This indicates that the quality of the financial statements as a form of local financial management transparent and accountable to all users of the financial statements of local governments is the decisive factor in the application of the principles of good governance.

## VIII. CONCLUSION

Based on the data analysis and discussion of research results, it can be concluded as follows; internal audit function has a positive effect on the quality of financial reporting. Internal audit Function has a positive effect on Good Government Governance. And, Quality Financial reporting has a positive effect on Good Government Governance.

From the results of different test Krusskal Wallis, obtained probability value of more than 0.05 which is equal to 0.894 for the effectiveness of the internal audit, 0.527 for financial reporting quality and 0.871 for the good government and governance, this means there are no significant differences between districts / cities in the former residency Pekalongan. Directly the effectiveness of the internal audit function accounted for 29.7% of the quality of local government financial reporting. Internal audit function partially contribute to or influence by 16.5% against Good Government Governance. Internal audit function partially contribute to or influence by



55.8% against Good Governance Government. The phenomenon that the quality of internal audit conducted by the local government needs to be improved. This is consistent with the results of research conducted that of indicators of internal audit, an independent who got the lowest score. This is because as far as the internal audit inspectorate colleagues assess the auditee so that it could be possible in a less independent examination.

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