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## The Influence of Transformational Leadership, Audit Committees' Role and Internal Control Toward Financial Reporting Quality and Its Implication on Investment Efficiency (Survey on Indonesia State Owned Companies of Non-Public Service and Non-Financial)

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**Abstract:** This research is aimed to investigate the influence of transformational leadership, audit committee's role, and internal control toward the financial reporting quality, and its implication on the investment efficiency in Indonesia. The new issue discussed in this research is the relationship between financial reporting quality and transformational leadership as such relationship has never been investigated. The primary data are based on questionnaires which are randomly distributed to 70 state-owned enterprises (SOEs) of non-financial and non-public service and the secondary data are in reference to audited financial statements. Data collected are of 56% response rate, and analyzed using the statistical software SEM-PLS. The research results provide empirical evidence that the financial reporting quality significantly influences on the investment efficiency. Meanwhile, financial reporting quality are influenced by transformational leadership and the roles of the audit committees. Unexpectedly, for this research data context, the internal control does not influence on the quality of financial reporting. These findings suggest that investment inefficiency in Indonesia will be solved if top management uses the information from a high financial reporting quality, and the financial reporting quality will be enhanced if top management implements the transformational leadership approach and strengthens the audit committees' role.

**Keywords:** Transformational leadership, audit committee's role, internal control, financial reporting quality, investment efficiency

### 1. INTRODUCTION

The United Nations Conference on Trade and Development (UNCTAD) ranked Indonesia as the third prime investment destination throughout the world in 2014-2015. The ASEAN Business Outlook Survey 2015 prescribed Indonesia as the most popular country for business expansion in ASEAN and the second ranking of investment destination country in Asia (Adityaswara, 2014; The Economist, 2015).

According to neo-classical economics theory framework, the key driver of investment is growth opportunity (Yoshikawa, 1980; Hayashi, 1982; Abel, 1983 in Biddle, *et al.*, 2009; Hubbard, 1990; 1997; Verdi, 2006; Shimin Chen, *et al.*, 2011). Unfortunately, Indonesia has not maximized its advantage of investment opportunity yet. The initial stage implementation of Masterplan Program Percepatan Pembangunan Ekonomi Indonesia (MP3EI) 2011-2014 for improving 22 sector of economic and infrastructure improvement was realized only 21.5% of total project value Rp4,000 trillion (Kementerian Keuangan, 2014). The similar problems exist in business, *e.g.* there are many unproductive asset investments and around 54% of SOEs' losses triggered by misinvestment decisions (Said Didu, 2014; Achsanul Kosasih, 2015). Other causes are such as illiquidity (Kompas, 2012), delayed project finishing and settlements (Lin Che Wei, 2007; Gatra, 2014), project cost markup (MaPPI-FHUI, 2012; Bahrullah Akbar, 2012), bad planning and short-term orientation (Media Pertamina, 2010).

The investment efficiency is influenced by the financial reporting quality (Verdi, 2006; Beatty, *et al.*, 2007; Biddle, *et al.*, 2009; McNichols and Stubben, 2008; Feng Chen, *et al.*, 2010; McDermott, 2011; Gomariz and Ballesta, 2014). Theoretically, financial reporting quality mitigates the imperfection of capital market caused by information asymmetry, moral hazard, and/or adverse selection that result in over-/under-investment (Hubbard, 1990; 1997; Verdi, 2006; Biddle, *et al.*, 2009; Gomariz and Ballesta, 2014). The financial reporting quality is defined as the managers' intention and attitudes to present information completely, neutral, and free from error so that it improves the accuracy in cash flow prediction (Miller, 2002; Richardson and Tuna, 2008; Baxter, 2007; Dechow and Skinner, 2000; Kepsu, 2012; Gaffikin, 2006). Financial reporting quality provides an accurate information about investment project and company risk (Hubbard, 1990; IASB, 2008;2010; Biddle, *et al.*, 2009).

However, financial reporting quality in Indonesia still has been in low quality. Compared to other countries, financial reporting quality in Indonesia was ranked sixth and seventh among eight countries in Asia Pacific in 2004 and 2005 and ranked 36<sup>th</sup> among 38 countries in 2000-2007 (Tang, *et al.*, 2011; 2012). The ADB (2014) and The World Bank (2010; 2011) found that the majority of public company's financial report did not comply with the accounting standard PSAK especially in the presentation and disclosure of information on segment and related party transaction. The Capital Market Supervisory Boards Bapepam-LK (2012) found that many annual reports did not comply with the regulation. Also, the financial services authority, OJK (2013) reported that many companies did not deliver their financial reports timely. Furthermore, Hasan Bisri (2013) announced that the Audit Board of the Republic of Indonesia BPK-RI frequently found manipulation and earnings management in SOEs' financial reports. In government, BPK-RI (2015) disclosed that 25% of central government and 70% of district government financial reports did not get clean or unqualified opinion.

Therefore, the World Bank (2011) suggests that in Indonesia, there is a need to enhance the quality of corporate financial reporting and to further strengthen the effectiveness of monitoring and enforcement mechanisms. According to BPK-RI (2015), generally, the low quality of financial reporting is caused by the negligence of the officers triggered by the weaknesses of monitoring activities. Bahrullah Akbar (2015) argued that the key of financial reporting quality is the leaders' strong commitment. Tarkosunaryo (2013), chairman of the Institute of Public Accountant in Indonesia (IAPI), asserted that without strong commitment of top management and those charged with governance, high quality financial information is just a fantasy.

In financial reporting 'supply chain', CEO and CFO are the most significant effect on financial reporting quality, and on fraudulent financial reporting (CAQ, 2010; 2013; Kepsu, 2012; Amernic, *et al.*, 2010; Beasley, *et al.*, 2010; Staicu, *et al.*, 2013). Thus, examining the relationship between the leadership and financial reporting quality is very important (Larcker and Tayan, 2013). Transformational leadership is a moral leadership that enable to mobilize all of the energy and resources in an entity to achieve its goals more efficiently and effectively (Yukl, 2010; Burns, 1978, Bass, 1985, Northouse, 2007 in Winkler, 2010). It is evidenced that transformational leadership is found more on successful companies than failed companies (Jandaghi, *et al.*, 2009; Andrea and Tsai, 2011). Concerning with this issue, we initiate to investigate the influence of transformational leadership on financial reporting quality. The superiority of the transformational leadership is its established dimensions and its instrument called the multi-factor leadership questionnaires (MLQ) (Avolio and Bass, 2006) is accurate, free from bias, and effective to measure (Shacklock and Lewis, 2007; Hemsworth, *et al.*, 2013; Bass and Riggio, 2006; Lievens, *et al.* 1997).

In order to strenghten the effectiveness of monitoring mechanisms, the audit committee is considered as the key element of financial reporting integrity and quality (Arens, *et al.*, 2014; IFC, 2014; Gorman, 2009; Ramanathan and Sim, 2010; DeZoort, *et al.*, 2002, Cohen, *et al.*, 2007 in Salleh and Stewart, 2012; DeZoort, 1997 in Elnaby, *et al.*, 2007). But, Kanaka Puradireja (2011), the honor board chairman of Ikatan Komite Audit Indonesia (IKAI), exclaimed that the role of audit committee was still ineffective yet, consequently it generates many discrepancies and negative effects on the company and its shareholders' values. Indreswari (2006) found that many audit committees cannot keep up with the ever changing in business environments as their elections were based on political backgrounds. Whereas, Cheetam and Chivers (1998) stated that a profession must reflect current best practices. Therefore, the effectiveness of audit committee's role should reflects in its membership, active involvement, control meeting agenda, information accuracy, formal communication, informal meeting, tone at the top, and leadership as introduced by the Audit Committee Institute based on its survey findings (ACI, 2014) as these fundamental factors are applied in practice globally and supported by previous qualitative research findings, *e.g.*. Gendron, *et al.* (2004), Gendron and Bédard (2006), Zain and Subramaniam (2007), Turley and Zaman (2007), Salleh and Stewart (2006; 2008; 2012), Beasley, *et al.* (2009).

Regarding to avoid, detect, and correct any error and fraud in financial reporting so that the company must have an internal control designed to present the financial report fairly (Garrett, *et al.*, 2012; Amernic, 2010; Ratcliffe and Landes, 2009). Internal control gives reasonable assurance for management and capital providers to achieve financial reporting objective (COSO, 2013; Pfister, 2009). However Muliaman D. Hadad (2011) said that weaknesses of Indonesia companies are loose internal control. Ashbaugh-Skaife, *et al.* (2008) (in Hunton, *et al.*, 2010) and Thanh and Cheung (2010) discovered that internal control could increase accounting quality. In contrast, low internal control quality associates with unrealized cash flow (Doyle, *et al.*, 2007). In order to enhance financial reporting quality, therefore there is a need to improve internal control system.

In accordance with phenomena, the research questions are identified as follows:

1. How much does the transformational leadership influence on the financial reporting quality.
2. How much does the audit committee's role influence on the financial reporting quality.
3. How much does the internal control influence on the financial reporting quality.
4. How much does the financial reporting quality influence on the investment efficiency.

## 2. LITERATURE REVIEW

### 2.1. Transformational Leadership

Based on research result and best-seller book of *'political leaders'* authored by James McGregor Burns in 1978, transformational leadership is becoming popular (Northhouse, 2013 in Cahayani, 2013; Yukl, 2010; Jandaghi, *et al.*, 2009). Transformational leadership focuses on leaders' interaction and attention to their followers' need so that the moral of leaders and their followers increases to the higher level (Burns, 1978; Bass, 1985; Northhouse, 2007 in Winkler, 2010; Burns, 1978 in Jandaghi, *et al.*, 2009). Transformational leadership activates moral intrinsically and mobilize all energy and sources more efficiently and effectively (Winkler, 2010; Suryani, 2014; Yukl, 2010).

Transformational leadership concept was then developed by Bass (1985) and Bass and Avolio (1990), consists of four principles, called "4i", *i.e.* idealized influence, inspirational motivation, intellectual stimulation, individualized consideration (Stone and Patterson, 2006; Bass and Avolio, 2002; Hall, *et al.*, 2012), and two transactional dimensions, *i.e.* contingent reward and management by exception (Avolio and Bass, 2002). Idealized influence is condition that followers identify themselves based on their leaders (Avolio and Bass, 2002; Shacklock and Lewis 2007). Inspirational motivation is ability to motivate and communicate the vision and mission persuasively and effectively (Avolio and Bass, 2002; Bass and Avolio, 1990 in Hemsworth, *et al.*, 2013). Intellectual stimulation maximalizes followers' intellectual by recognition to enhance followers' self-confidence to be inovative (Avolio and Bass, 2002; Bass, 1985 in Hemsworth, *et al.*, 2013). Leaders with individualized consideration treat followers personally and give special times for mentoring and coaching (Avolio and Bass, 2002, Bass, 1985; Avolio, *et al.*, 1988 in Hemsworth, *et al.*, 2013). Contingent reward relates to satisfied duties accomplishment (Avolio and Bass, 2002), and management by exception is proactive actions to keep away from any mistakes (Avolio and Bass, 2002).

Jandaghi, *et al.*, (2009) found that tranformational leadership is existed more on successful companies than failed companies. According to Avolio and Bass (2002), the real transformasional leaders can be observed easily through their orientations, values and moral improvements. Otherwise, pseudo-transformasional leader will have a long term orientation and value on self-interest. In Indonesia, Rudjito (2011) found that the better performance SOEs have been likely implement a tranformational leadership approach with prominently in inspirational motivation principle. Other studies in Indonesia found that transformational leadership positively associates with organizational committment, satisfaction and performance improvement (Annekinda and Rahmani, 2013; Atmojo, 2012; Thamrin, 2012).

### 2.2. Audit Committees' Role

The audit committee is recognized as the key element of corporate governance (Gorman, 2009). Thus, IFC (2014) declares that audit committee is the most important committee from the shareholder perspective. The audit committees' role and position is reinforced by Sarbanes Oxley Act (SOX) as a response on financial scandals of the Enron, WorldCom, and Tyco (Turley and Zaman, 2003; Cohen, *et al.*, 2004; Kumar and Singh, 2012). In Indonesia, roles and duties of audit committee for publicly companies are enforced in the decree of Bapepam-LK No: Kep-643/BL/2012 and for SOEs is in the decree of SOE Ministry No: PER-12/MBU/2012.

Eventhough the audit committes' role is recognized globally important, there is no universally definition of audit committee effectiveness. For examples, DeZoort, *et al.*, 2002 (in Ika and Ghazali, 2012) defined

effective audit committee as having high qualification, proper authority and resources, and diligent in monitoring the financial reporting. While according to the Guidance for audit committee announced by Financial Reporting Council (FRC, 2012) revealed that effectiveness of audit committee is determined by various factors, e.g. membership, meeting frequency, resources, remuneration, skill, experience, and training. Therefore, Wu (2012) argued that the lack of definition led poor measurements and resulted in inconsistent findings. For examples, in the Report of Fraudulent Financial Reporting 1998-2007, Beasley, *et al.* (2010) found that size of audit committee's member and the frequency of audit committee meeting between fraudulent and nonfraudulent companies are indifferent. According to Beasley, *et al.* (2009) "input" of audit committee as designated by the regulator can enhance the disclosures of corporate financial reports. Research in quality of "process" for effective audit committee such as qualitative study conducted by Gendron, *et al.* (2004) found that audit committee effectiveness is determined by ability to ask challenged questions. Gendron and Bédard (2006) discovered competency of formal leadership. Zain and Subramaniam (2007) and Turley and Zaman (2007) found informal communication and informal networks as determinant factors. Salleh and Stewart (2006; 2012) noticed factors such as power and authority, accounting and audit issues understanding, business skills, monitoring commitment, meeting control ability, information accuracy, advise skill, and problem solutions.

Cameron, 1981 (in Mohiuddin and Karbhari, 2010) stated that effectiveness is an elusive concept that can be approached through several models, none of them is appropriate in every circumstance. However, Cheetam and Chivers (1998) argued that in a profession, the concept of reflective professional becomes the core doctrine. Consequently, the concept of effectiveness is reflected on current professional practices. The most advantage in reflecting current best practice is that the inclusion of professionals' tacit knowledge.

### 2.3. Internal Control

Internal control was conceptualized originally by the AICPA in 1949. In 1992 the Committee on Sponsoring Organizations of the Treadway Commission (COSO) issued Internal Control Integrated Framework which is adopted broadly and recognized internationally (COSO, 1992; Moeller, 2009). It was accepted by the U.S. Securities and Exchange Commission (SEC) as a framework for verifying internal control over financial reporting (Half, 2015). In 2002, Sarbanes Oxley Act (SOX) 2002 section 302 mandates CEO and CFO to disclose the internal control effectiveness in their company's financial report, and Section 404 directs a mandatory disclosure of audit opinion on the effectiveness of internal control system in company's financial reporting (Doyle, *et al.*, 2006; He, 2009). In Indonesia, it is not mandatory yet for entity to disclose the audit opinion of internal control effectiveness, as stated in SA265.4 (IAPI, 2013) "the audit objective is not aimed to make an opinion on internal control effectiveness".

After twenty years since the original framework, as business and operating environments have changed dramatically and at the same time, stakeholders are more engaged, seeking greater transparency and accountability, in 2013, COSO updated the framework that can adapt to changes and can enhance the likelihood of achieving the entity's operation, reporting and compliance objectives. Reporting objectives pertain to internal and external financial and non-financial reporting and may encompass reliability, timeliness, transparency, or other terms as set forth by regulators (COSO, 2013). One of the biggest changes in the 2013 framework is the articulation of the 17 principles that are concepts underlying the five components. The 17 principles need to be present and functioning in an effective system of internal control (EY, 2014:5). Control environment principles are:

1. demonstrates commitment to integrity and values;
2. exercises oversight responsibility;
3. establishes structure, authority and responsibility,
4. demonstrates commitment to competence;
5. enforces accountability.

Risk assessment principles are:

6. specifies suitable objectives;
7. identifies and analyzes risks;
8. assesses fraud risk;
9. identifies and analyzes significant change.

Control activities principles are

10. selects and develops control activities;
11. selects and develops general controls over technology;
12. deploys thorough policies and procedures.

Information and communication principles are:

13. uses relevant information;
14. communicates internally;
15. communicates externally.

Monitoring principles are:

16. conducts an on-going and/or separate evaluation;
17. evaluates and communicates deficiencies (Martin, 2015).

According to the COSO board, the updated framework offers companies more effective internal controls, which will allow organizations to better mitigate risks and have the data necessary to support sound decision-making. This also helps put organizations on the right path toward confronting of cyber-attacks. Thus, adopting the 2013 framework will reflect commitment to integrity and ethical values and effective internal control to potential investors (Half, 2015). This new framework has also been socialized at a national symposium in Indonesia. An effective implementation of internal control system could mitigate risks and management is required to understand and design it comprehensively (BPK-RI, 2013).

#### 2.4. Financial Reporting Quality

Quality is a multidimensional concept (OECD, 2013). According to Richardson and Tuna (2008) financial reporting quality refers to the accuracy with which a company's reported financials reflect its operating performance and to their usefulness for forecasting future cash flows. While Miller (2002) stated that

quality of financial reporting is an attitude, not a set of specific practices. In this research, financial reporting quality is defined as manager's intention and behavior to present operational performance accurately so that cash flow prediction can be conducted easily (Dechow and Skinner, 2000; Miller, 2002; Richardson and Tuna, 2008). This definition implies that manager has no intention to misleading and deceiving financial report information (Jonas and Blanchet, 2000 in Baxter, 2007; Dechow and Skinner, 2000; Kepsu, 2012). This manager's intention and behavior in financial reporting is measured by the fact of lower estimation error embedded in the accruals process (Verdi, 2006), because the primary focus of financial reporting is information about earnings and its components (FASB, 2008).

Measurement models used generally are Dechow and Dichev (2002) and Jones (1991) (Francis, *et al.*, 2006). Dechow, *et al.* (1995) discovered that Jones (1991) model and modified Dechow, *et al.* (1995) model is more powerful for the explanation (Ton, 2011). Nevertheless, there is a weakness of Jones (1991) model which is focused on a particular survived company with bad performance, accordingly sample of extremely good performance companies have a tendency to become unreliable (Gerakos, 2012). Kothari, *et al.* (2001) modified Jones (1991) model by adding up control variable of performance (ROA) which demonstrates that researchers will be able to draw more reliable inferences if they use a performance-matched discretionary accrual measure (Kothari, *et al.*, 2001). The model is as follows:

$$TAC_i/TA_{i-1} = \alpha_1/TA_{i-1} + \beta_2(\Delta REV_i - \Delta AR)/TA_{i-1} + \beta_3 PPE_i/TA_{i-1} + ROA_i + \varepsilon_i$$

ROA<sub>*t*</sub> is performance at year *t*, because accrual is a common function to measure performance. ROA at year *t* is appropriately matching on ROA<sub>*t*</sub> performs better than matching on ROA<sub>*t-1*</sub>, (ΔREV<sub>*t*</sub> - ΔAR)/TA<sub>*t-1*</sub> is ratio of variance between changes of revenue and account receivable at year *t* divided by total asset at year *t* - 1 as explanatory on total accrual (Kothari, *et al.*, 2005).

$$TAC_i/TA_{i-1} = (\Delta CA_i - \Delta Cash_i - \Delta CL_i + \Delta DCL_i - DEP_i)/TA_{i-1}$$

TAC<sub>*t*</sub> is an estimation of total accrual at year *t*; ΔCA<sub>*t*</sub> is current assets changes at year *t*; ΔCash<sub>*t*</sub> is cash and cash equivalent changes at year *t*; ΔCL<sub>*t*</sub> is short term liabilities changes at year *t*; ΔDCL<sub>*t*</sub> is long term liabilities changes due at year *t*; DEP<sub>*t*</sub> is depreciation and amortization expense at year *t*; and TA<sub>*t-1*</sub> is total assets at year *t* - 1 for standardization and for avoidance of heteroscedasticity. ε<sub>*t*</sub> is residual value at year *t* as indicator of financial reporting quality which is unexplainable normal accrual on fundamental accounting of transaction and performance (Chen and Liu, 2010). Aaker (2009) stated that the matching procedure model Kothari, *et al.* (2005) performs best because of the relationship between accruals and performance.

## 2.5. Investment Efficiency

Investment is making an outlay on something with economic value, usually cash, at one point in time that is expected to yield economic benefits for the investor at some other point in time (Mc Laney, 2002 in Serfas, 2011). Based on its component, investment is divided into financial investment and capital investment. Capital investment is nonspeculative (Serfas, 2011) and considered as crucial importance to the business as it involves a large expenditure, not easily reversible, and has a significant effect on long term successful of business. Another characteristic is that capital investment is conducted rarely so that management has less experience on it (McLaney 2002, Drury 2004, Chadwick 1998 in Serfas, 2011). All characteristics of capital investment are considered as the key challenges for the success of every company (McLaney, 2006 in



Serfas, 2011). Financial economist admits that investment decision influences the growth of company eventhough it has significant risk (Berk, *et al.*, 1999 in Hsiao and Li, 2013). Accordingly, efficiency of investment can be achieved by optimizing resources input to productive level in order to get output for increasing company value (Rollins and Lanza, 2005; Pike and Neale, 2009; Fabozzi and Drake, 2009).

In a perfect market, investment is not influenced by internal cash availability (Modigliani and Miller, 1958 in Richardson, 2005), so that managers can focus their investment to fund a positive, even the highest NPV project (Hubbard, 1997; Baker and English, 2011; Kalyebara and Islam, 2014). However in the real world, there is no perfect market for the company (Fabozzi and Drake, 2009), therefore investment will not always response on opportunity growth (Ruiyuan Chen, *et al.*, 2013). Besides, managers do not always choose investment alternatives efficiently and suitably (Baker and English, 2011). Imperfection of market and inefficiency of investment particularly are caused by information asymmetry, agency conflict, or overconfident (Baker and English, 2011). Information asymmetry will trigger underinvest because managers refuse to make an investment even on a positive NPV (Baker and English, 2011). The refusal is also a reflection that lenders do not have perfect information about the riskiness of a firms' projects and the firm itself (Hubbard, 1990). As a result, expensive capital cost will obstruct investment opportunity even it is feasible (Myers and Majluf, 1984 in Richardson, 2006). The agency conflict can produce under- or overinvest (Baker and English, 2011), as mentioned in the agency theory of Jensen and Meckling (1976) and the separation of ownership and control of Berle and Means (1932) (in Biddle, *et al.*, 2009). Moral hazard will lead to overinvest eventhough it generates negative NPV (Biddle, *et al.*, 2009; Shimin Chen, *et al.*, 2011). Following previous studies, such as Biddle, *et al.* (2009), investment efficiency is measured as follows:

$$\text{Investment}_{t+1} = \beta_0 + \beta_1 \times \Delta S_{t-t-1} + \varepsilon_{t+1}$$

$\varepsilon_{t+1}$  is a residual value, the closer to zero point, the more efficient investment.  $\Delta S$  is sales growth. Sales growth data is used instead of  $q$  (Tobins'  $q$ ) because it is not influenced by company's ages, accounting standard changes, and easier to measure (Hubbard, 1990; Gao and Sidhu, 2014; Biddle, *et al.*, 2009).  $\text{Investment}_{t+1}$  is estimation of total investment following Hsiao and Li (2013) that investment variable that is acquired from accounting statistic data of property, plant, and equipment (PPE) is better than common capital expenditures data. For examples, Richardson (2005; 2006), Verdi (2006), Biddle, *et al.* (2009) used capital expenditure data added by acquisition and R&D then deducted by PPE disposal and depreciation and amortization to estimate total investment. Hsiao and Li (2013) evidenced that in relation with future growth, PPE growth is very powerful for most of industrial types or segments.

## 2.7. The Influence of Transformational Leadership on Financial Reporting Quality

Transformational leadership is a leadership model that leaders apply highly ethical standard and moral, so it becomes reference for followers (Avolio and Bass, 2002). Through transformational leadership, moral of leaders and their follower can be escalated to higher level because they will motivate each other to carry on the morality (Burns, 1978, Bass, 1985, Northouse, 2007 in Winkler, 2010; Burns, 1978 in Jandaghi, *et al.*, 2009). Financial reporting quality itself is a reflection of manager's attitude in presenting operational performance, cash flows and financial position information transparently and completely to support users in predicting cash flow accurately (Miller, 2002; Richardson and Tuna, 2008; Jonas and Blanchet, 2000 in Baxter, 2007; Robinson and Munter, 2004). Thus, transformational leadership could bring the philosophy of accounting as moral based social science.

Financial reporting requires intention and behavioral as fundamental element to present unobservable things in a relevance and faithful representation information by recording and presenting economic transactions completely, neutral, and free from error (Avolio and Bass, 2002; Gaffikin, 2006; Dechow and Skinner, 2000; IASB, 2008; 2010). In other words, transformational leadership will obstruct fraudulent or unintentionally error in financial reporting (Kalawksy 2005; Mavin 2007; SEC, 2007 in Luippold, 2009). Otherwise, there is some evidence that pseudo-transformational leader, which is self-oriented, self-aggrandizing, exploitative, and narcissistic, is associated with financial misreporting and a tendency to inflate financial results (Avolio and Bass, 2002; Larcker and Tayan, 2013). The concept of relationship between transformational leadership and financial reporting quality is as follows:

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### 2.8. The Influence of Audit Committees' Role on Financial Reporting Quality

In financial reporting supply chain, audit committee is admitted as the key element in monitoring of financial reporting quality and integrity (CAQ, 2010; Elnaby, et al. 2007). The primary role of the audit committee is assisting the BODs in overseeing the quality and integrity of the company's financial information (Ramanathan and Sim, 2010). Therefore, audit committees are recognized globally as an important governance mechanism to give assurance on the integrity of the financial reporting and audit process (DeZoort, et al., 2002, Cohen, et al., 2007 in in Salleh and Stewart, 2012).

Previous studies revealed that effective audit committees positively influence on financial reporting quality or negatively influence on earnings management. However the attribute of its effectiveness are varies and some findings are inconclusive. According to Wu (2012), the poor measurement causes inconsistent findings. For examples, Goodwin, et al. (2005) and Bukit and Mohd Iskandar (2009) found that independency is the main factor of audit committee effectiveness in improving financial reporting quality. Chtourou, et al. (2001) found independency and clear mandate. Carcello and Hollingsworth (2006) and Velte and Stiglbauer (2011) discovered independency and financial expertise. Wardhani and Joseph (2010) showed that independency has an influence but expertise has no influence. Baxter (2007) evidenced that the establishment of audit committee has an influence, but composition and size of members have no influence. However Sanjaya (2008) found that there is no difference between company with and without audit committee establishment. Miettinen (2008) confirmed that the number of members and the meeting of audit committee have an influence on financial reporting quality. However, García, et al. (2010) found that audit committee meeting has an influence, but number of audit committee member has no influence.

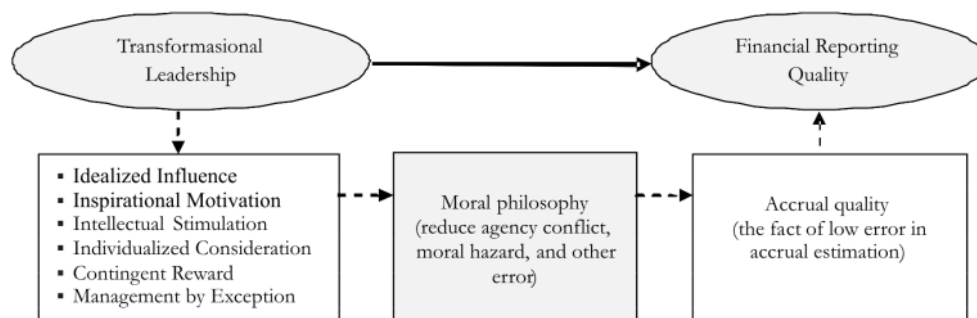


Figure 1: The Influence of Transformational Leadership on Financial Reporting Quality

Cameron, 1981 (in Mohiuddin and Karbhari, 2010) stated that effectiveness is an elusive concept. According to Cheetam and Chivers (1998) the concept of the reflective professional has become a core doctrine. Their current professional best practices reflect more tacit knowledge than applied theory. The current best practices based on the Audit Committee Institute (ACI) survey result in 2014 reveal that there are eight fundamental factors of effectiveness of audit committees:

1. Membership,
2. Active involvement,
3. Driving the audit committee's agenda,
4. Effective communication,
5. Getting the right information,
6. Informal meetings,
7. Tone at the top,
8. Leadership (KPMG, 2014).

These eight factors of effectiveness is also reflecting the quality of process as found by some qualitative researchers, e.g., Gendron, *et al.* (2004), Gendron and Bédard (2006), Zain and Subramaniam (2007), Turley and Zaman (2007), and Salleh and Stewart (2006; 2012). Accordingly, those eight fundamental factors of professional practitioners can be considered as the better indicators of audit committee's role effectiveness.

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## 2.9. The Influence of Internal Control on Financial Reporting Quality

Internal control comprises policies and procedures designed to avoid, detect, and correct error and fraud in financial reporting (Garrett, *et al.*, 2012; Amernic, 2010; Ratcliffe and Landes, 2009). An effective internal control supports reliable external financial reporting, which in turn enhances investors confidence in providing the requisite capital and supports management and board decision making on matters such as capital investment (COSO, 2013). Thus, an effective internal control can lead users face business risks only, excluding on financial reporting risks (Pfister, 2009; COSO, 2011; 2013; Doyle, *et al.*, 2006).

Thanh and Cheung (2010) found that companies with good internal control have good accounting quality as well. Doyle, *et al.* (2007) discovered that weak internal control associates with unrealized estimated accrual into cash flow. Ashbaugh-Skaife, *et al.* 2008 (in Hunton, *et al.*, 2010) showed a positive influence of internal control improvement on accrual quality. Most previous studies generally used material weakness based on external auditor report as a proxy of effective internal control. As regulator in Indonesia still not oblige auditor to give opinion on effectiveness of internal control yet (IAPI, 2013), the proxies are varies, even Pratama (2013) confirmed that there is no appropriate guidance on internal control system effectiveness in the analysis unit. Warongan, *et al.* (2014) measured internal control effectiveness by proxy of target achievement on quantity, quality, and time. Wijayani and Hermawan (2015) found that internal control is negatively associated with discretionary accrual. However, they declared that measurement adopted from the illustrative tools COSO 2012 could be subjective and bias because of misinterpretation or inconsistency in scoring the secondary data.

COSO framework 2013 formalizes the point of focus of five components into 17 principles, including any risk related to fraudulent financial reporting, management override, potential loss of assets and corruption (EY, 2014). It could encompasses entity's ability to avoid, detect, and correct any error and fraudulence in

financial reporting (Garrett, *et al.* 2012; Ratcliffe and Landes, 2009; Amernic, 2010) at the comprehensive and the specific level on transactions, balances, and disclosures (IAPI, 2013). COSO boards ensured that framework 2013 can encompass reliability, timeliness, transparency, or other terms as set forth by regulators, so that it can enhance the likelihood of achieving the entity's reporting objectives (COSO, 2013). It offers companies more effective internal controls, allows organizations to better mitigate risks and have the data necessary to support sound decision-making. In addition, Half (2015) mentioned that adopting the framework 2013 will reflect commitment to integrity and ethical values and effective internal control to potential investors.

## 2.10. The Influence of Financial Reporting Quality on Investment Efficiency

The financial reporting quality influences the investment efficiency because good managers' attitude in financial reporting will present all economic transactions completely, neutral, and free from error, so that it enables users to predict future cash flow accurately (Dechow and Skinner, 2000; Miller, 2002; Richardson and Tuna, 2008; Jonas and Blanchet, 2000 in Baxter, 2007; Dechow and Skinner, 2000; Kepsu, 2012). Users of financial reports will face on business risk only, not on financial reporting risks (Pfister, 2009; COSO, 2011; 2013; Doyle, *et al.*, 2006). Previous studies provided empirical evidence that financial reporting quality mitigates information asymmetry, agency conflict and mis-investment. Financial reporting quality negatively associates with under-/over-investment (Verdi, 2006; Biddle, *et al.*, 2009; Feng Chen, *et al.*, 2010; Mohammadi, *et al.*, 2014; EbrahimiRad, *et al.*, 2014; Li and Wang, 2010; Kangar-louei, *et al.*, 2011; McDermott, 2011; Wilford, 2012).

Based on literature reviews, the first three research hypotheses is two-tail test and the forth is one-tail test.

- H<sub>1</sub>: The transformational leadership influences on the financial reporting quality.
- H<sub>2</sub>: The audit committee's role influences on the financial reporting quality.
- H<sub>3</sub>: The internal control influences on the financial reporting quality.
- H<sub>4</sub>: The financial reporting quality influences on the investment efficiency.

## 3. RESEARCH METHODOLOGY

Research objects of this study are transformational leadership, audit committees' role, internal control, financial reporting quality, and investment efficiency. The objective is to solve the problems regarding those variables. In order to achieve this objective, we first operationalize those all variables to enable us in getting current and factual data (Kothari, 2004; Sekaran and Bougie, 2013). Transformational leadership questionnaire is adopted from the *Multi-factor Leadership Questionnaire (MLQ 5X)* (Avolio and Bass, 2002; 2006; Northouse, 2013:20; Hemsworth, *et al.* 2013). Audit committees' role questionnaire is developed from the ACI's eight fundamental factors effectiveness (ACI, 2014), *the Audit Committee Handbook - the Audit Committee Institute* (KPMG, 2013), Deloitte and Touche (2007), Beasley *et al.* (2009), Turley and Zaman (2007), and Salleh and Stewart (2012). Internal control questionnaire is adopted from *Transitioning to the 2013 COSO Framework for External Financial Reporting Purposes* (EY, 2014). In addition to those questionnaires, we ask some open ended questions to enable participants give any explanations needed (Kothari, 2004;

Ratray and Jones, 2005). Data of financial reporting quality and investment efficiency are based on audited financial statements year 2012-2014. These secondary data are obtain from the official website and/or directly from relevant SOEs. These data can be *reliable, suitable and adequate* as required (Kothari, 2004).

Analytical method, descriptive and verificative analysis, are based on PLS-SEM version 2.0. PLS-SEM is a powerful statistical method that can identify relationships in social science research (Hair, *et al.*, 2014) and it works efficiently with small sample sizes and complex models and makes practically no assumptions about the underlying data. In addition, PLS-SEM can easily handle reflective and formative measurement models, as well as single-item constructs (Hair, *et al.*, 2014). PLS-SEM procedures are designing the structural model; specifying the measurement models, data collection, established PLS path model estimation; assessing PLS-SEM results for reflective and formative measurement models and structural model; and interpreting results; and drawing conclusions (Hair, *et al.*, 2014).

In the evaluation of the measurement model, the objective is to test its reliability and validity of the measurements (Hair, *et al.*, 2014). In measuring transformational leadership construct we use six reflective (first-order) and two formatives (second-order) measures, audit committees' role effectiveness uses 16 reflective (first-order) and eight reflective (second-order) measures, and the effectiveness of internal control construct uses 17 reflective (first-order) and five reflective (second-order) measures. The reliability and validity of reflective type of measures are tested by the rule of thumb of its indicator reliability, internal consistency, convergent validity, and discriminant validity. Formative type measures are tested their convergent validity, collinearity, and significance. In the evaluation of the structural model, after reliability and validity are established, the primary evaluation criteria are the coefficients of determination ( $R^2$  values), the level and significance of the path coefficients to assess the model's ability to predict. Based on rules of thumb, the evaluation also use bootstrapping procedures, that is subsamples are randomly drawn repeatedly with replacement from the original set of data until about 5,000 (Hair, *et al.*, 2014). In this study bootstrapping used until 500.

Target population of this study is SOEs of non-financial and non-public service in Indonesia in 2015. Based on simple random sampling technique, questionnaires were distributed to 70 SOEs. The response rate is of 56% that is 39 SOEs, with 72 respondents as participants. Thus, it is acceptable as returned questionnaires above 30% (Sekaran and Bogie, 2013) and fulfills minimum samples required by the rule of thumb 10 times the maximum number of arrow heads pointing at a latent variable anywhere in the PLS path model (Barclay, *et al.*, 1995 in Hair, *et al.*, 2014). The 72 respondents are of 14 CEO/CFO (19%), 20 audit committee member (28%), 28 internal auditors (39%), 10 corporate secretary and others (14%). 38 respondents have education background on accounting (53%), 22 economics non-accounting (31%), 9 non-economics (12%), and 3 unidentified (4%). According to their education level, 3 respondents are doctorate degree (4%), 41 master degree (57%), 25 bachelor degree (35%), and 3 unidentified (4%). For the gender, there are 61 male (85%) and 9 female (12%). Respondents' average ages is 49,7 years with length of work in the current position is 3,5 years and total length of work experience is 11,7 years in average. Based on this profile, the response result portrays the real condition in accordance with respondents' knowledge and experience.

Based on data of the Company Overview Financial Statements (SOEs) in 2013 ([www.bumn.go.id](http://www.bumn.go.id)), total assets of the target population of 86 non-financial and non-public service SOEs is Rp1,877 trillion, revenue Rp1,611 trillion, and net profit Rp63.8 trillion. While the 39 SOE respondents of this study, the

total assets is of Rp 1,160 trillion (62%), revenues is of Rp 1,276 trillion (79%), and net profit is of Rp80.1 trillion (126%). Thus it indicates that the research data sample represents the target population, mainly because it includes PT. Telkom and PT Pertamina, which are the largest state-owned enterprises in Indonesia.

## 4. RESULT AND DISCUSSION

### 4.1. Descriptive Analysis

In order to collect factual data regarding the implementation of transformational leadership, the respondents are required to choose one of five answers in forms of ordinal scale, that are 1 = never, 2 = very rarely, 3 = sometimes, 4 = often enough, and 5 = frequently (almost always). The average score is of 3.88 that indicates that the implementation of transformational leadership is categorized "sometimes". The score of transformational dimension is of 3.94 higher than transactional which scored 3.82 and among six indicators, inspirational motivation get the highest score 4.15, consistent with previous study Rudjito (2011). This descriptive result reveals the weakness phenomena in leadership as the leaders are considered only "sometimes" acting or behaving as the role model and walking the talk, do not attractive in delivering vision and mission of the company, do not frequently ask followers to get more involvement in solving problems, do not frequently utilize personal approach and coaching, do not consequent in giving reward on satisfied performance, and also do not consistent in conducting corrective action proactively on every deviation.

In measuring the effectiveness of audit committees' role, participants were ask to choose among 1-5 alternative answers, 1 = none, 2 = less, 3 = enough, 4 = frequent/effective, 5 = very frequent/effective. The average score is of 3.97 that indicates the role of audit committee is categorized "enough" but not effective yet. The descriptive analysis results describe evidences of the audit committees' role weakness phenomena. The prominent weaknesses are mainly weak leadership in attitude and skill. In this sense, the audit committees are considered do not reflect strong commitment to improve their competency by benchmarking to the best practices, so that audit committee contributes suboptimal in financial reporting integrity. Besides, there is no consistency in developing financial reporting integrity, less conducting self-assessment and informal meeting, incapable to control the meeting agenda, ability to obtain accurate information though oversight such as the accounting policy, employee benefit obligation, presentation and disclosure of related party transaction.

The effectiveness of internal control are measured in the 1-5 scale measurements, which are 1 = none, 2 = less, 3 = enough, 4 = effective, 5 = very effective. The average score is of 3.72 that indicates that internal control is classified as "enough", or still not effective yet. The descriptive analysis shows the phenomena of weaknesses in internal control implementation are mainly inconsistent management commitment in recruitment and placement of human resources. Also, ownership of general control of IT and human resources is inadequate and inappropriate so that information and communication system and monitoring is not effective.

Financial reporting quality is measured by the lower estimation errors in accrual process. The descriptive analysis result describes the phenomena of low financial reporting quality as the standard deviation is of 0.0713 larger than average residual value, though the average residual value tends closer to zero point. This result confirms previous study eg. Tang, *et al.*(2011:2012), ADB (2014), World Bank (2010; 2011).

The average residual value of the investment equation is far from zero point with deviation standard 34.9219 much higher than the average value. This descriptive analysis result indicated many inefficient capital investment outlays are occurred because the investment is not aligned with the growth opportunity of companies.

#### 4.2. Verificative Analysis

Verificative analysis consists of measurement model and structural model evaluation. Measurement model evaluation is aimed to get justification that measurement model on every construct is reliable and valid according to the criteria. Structural evaluation model is aimed to assess predictive ability of the research model.

In the evaluation of measurement model, the result of first order measures shows that all outer loading value  $> 0.50$  which indicates that reliability indicator is accomplished and that all dimensions reflect of every construct. The t-statistics of all indicators  $> 1.96$  which is significant for level of confidence 95% so that all measurement are valid. Internal consistency reliability indicated by the composite reliability (CR) value show that all CR value  $> 0.70$ , so that the measurement are reliable. Convergent validity is justified by AVE value  $> 0.50$  which is also fulfilled. Discriminant validity is testing highest outer loading indicators on its dimension. The result shows that all cross loading are lower than the outer loading on its constructs. The second order measurement show that VIF is in the tolerable range  $0.2 < VIF < 5$ , so that there is no significant corellation among exogenous constructs. The path coefficient shows significant in confidence level 95% as the t-statistics  $> 1.96$ . The determination coefficient  $R^2$  also fulfill the criteria (Hair *et al.*, 2014). As all measurement models fulfill all requirements of the reliability and validity quality, then the structural model can be evaluated.

In evaluating structural model, the first step is testing the collinearity among independent constructs. As seen in Table 1, the scores of VIF among exogenous variables  $X_1, X_2, X_3$  consecutively are 1.241, 1.227 and 1.016 which are in the tolerable range  $0.2 < VIF < 5$ . These indicate that collinearity among them will not distort the predictive ability of the structural model.

**Table 1**  
**The Results of Structural Model Evaluation**

Influence	VIF	Path Coefficient	t-stats	Conclusion	R <sup>2</sup>
$X_1 \rightarrow Y$	1,241	0,417	2,982	H <sub>0</sub> rejected	0,483
$X_2 \rightarrow Y$	1,227	0,343	2,044	H <sub>0</sub> rejected	
$X_3 \rightarrow Y$	1,016	0,227	1,711	H <sub>0</sub> accepted	
$Y \rightarrow Z$	–	–0,561	3,524	H <sub>0</sub> rejected	0,314

The Table 1 above shows that transformational leadership ( $X_1$ ) influence positively on financial reporting quality (Y) as the t-statistics is of  $2.982 > 1.96$  at significant level of 5%. Thus, it provides an empirical evidence that the transformational leadership can improve the financial reporting quality approximately 0.417 deviation standard. The audit committee's role ( $X_2$ ) influence on financial reporting quality (Y) as the t-statistics is of  $2.044 > 1.96$  at significant level of 5%. This result also provides an empirical evidence that the audit committees' role influences positively on the financial reporting quality.

The path coefficient 0.343 means that the audit committee's role will improve the financial reporting quality around 0.343 deviation standard. However, internal control ( $X_3$ ) does not influence on financial reporting quality as the  $t$ -statistics 1.711 < 1.96. It means that in this research data context, improvement in internal control does not influence on the financial reporting quality. Financial reporting quality ( $Y$ ) influence on investment efficiency ( $Z$ ) as the  $t$ -statistics is of 3.524 < -1.96 at significant level of 5%. This result provide an empirical evidence that the financial reporting quality negatively influences on the investment inefficiency. The path coefficient -0.561 means that the improvement in financial reporting quality will increase the investment efficiency about 0.561 deviation standard.

The coefficient determinance in financial reporting quality ( $R^2 = 0,483$ ) reflects that the variables of transformational leadership, audit committee's role, and internal control are able to explain 48.3% variation in the financial reporting quality. The coefficient determinance in investment efficiency ( $R^2 = 0.314$ ) depicts that financial reporting quality can explain 31.4% variation in the investment efficiency. The figure below shows the results of structural model evaluation.

### 4.3. Discussion

#### 4.3.1. The Influence of Transformational Leadership on Financial Reporting Quality

A major determinant of an effective leader is the extent to which the leader is able to have a positive influence on followers' development (Bass and Riggio, 2006). Transformational leadership emphasis on interaction and attention of leaders on the followers needs. Thus, it adds to transactional leadership in its effects on follower satisfaction and performance. Through this process, moral leaders and followers will rise to a higher level, because they will be motivated, which is based on mutual respect and morality (Burns, 1978; Bass, 1985; Northouse, 2007 in Winkler, 2010; Burns, 1978 in Jandaghi, *et al.*, 2009; Avolio and Bass, 2002). Transformational leadership is more common in successful company than the failed company (Jandaghi, *et al.*, 2009). For example, Howell and Avolio, 1993 (in Avolio and Bass, 2002) found that transformational leaders among business departments achieve more financial success compared to other business departments. Rudjito (2011) provided evidence that among the SOEs were awarded the IQA in 2007, transformational leadership is more common in companies that have a better performance than worse performance.

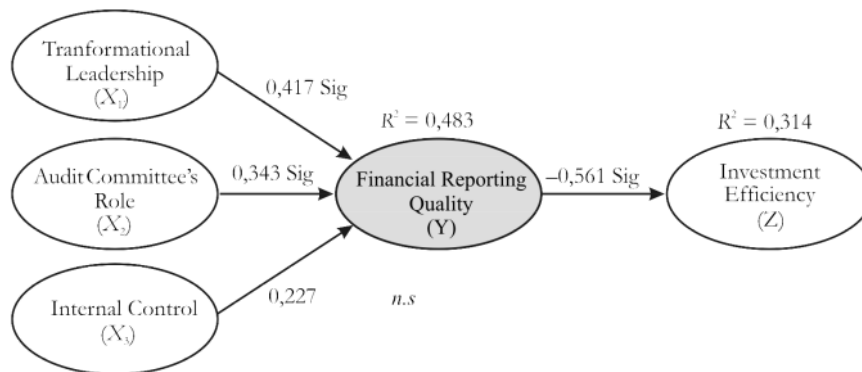


Figure 2: The Structural Model



Transformational leadership can be observed. The advantages of transformational leadership model is already own definitions, dimensions and measurement instruments called MLQ. Dimensional measurements in the MLQ include the principles of "4i" and the dimensions of transactional contingent reward and management by exception. Truly transformational leaders are socialized and shown in the form of orientation, values and moral elevation. Instead leader who pretend or pseudo-transformational, long-term orientation and its value will lead to personal interest, contrary to the goal of building a community that is stronger for long-term success (Avolio and Bass, 2002). There are some evidences that pseudo-transformational narcissistic leader is associated with financial misreporting and a tendency to inflate financial results (Larcker and Tayan, 2013). While a pseudo-transactional leader is generally not fulfilling the promise of the award, monitoring without corrective action, and violating the rules they have made (Avolio and Bass, 2002).

Transformational leaders who motivate and build intrinsically moral individuals towards achieving the long-term goal, of course, should be able to act as a role model and walking the talk to become the reference for followers and others. Moral-based transformational leadership is in line with the objective of financial reporting, which is intended to present all economic transactions in accordance the applicable financial reporting standards which will help users of financial statements predicts cash flow more accurately. Thus, transformational leadership can prevent intentions and self-interested behavior, moral hazard, and other agency relationship conflicts.

Kanagawa, CEO of Shin-Etsu Chemical Company, is recognized as a transformational leader for value-creating market capitalization surpassed reputable companies Misubishi, Mitsui, and Sumitomo Chemical within 10 years. In planning and implementing its vision, including the expansion and opening of new businesses, Kanagawa always monitor the data of interest expense, dividends, ROE, and net income (Kase, *et al.*, 2005). This shows that transformational leaders support quality financial reporting that provided financial data accurately, free from error, neutral, and completely so that investment expenditure will be in line with the company's growth opportunities (Fabozzi and Drake, 2009; Ruiyuan Chen *et al.*, 2013). Thus, the quality of financial reporting overcome the problem of inefficiency of investment for over-/under-invest (Baker and English, 2011; Verdi, 2006).

In Indonesia, Jonan, president director of the railway company PT KAI, according to research Saragih (2015) shows the characteristics of transformational leadership because he gives concrete examples and role models to build commitment and support of all employees to change. Based on interviews with the staff of PT KAI, Jonan is very attentive to the needs of employees and strictly enforces discipline. The initial stage is done by the management that the analysis of the problem. Among various issues, the management decided that the issue of remuneration is a top priority that must be addressed. For example, salaries of a Regional Head of Operations (Ka Daop) which was originally no more than Rp4 million per month increased to Rp17 million plus communication allowance of Rp1 million and a corporate credit card to boost confidence that was previously only granted to directors. The significant changes that can be directly observed was improvement of service system which was originally chaotic be more convenient for passengers. PT KAI increased financial performance, from the original loss of Rp85 billion in 2008 to a net profit Rp560.4 billion in 2013. Revenues increased from Rp3 trillion to Rp7 trillion in 2007 and the target of Rp14 trillion in 2014. The marketing director of PT KAI states that now anyone at any time can see the financial statements and the number of passengers in the website of PT KAI (SWA, 2012; 2015).

It can be concluded that the transformational leadership approach will change the behavior of the overall management and employees to be better in terms of service to customers and owners as well as improve the quality of financial reporting which facilitate management and capital providers in making decisions. In other words, the application of transformational leadership model can cope with the phenomenon of the poor quality of financial reporting.

#### 4.3.2. *The Influence Of Audit Committees' Role On Financial Reporting Quality*

The results of this study confirm that the effectiveness of the audit committee improves the financial reporting quality. The audit committee considers the potential for management override of internal controls and oversees management's fraud risk assessment process, as well as assists in creating an effective tone at the top about the importance of honesty and ethical behavior by reinforcing management's zero tolerance for fraud (Arens, *et al.*, 2014). These roles, of course, make the audit committee is recognized to have an important role in improving the integrity and quality of financial reporting (DeZoort, *et al.*, 2002 and Cohen, *et al.*, 2007 in Salleh and Stewart, 2012; Ramanathan and Sim, 2010).

As there is no universally accepted definition of the effectiveness of the audit committees' role, it causes the attributes and previous research findings inconclusive and inconsistent (Wu, 2012). To overcome the problems, following the results of the ACI survey in 2014, the measurement of the effectiveness of the audit committee used in this study is the quality of the eight fundamental factors. The advantage of using measurements of the eight fundamental factors is because it reflects the tacit knowledge of the professional and in line with the findings of some researchers who use qualitative methods to discover the effectiveness and quality control processes are carried out by the audit committee.

Descriptive analysis revealed that the cause of the less effective audit committee is the leadership factor, especially the commitment to improve the competence and self-assessment. In addition, the audit committee has not been effective in informal dialogue, have not been able to effectively control the agenda of the meeting, and also in accounting policy oversight, monitoring presentation and disclosure of related party transactions. These facts represent the phenomenon of the ineffectiveness of the oversight role of audit committees that affect the poor quality of financial reporting. The results of interviews with one member of the audit committee revealed that the self-assessment was never conducted and the effectiveness of the audit committee's role is highly dependent on the power and the strong commitment of the chairman of the audit committee. The results of this study are also consistent with the literature indicating that most of the audit committee has not completely through professional recruitment system but tends to prefer the good relations, and political (Indreswari 2006; Panglaykim, 2011; ADB, 2014; IFC, 2014). Thus, we can conclude that the improvement of the eight fundamental factors necessary for an effective oversight role of the audit committee will improve the quality of financial reporting.

#### 4.3.3. *The Influence Of Internal Control On Financial Reporting Quality*

Verification analysis provides evidence that internal control does not influence on the quality of financial reporting. This result is in contrast to the expectation that has been hypothesized because in the context of this research data, concluded that internal control will not improve the quality of financial reporting. Based on the analysis of the answers to open-ended questions, the improvement of the internal control effectiveness

requires updating or replacement of IT systems, internal audit oversight role more intensive, commitment towards the implementation of SOP. Thus, overall this indicates that the effectiveness of internal controls is in need of support and strong commitment from top management. However, the research results are in line with previous research findings Foster and Shastri (2013) who found that an effective or ineffective internal control does not influence on the quality of financial reporting. At companies that received an unqualified audit opinion, the level of effectiveness of internal control only affects the audit fees. In addition, according to Doyle, *et al.* (2006a) weaknesses in the application of internal control at the level of the account, even of the material weakness, it will be found and corrected during the audit by the external auditors. Unless the internal control weaknesses occur at the entity level. Another possibility that could lead to the study's findings do not fit the hypothesis, in practice, the assessment of the effectiveness of internal control is often very difficult and subjective though with direct observations (COSO, 2011; Pfister, 2009). Based on the description above, in the context of this research data, it can be concluded that the "people", especially top management largely determines the effectiveness of internal controls in relation to the quality of financial reporting.

#### 4.3.4. The Influence of Financial Reporting Quality on Investment Efficiency

The hypothesis testing result demonstrates that financial reporting quality influences on the investment inefficiency negatively. In other words, the financial reporting quality increases investment efficiency. This research result strengthens previous finding such as Verdi (2006), Shimin Chen, *et al.* (2009), Biddle, *et al.* (2009), Feng Chen, *et al.* (2010), Li and Wang (2010), Kangarlouei, *et al.* (2011), McDermott (2011), Wilford (2012), Mohammadi (2014), Ebrahimi Rad, *et al.* (2014).

Rationalization of the explanation for this finding is that in financial reporting quality, intentions and behavior of top management refers to the moral philosophy disciplines of accounting, so as to maximize the capability and expertise to provide a complete, free from error and neutral financial statement, which facilitates capital owners and managers in making investment decisions more accurately. Thus, financial reporting quality can prevent and inhibit the managerial behaviors perform fraudulent financial reporting. As already noted, the cause of frequent occurrence of cases of fraudulent financial reporting that is because it is difficult to prove and distinguish between fraudulent intent and the accidental errors. (Dechow and Skinner, 2000; Miller, 2002; Gaffikin, 2006; Richardson and Tuna, 2008; Luippold, 2009; Kepsu, 2012;). With the availability of reliable data resulting from quality financial reporting, investment decisions are only dealing with business risk, not the risk of fraudulent financial reporting.

In the practices, as illustrated earlier, Kanagawa CEO of Shin-Etsu a chemical company always monitors four key indicators of business, *i.e.* decreasing in interest expenes, dividend payment, ROE and net income (Kase, *et al.*, 2005). Rationally, managers and capital providers make investments that generate profits, increase the wealth of the owner, and the value of the company over the long term (*e.g.* Hubbard, 1997; Baker and English, 2011; Kalyebara and Islam, 2014). They decided to invest and monitor the success or failure of the investment through financial statement analysis tools. Thus only the quality of financial reporting that is free from conflict of interest and the moral hazard that can help managers and owners monitor the efficiency of capital investment. As a guideline for investors, the efficiency of capital investment spending should be aligned with the company's growth opportunities. If not aligned, indicating inefficiency of investment, either over- or under-invest, both of which would potentially harm investors (*e.g.* Fabozzi

and Drake, 2009; Ruiyuan Chen *et al.*, 2013; Baker and English, 2011; Verdi, 2006). So, with the improvement of the quality of financial reporting, where top management has no intention at all to commit fraudulent financial reporting, it can improve investment efficiency or reduce over-/under-investment.

## 5. CONCLUSION

Overall, the results of this study provide empirical evidence that financial reporting quality influence significantly on investment efficiency. The quality of financial reporting itself is influenced by the transformational leadership and the effective roles of the audit committees. But in the context of this research data, internal control does not affect the quality of financial reporting. The limitation of this study is relatively small sample size. For further research, it is advisable to increase the number of samples.

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