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Detecting fraud of financial statement through pentagon's fraud theory

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Abstract

This study aims to detect fraudulent financial statements using the Pentagon's fraud theory. The fraud pentagon theory is projected with financial targets, financial stabilities, external pressure, institutional ownership, ineffective monitoring, quality external auditors, change in auditor, capability, and CEO arrogancy. This study uses a quantitative research design and secondary data from 44 state-owned enterprises. The multiple regression analysis shows that external pressure and institutional ownership affect fraudulent financial statements. While financial targets, financial stabilities, ineffective monitoring, quality external auditors, change in auditor, capability, and arrogancy do not affect fraudulent financial statements.

Keywords: Pentagon fraud theory; fraud; state-owned enterprise

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Introduction

Financial reports are a source of information regarding the performance of an entity during a period that is carried out by management to stakeholders and is very important for the entity in maintaining the company's internal economic stability. Misstatements in financial statements can result from manipulation, falsification, or changes in accounting records (Zimbelman et al., 2014).

Jensen & Meckling (1976) stated that the agency relationship arises because of a contract between the principal and the agent by delegating some decision-making authority. It assumes that each individual is motivated only by their interests. The company manager who acts as an agent has a responsibility to increase the profits of the owner (principal) but also has an interest in maximizing his welfare. Fraud is a general action that includes various meanings in clever ways designed by someone to gain an advantage in the wrong way (Albrecht et al., 2011). According to Statement on Auditing Standards No. 99, fraud is defined as "an intentional act that results in a material misstatement of the financial statements that are the subject of the audit."

Frauds do not happen only in private sectors but also in State-Owned Enterprises (BUMN). The Audit Board of the Republic of Indonesia (BPK) reveals that BUMN often does frauds in terms of accounting. BUMN is thought to present profit higher than it is supposed to be in their Financial Statements. This will lead to a reward or bonus. In a recent case in PT Garuda Indonesia Tbk, profit was presented as higher on their 2018 Financial Statements. Audit opinion was given as "Unqualified," whereas, in 2017, the company suffered a loss. Investigation performed by BPK reveals that the company served Window Dressing. BDO Indonesia Public Accounting Firm is considered to fail to detect management fraud.

Economic crimes in the business world require auditors to determine factors that can detect frauds in companies. This acts as preventive actions or to minimize more significant frauds. Research done by Cressey (1953) states Fraud Theory called Fraud Triangle, in which Cressey categorizes three factors that would affect scams which are pressure, opportunity, and rationalization. Wolfe & Hermanson (2004) developed Cressey's theory called Fraud Diamond, which adds a new element of ability. In this theory, Wolfe & Hermanson describes that people will not stop committing fraud if they have knowledge or capability. Furthermore, in 2011 Crowe developed Cressey's theory and concluded with Fraud Pentagon by adding two new elements, ability and arrogance, where people commit frauds determined by power or capability and by being in high-level management.

We try to detect frauds in BUMN by implementing Pentagon's fraud theory. BUMN are chosen due to their complexities related to numbers of stakeholders compared to private sectors, more complex regulations, and collusion-prone management style. Since elements of fraud risk variables can't be measured directly, Aprilia (2017), Sihombing & Rahardjo (2014), Skousen et al. (2009) used proxy variables to measure them. Pressure is proxied by using financial targets, financial stability, external forces, and institutional ownership. Opportunity is proxied by observing ineffective auditor quality. Rationalization is proxied by following the auditor's change in reviewing financial statements. Capability is proxied by keeping the director's ability to manage the organization. Finally, arrogance is proxied by observing the number of photographs in the company's financial statements.

Selection of these proxy variables is based on inconsistent findings of variables in researches done by Indarto & Ghozali (2016), Santoso & Surenggono (2018), Manurung & Hardika (2015), Sihombing & Rahardjo (2014), Septriani & Handayani (2018), Akbar (2017), Aprilia (2017) and Husmawati et al. (2017). While financial reporting fraud is proxied by using F-Score (Sukrisnadi, 2010), F-Score covers two factors observed in financial statements: quality of accrual and financial performance. Previous research above has not analyzed financial statement fraud in BUMN.

This research is expected to explain how to detect fraud in financial statements in BUMN by using Pentagon Theory which consists of elements that are pressure, opportunity, rationalization, capability, and arrogance. These five elements are proxied by using variables: the financial target, financial stability, external pressure, institutional ownership, ineffective observation, high-quality external auditor, change in auditors, CEO's capability, and frequent photographs of CEO.

Method

The population used in this study is state-owned enterprises registered with the IDX for 2017-2019. They are using the purposive sampling method. Samples were obtained from 44 companies, so we generate a number of samples (n) over three years of 132. Variable explained (dependent), a fraudulent Financial Statement was detected using the Fraud score model (F-Score model) (Dechow et al., 2012). The F-Score model is the sum of two variables, namely the quality of accruals and financial performance (Skousen dan Twedt, 2009), while the independent variables consist of Financial Target, Financial Stability, External Pressure, Institutional Ownership, Ineffective Monitoring, External Auditor Quality, Change in Auditor, Capability, and Frequent Number CEO's Picture. The research’s model follows Fig. 1

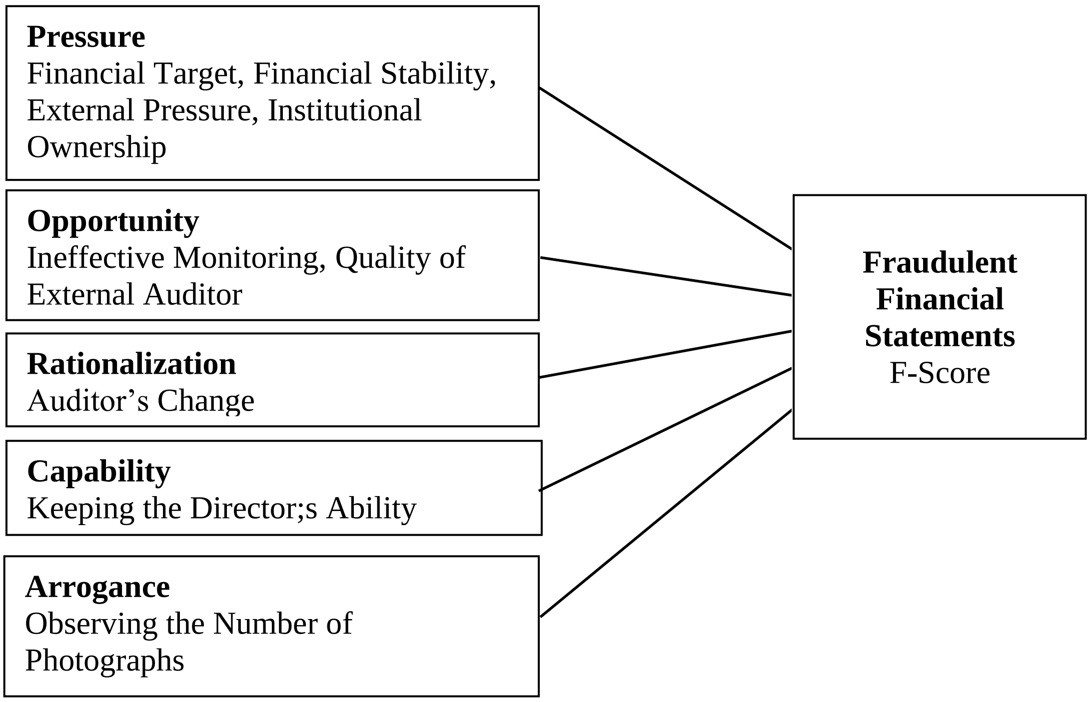

Figure 1. Research’s model

Empirical Result

Based on Table 1, we can see that Financial Targets; Financial Stabilities; Ineffective Monitoring; The quality of external auditors; Change in Auditor; The capability of the CEO, and Frequent Number of CEO's Pictures don't affect fraudulent financial statements. Meanwhile, External pressure and Institutional ownership have a significance level less than 0.05; both of them affect fraudulent financial statements.

Table 1. Regression result

Variable	Coeeficient	t	Sig.
(Constant)	0.683	3.145	0.002
Financial Targets	-0.128	-1.91	0.059
Financial Stabilities	0.261	1.482	0.141
External pressure	-1.159	-4.414	0
Institutional ownership	-0.92	-2.039	0.044
Ineffective Monitoring	0.205	0.493	0.623
External auditors	0.228	1.496	0.137
Change in Auditor	0.001	0.01	0.992
Capability	0.04	0.353	0.725
CEO's picture	0.043	0.957	0.34
F Statistics	3.764	0.000	
R-squared (Adjusted)	0.217 (0.160)		

External pressure affects fraudulent financial statements when a lot of pressure from third parties given to company managers will result in fraudulent actions. The results of this study support the research conducted by Tessa & Harto (2016) and Yesiariani & Rahayu (2016). Managers have responsibilities to individuals and institutions; the more significant the ownership shares the institution owns, the greater the pressure on the company, thus enabling managers to commit fraudulent financial statements. The results of this study support the research of Agustina & Pratomo (2019) and Aprilia (2017) but do not support the research of Ulfah et al. (2017).

The supervision of the board of commissioners is carried out independently without any conflict of interest carried out objectively so as not to trigger managers to commit fraud in the preparation of financial statements. The results of this study support research conducted by Sihombing & Rahardjo (2014), Tessa & Harto (2016), and Yesiariani & Rahayu (2016) but do not support the results of research conducted by Putriasih (2016).

The quality of the External Auditor does not affect the Fraudulent Financial Statement. The exact role as an external auditor (both KAP BIG-4 and

KAP Non-BIG-4) in conducting audits of financial statements based on generally accepted accounting standards. The results of this study support the research undertaken by Tessa & Harto (2016) and Hanifa & Laksito (2015).

The change of Auditor is a form of compliance with the Government Regulation of the Republic of Indonesia No. 20 of 2015 article 11 (1), which states that the provision of audit services on financial statements to an entity by a Public Accountant is limited to a maximum of 5 (five) consecutive financial years (Yesiariani & Rahayu, 2016). In addition, dissatisfaction with the performance of the old external Auditor allows the company to change auditors. The results of this study support the research conducted by Sihombing & Rahardjo (2014), Tessa & Harto (2016), and Yesiariani & Rahayu (2016), but do not support the results of research conducted by Ulfah et al. (2017).

Replacement of directors who are more competent and able to work optimally is a decision to improve the performance of the previous directors. The results of this study support the research conducted by Tessa & Harto (2016) and Yesiariani & Rahayu (2016) but do not support the results of research conducted by Ulfah et al. (2017).

Frequent Number of CEO's Picture has no impact on Fraudulent Financial Statement. The various CEOs of the company will come up with ideas to run an organization that benefits the company to minimize the occurrence of fraud in the preparation of the company's financial statements. The results of this study support the research conducted by Ulfah et al. (2017) but do not support the results of research conducted by Tessa & Harto (2016) and Siddiq (2017).

Conclusions

The study showed that external pressure and institutional ownership affect fraudulent financial statements. While financial targets, financial stabilities, ineffective monitoring, quality external auditors, change in auditor, capability and a frequent number of CEO's pictures do not affect fraudulent financial statements.

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