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DETECTION FRAUDULENT FINANCIAL REPORTING AND CORPORATE GOVERNANCE MECHANISMS USING FRAUD DIAMOND THEORY OF THE PROPERTY AND CONSTRUCTION SECTORS IN INDONESIA

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Abstract

Purpose of the study: This study aims to analyze the detection of the risk factors of fraudulent financial reporting and corporate governance mechanisms as moderating variables with fraud diamond theory of the property and construction sector in Indonesia. The risk factors of fraudulent financial reporting by financial targets, ineffective monitoring, auditor change, change of directors.

Methodology: The sample selection using purposive method sampling. The number of population in this study was 219. The samples of this study were 114 property and construction sector companies listed on the Indonesia Stock Exchange during 2016-2018. This study tests the hypothesis in multivariate analysis using logistic regression with IBM SPSS Statistics 25.

Main Findings: The results of this study the board of commissioners, independent commissioners, institutional ownership are able to moderate the relationship between financial targets on fraudulent financial reporting. The companies are able to optimize corporate governance mechanisms, especially the roles of the board of commissioners, independent commissioners, institutional ownership. So, that fraudulent financial reporting in the companies can decrease.

Implications of this study: The results of this study are expected to provide practical implications for companies listed on the Indonesia Stock Exchange, namely the need to strengthen the board of commissioners, independent commissioners, and institutional ownership to detect and prevent fraudulent financial reporting. The higher effectiveness of monitoring will be able to minimize the occurrence of fraudulent financial reporting.

Novelty/Originality of this study: This study uses fraud diamond theory to detect and tests the moderating variables of corporate governance mechanisms on the relationship between the determinant fraudulent financial reporting. The study uses a moderating variable that is corporate governance mechanisms which is proxy by the board of commissioners, independent commissioners, institutional ownership, and audit committee.

Keywords: Corporate Governance Mechanism, Fraud Diamond Theory, Fraudulent Financial Reporting, Financial Target, Independent Commissioners, Institutional Ownership.

INTRODUCTION

Fraud diamond theory is a theory put forward by Wolfe & Hermanson, (2004) adding capability as a complementary element of the fraud triangle, namely pressure, opportunity, and rationalization. Opportunity is a door for someone to commit fraud, pressure and rationalization can encourage people to do it. However, fraud will not occur without the right people with capability (Wolfe & Hermanson, 2004). In fact, there many people who commit fraud in presenting financial statements such as marking up and manipulating the amount of data of financial statements (Irwandi et al., 2019; Ugrin & Odom, 2010; Utomo et al., 2019). Fraudulent financial reporting is a deviation from the financial statements. Fraudulent financial reporting is common in Indonesia, including PT Waskita Karya. In the middle of 2009, it was discovered the financial engineering carried out by the directors of the previous period, there was an excess of profit recording by Rp.400 billion. At the end of 2018, PT Waskita Karya was again exposed to fraud cases involving managers of PT Waskita Karya, it is suspected that they have recorded 14 fictitious projects and caused the state to suffer a loss of Rp.186 billion. Based on the Indonesian Consumers Foundation (YLKI), cases of complaints against fraudulent financial reporting in the property sector ranked third in 2014, went up to second place in 2015, and in 2016 it still ranked second. In 2017, the property was rank third, and in 2019 complaints against the property ranked third.

This research is conducted to show inconsistencies in the fraud diamond theory from previous research such as Pamungkas et al., (2018), Azizah & Anisykurlillah, (2014), Annisya et al., (2016), Zaki, (2017) show that the financial target does not affect the fraudulent financial reporting. Meanwhile, on the studies of Santoso, (2019), Mardiani et al., (2017), Nugraheni & Triatmoko, (2016) financial target has an effect on fraudulent financial reporting. The nature of industry, research conducted by Zaki, (2017) shows that there is an influence on fraudulent financial reporting. However, the research of Nugraheni & Triatmoko, (2016) and Annisya et al., (2016) show that the nature of the industry does not affect on fraudulent financial reporting. Research conducted by Mardiani et al., (2017) and Zaki, (2017) show that the



Auditor change does not affect fraudulent financial reporting. Meanwhile, Santoso, (2019) stated that the auditor change has an effect on fraudulent financial reporting. In the research of Pamungkas et al., (2018) the change of directors influences fraudulent financial reporting. However, Santoso, (2019), Mardiani, et al., (2017), Annisya et al., (2016) shows that the change of directors has no effect on fraudulent financial reporting.

Based on the background description, the phenomenon and the research gap provide the opportunity for researchers to examine the factors that can affect fraudulent financial reporting. There are still inconsistencies in the results of previous studies so that motivating and interesting to do further research with the corporate governance mechanism as a moderating variable.

LITERATURE REVIEW

Fraud Diamond Theory

This theory assumes that between principal and agent have their respective interests which will lead to a conflict of interest (Jensen & Meckling, 1976). Principal as a shareholder wants the company's financial performance to increase so that the rate of return on investment is high while management as an agent also has an interest in improving their welfare (Nugraheni & Triatmoko, 2016). Managements can easily commit fraud because they have the ability and the opportunity to commit fraud (Y 28 f and Lai, 2014). In 2004, there was a fraud theory that was introduced by Wolfe & Hermanson, (2004), the theory known as fraud diamond theory. Research conducted by Wolfe & Hermanson, (2004) perfected the theory found by Skousen et al., (2009) by adding the capability element as the fourth element besides pressure, opportunity, and rationalization, these factors influence someone to commit fraud. Wolfe & Hermanson, (2004) argue that a lot of fraud worth billions of dollars cheating will not occur without capability. Opportunity can open a way for someone to commit fraud. Still, the person must have the ability to be able to recognize these opportunities.

Hypothesis Development

Cases of fraud on these financial statements are common and seize the attention of economists. One of them is the fraud diamond theory. Thus, the researchers use corporate governance mechanisms as a moderating variable to prevent fraudulent financial reporting in the fraud diamond theory. Company managers strive to improve their performance to achieve financial targets that have been planned (Manurung & Hardika, 2015; Pamungkas & Utomo, 2018). Investors will be interested in a company if the ROA value of the company is high (Nugraheni & Triatmoko, 2016). Hence, the higher the probability of a company commits fraudulent financial reporting by manipulating the numbers in the financial statements to look good and achieve the planned targets (Nugraheni & Triatmoko, 2016). This is consistent with the opinion of Skousen et al., (2009) uncollectible accounts, and obsolete inventory can be used to identify the time of manipulation of financial statements in the company. This argument is supported by Loebbecke et al., (1989) found that accounts receivable and inventories accounts were involved in a large number of frauds.

Rationalization is one of the important factors in fraud. Rationalizing fraud can be easily measured by those who are accustomed to dishonesty (Mardiani et al., 2017). Auditor change or public accounting firm is one of the proxies of rationalization (Skousen et al., 2009). Higher the public accounting firm switching, the higher the fraud that occurs in the company (Pamungkas et al., 2018). Wolfe & Hermanson, (2004) ability is a person's attempt to commit fraud to achieve certain goals. Six important elements that exist in capability, namely: position/function, the level of confidence/ego, intelligence, coercion skills, immunity to stress, and effective lying (Wolfe & Hermanson, 2004). Based on these characteristics, the positions of directors, CEO, and other division heads are in accordance with the characters.

The change of directors aims to get rid of old directors who have known fraud committed by the company (Nugraheni & Triatmoko, 2016; Pamungkas & Utomo, 2018). The change of directors can cause a stress period, so that it can trigger opportunities and chances to do. This is due to the new directors do not fully know about the company, which leads to ineffective performance, so it can open up opportunities to commit fraud (Nugraheni & Triatmoko, 2016). The effectiveness of the monitoring carried out by the board of commissioners will minimize the occurrence of fraud, despite the high level of financial targets, nature of the industry, auditors change, and changes of directors. Dechow et al., (1996) also stated that the composition of the board of commissioners is able to prevent fraud action. Pamungkas et al., (2018) conclude that the board of independent commissioners can influence fraud because in its supervision it works independently. Fraud on these financial statements will be reduced, even though the level of financial targets, the nature of the industry, auditors change, and changes of directors in the company are high.

Another ownership structure is institutional ownership. Institutional shareholders usually take the form of entities such as pension funds, mutual funds, banking, and insurance (Das, 2017; Hu & Zhou, 2008). Institutional investors have the capability to analyze financial statements directly compared to other investors (Cheung et al., 2015; Ibrani et al., 2019; Trisnantari, 2010). The audit committee is the internal party of the company whose job is to assist the board of commissioners in ensuring oversight of financial reporting (Santoso, 2019). Anwaar, (2016); Gama 38 i, (2015); Utomo et al., (2018) stated the company can provide more supervision over management performance so that the existence of the audit committee can detect fraudulent financial reporting that exist in the company. The existence of an audit committee in a company will minimize the occurrence of fraudulent financial reporting in the company despite the



financial targets, nature of the industry, auditors change, and change of directors are high. Thus, the researchers can formulate a hypothesis as follows: The theoretical framework for examining the effect of financial targets, nature of industry, auditors change, changes of directors on fraudulent financial reporting and corporate governance mechanisms as moderating variable.

H1: Financial target has an effect on fraudulent financial reporting.

H2: Nature of industry has an effect on fraudulent financial reporting.

H3: Changes in auditors has an effect on fraudulent financial reporting.

H4: Change of directors has an effect on fraudulent financial reporting.

H5: Board of commissioners can moderate the relationship of financial targets, nature of the industry, auditor change and change of director on fraudulent financial reporting.

H6: Independent commissioners can moderate the relationship of financial targets, nature of the industry, auditor change and change of director to the fraudulent financial reporting.

H7: Institutional ownership can moderate the relationship of financial targets, nature of the industry, auditor change and change of director on fraudulent financial reporting.

H8: Audit committee can moderate the relationship of financial targets, nature of the industry, auditor change and change of director on fraudulent financial reporting.

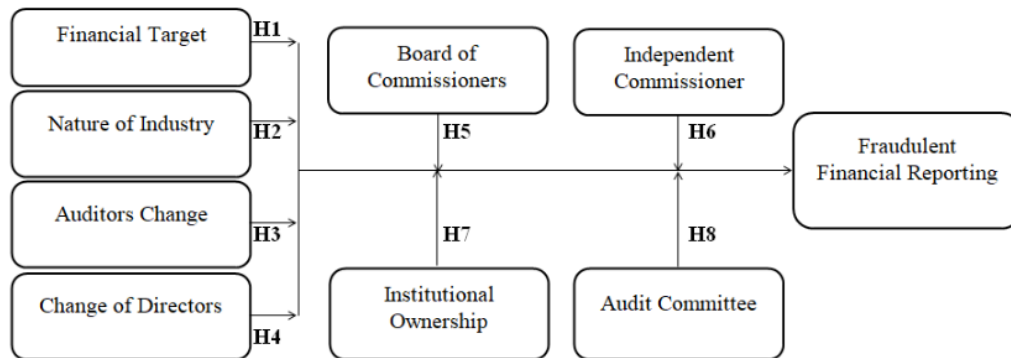


Figure 1: Research Model

METHODOLOGY

This research used quantitative methods and secondary data. The population used in this study property and construction sector companies listed on the Indonesia Stock Exchange (BEI) for the period of 2016-2018. The sample selection was based on purposive method sampling. The number of population in this study was 219, from the sample collection, 114 samples were obtained. The following is a sample selection based on predetermined criteria:

Table 1: Sample Criteria

No.	Sample Criteria	Number of Companies
1.	Property and construction sector companies listed on the Indonesia Stock Exchange in the 2016-2018 periods.	74
2.	Companies that were not listed on the IDX during the 2016-2018 period.	(15)
3.	Companies that did not publish annual financial statements on the company's website or IDX website during the 2016-2018 period.	(1)
4.	Companies that did not disclose data relating to research variables and Which were not completely available (overall data not available on publication during the 2016-2018 periods).	(7)
Total companies that meet the criteria		51
Data outlier when processing data		(13)
Total Sample		38 x 3 = 114

Source: The Processed Secondary Data (2020)



All components of risk from fraud diamond theory cannot be observed directly. The pressure is proxy by financial targets (ROA), the opportunity is proxy by nature of the industry (Receivable), rationalization is proxy by auditor change (ACPA), and capability is proxy by director replacement (DCHANGE), as well as corporate governance mechanisms proxy with boards of commissioners, independent commissioners, institutional ownership and audit committees.

Table 2: Operational Definition of Variables

Variables	Definition	Indicators	Scale	References
Fraudulent Financial Reporting (F-Score) (Dependent Variable)	This research is conducted to detect fraudulent financial reporting by using the fraud score model as specified by (Dechow, Ge, Larson, & Sloan, 2011).	F-Score Code 1 for companies commit fraudulent financial reporting, Code 0 non-fraudulent financial reporting	Nominal	Nugraheni & Triatmoko, (2016)
Financial Target (ROA) (Independent Variable)	The ratio used to describe the net earnings earned by the company in the current year.	$ROA = \frac{\text{Net Profit After Tax}}{\text{Total Asset}}$	Ratio	(Skousen et al., (2009)
Nature of Industry (Independent Variable)	Risk factors that arise as a result of the economic environment and the policies in which the entity operates.	$\text{Receivable} = \frac{\text{Receivable (t)}}{\text{Sales (t)}} - \frac{\text{Receivable (t-1)}}{\text{Sales (t-1)}}$	Ratio	Skousen et al., (2009)
Auditor Change (Independent Variable)	Change of Public Accounting Firm (KAP) every year by the company (Skousen et al., 2009)	Code 1 if there is an auditor change or KAP and if code 0 if there is no auditor change or KAP.	Nominal	Utomo et al., (2018) (Sugita, 2018)
Change of Directors (Independent Variable)	Transfer of authority and responsibility from the old board of directors to the new board of directors.	Code 1 is a change director and code 0 if no change directors.	Nominal	Zaki, (2017)
Board of Commissioners (Moderating Variable)	The board of commissioners has the authority and responsibility in overseeing, directing, and controlling the management of company resources.	A number of the company's board of commissioners.	Nominal	Pamungkas et al., (2018)
Independent Commissioners (Moderating Variable)	Members of the board of commissioners who are not affiliated with the controlling shareholder, between the commissioners, management, and other parties who are able to influence their ability to be independent.	A number of independent commissioners from outside the company.	Nominal	Pamungkas et al., (2018)
Institutional Ownership (Moderating Variable)	Institutional ownership has the ability to control management through effective supervision so as to minimize fraud on the company.	$KI = \frac{\text{Total institutional share}}{\text{Total outstanding share}}$	Ratio	Pamungkas et al., (2018)
Audit committee (Moderating Variable)	Having the responsibility to oversee financial statements, supervise external audits, and observe internal control systems in order to reduce the opportunistic nature of management.	Number of audit committees	Nominal	Utomo et al., (2018) (Sugita, 2018)

Source: The Processed Secondary Data (2020)

This study uses inferential statistical analysis for hypothesis testing. The method used to test the hypotheses in this study is a multivariate analysis using logistic regression because this research variable is a combination of metric and non-metric (nominal). Logistic regression is a regression to test the extent to which the probability of the occurrence of a dependent variable can be predicted with an independent variable. Hypothesis testing in this study uses logistic regression by ignoring the tests of normality, heteroscedasticity, and autocorrelation. Because before testing the hypothesis, the first step that must be done is to assess the feasibility of the regression model and to assess the fit model. The function of assessing the feasibility of the regression model and model fit is a substitute for the classical assumption test.



Research using logistic regression ignores the testing of normality for the independent variable. Regression model 1 is a factor that influences fraudulent financial reporting and in model 2 which is by analysis technique based on interaction regression. The logistic regression model in testing the hypothesis in model 1 is $\ln \frac{F}{1-F} = \beta_0 + \beta_1 x_1 + \beta_2 x_2 + \beta_3 x_3 + \beta_4 x_4 + e$ and hypothesis testing in model 2 is $\ln \frac{F}{1-F} = \beta_0 + \beta_1 x_1 + \beta_2 x_2 + \beta_3 x_3 + \beta_4 x_4 + \beta_5 x_5 + e$. $\ln \frac{F}{1-F}$ is a dummy variable, where companies that commit fraudulent financial reporting are represented by 1 and companies that do not commit fraudulent financial reporting are represented by 0. X1= Financial Target, X2= Nature of Industry, X3= Auditors Change, X4= Change of Directors, X5= Board of Commissioners, X6= Independent Commissioner, X7= Institutional Ownership, X8= Audit Committee, $\beta_1, \beta_2, \beta_3, \beta_4, \beta_5$, and (regression coefficient) and e = error. The result of the SPSS output, this testing was carried out with various stages that must be passed. First, assessing Hosmer and Lemeshow Goodness of the fit test or the feasibility of the regression model. Second, the coefficient of determination. Third, the Overall Fit model. Next, the descriptive statistical analysis which includes sample size, average, maximum, and minimum, and standard deviation.

RESULTS/FINDINGS

Descriptive statistics and logistic regression are statistics used to analyze data by describing collected data as it is without the intention of making inferences that are applicable to the public or generalizations. Table 3, presents descriptive statistics and Table 4, presents hypothesis testing using logistic regression.

Table 3: Descriptive Statistics

Variables	N	Minimum	Maximum	Mean	Std. Deviation
Financial Target	114	-.06	.16	.0388	.04260
Nature of Industry	114	-4.56	8.37	.1693	1.47489
Auditor Change	114	0	1	.25	.432
Change of Directors	114	0	1	.13	.340
Board of Commissioner	114	2	8	4.14	1.534
Independent Commissioner	114	0	4	1.40	.606
Institutional Ownership	114	.08	.97	.6528	.20335
Audit Committee	114	1	5	2.97	.488
Fraudulent Financial Reporting	114	0	1	.36	.482

Source: Secondary data processed (2020)

Table 4: Result of Hypothesis

Variables	Significance	Description
X1 → Y	0.693	Hypothesis Rejected
X2 → Y	0.374	Hypothesis Rejected
X3 → Y	0.620	Hypothesis Rejected
X4 → Y	0.780	Hypothesis Rejected
X1*Z1 → Y	0.033	Hypothesis Accepted
X2*Z1 → Y	0.086	Hypothesis Rejected
X3*Z1 → Y	0.100	Hypothesis Rejected
X4*Z1 → Y	0.227	Hypothesis Rejected
X1*Z2 → Y	0.012	Hypothesis Accepted
X2*Z2 → Y	0.089	Hypothesis Rejected
X3*Z2 → Y	0.999	Hypothesis Rejected
X4*Z2 → Y	0.367	Hypothesis Rejected
X1*Z3 → Y	0.034	Hypothesis Accepted
X2*Z3 → Y	0.274	Hypothesis Rejected
X3*Z3 → Y	0.268	Hypothesis Rejected
X4*Z3 → Y	0.827	Hypothesis Rejected
X1*Z4 → Y	0.346	Hypothesis Rejected
X2*Z4 → Y	0.859	Hypothesis Rejected
X3*Z4 → Y	0.615	Hypothesis Rejected
X4*Z4 → Y	0.997	Hypothesis Rejected

Source: Secondary data processed (2020)

Based on hypothesis test the results of this study are financial targets, nature of the industry, auditor change and substitution of directors have no significant effect on fraudulent financial reporting. The board of commissioners, Independent commissioners can significantly moderate the effect of financial targets on fraudulent financial reporting.



The board of commissioners cannot significantly moderate the influence of the nature of the industry on fraudulent financial reporting. The board of commissioners, independent commissioners, institutional ownership cannot significantly moderate the effect of auditor's change on fraudulent financial reporting. The board of commissioners, institutional ownership, audit committee cannot significantly moderate the effect of change of directors on fraudulent financial reporting. Independent commissioners, institutional ownership, the audit committee cannot significantly moderate effect of the nature of industry on fraudulent financial reporting. Institutional ownership can significantly moderate effect of financial targets on fraudulent financial reporting. The audit committee cannot significantly moderate the effect of financial targets on fraudulent financial reporting.

DISCUSSION / ANALYSIS

Empirically the financial target does not influence the fraudulent financial reporting. Manurung & Hardika, (2015) that an increase in company profitability can also be done by improving the quality of the company's operations. Annisya et al., (2016); Manurung & Hardika, (2015); Pamungkas et al., (2018) which states that financial targets do not have a significant effect on fraudulent financial reporting. However, this study contrasts with the findings of (Mardiani et al., 2017; Nugraheni & Triatmoko, 2016; Santoso, 2019). The nature of the industry has no effect on fraudulent financial reporting. The results of this study are in line with research conducted by Annisya et al., (2016); Nugraheni & Triatmoko, (2016); Skousen et al., 2009) which states that the nature of the industry does not significantly influence the fraudulent financial reporting.

The effect of auditor change is not significant in fraudulent financial reporting. However, the company made auditors change to show the company's performance which ways looks good. Pamungkas et al., (2018), Mardiani et al., (2017), and Zaki, (2017) state that auditor changes have no significant effect on fraudulent financial reporting. The aforementioned change rules are still in effect until the emergence of Government Regulation Number 20 the Year 2015 which explains the auditor's change to be made no later than for five consecutive financial years which come into force in April 2015. The change of directors does not influence fraudulent financial reporting. The results of this study are not in accordance with the theory of Wolfe & Hermanson, (2004) which states that the ability to influence acts of fraud. Santoso, (2019), Mardiani et al., (2017), Annisya et al., (2016), and Nugraheni & Triatmoko, (2017) who stated that the change of directors had no significant effect against fraudulent financial reporting. The higher effectiveness of monitoring will be able to minimize fraudulent financial reporting.

The number of accounts receivable owned by the company will definitely reduce the amount of cash that can be used by company for its operations (Utomo & Pamungkas, 2018). Board of commissioners cannot moderate the relationship between the nature of industry on the fraudulent financial reporting (Irwandi et al. 2019; Pamungkas & Utomo, 2018). This research is contrary to agency theory, where if companies change auditors more frequently, it will cause a higher conflict of interest between agents and principals. The adverse selection problem occurs because the agent has more extensive information about the company's condition than the principal so that the situation will be exploited by the agent to commit fraud (Dewi et al., 2018). Management will manipulate management performance information to make it look good and meet predetermined targets (Pamungkas et al., 2018). It can be concluded that the existence of an independent commissioner in a company will minimize fraudulent financial reporting. Monitoring and supervision conducted by an independent commissioner is not a guarantee that the company will not carry out fraudulent financial reporting. The results of this study are not in accordance with the theory of Wolfe and Hermanson (2004) which states that the ability to influence acts of fraud.

CONCLUSION

The results of this study the board of commissioners, independent commissioners, institutional ownership are able to moderate the relationship between financial targets on fraudulent financial reporting. The higher the effectiveness of supervision carried out by the institution will be able to minimize the occurrence of fraudulent financial reporting in the company. Supervision carried out by institutional ownership is not a guarantee that the company will not carry out fraudulent financial reporting. Next, Financial targets set by the company are able to increase the possibility of management making fraudulent financial reporting. The existence of an audit committee in the company that can help directors in the case of company supervision is not a guarantee that the company will not carry out fraudulent financial reporting.

LIMITATION AND STUDY FORWARD

In this study, there is a limitation that is the sample used only in the property and construction sector listed on the Indonesia Stock Exchange. Future studies are expected to be able to use a broader sample of other sectors, for more general results. Future studies can expand the observation period to a greater number of samples and be able to use other theories such as fraud pentagon theory.

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AUTHORS CONTRIBUTION

Maylia Pramono Sari contributed to the concepts, theories, and methodology. The data are gathered; furthermore, the data are processed and analyzed by Lintang Vernanda Rahmadani. The results of the study and translate were reviewed by Kiswanto. Then the results of this study are discussed by all authors to improve the quality of this manuscript. Hera Khairunnisa contributed add references to this study. Imang Dapit Pamungkas contributed to finishing, editing, and corresponding.

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