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Governance and Financial Statement Fraud: Evidence from Indonesia Listed Banking

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ABSTRACT

The purpose of this study is to obtain empirical evidence regarding the effectiveness of audit committees and the quality of external auditors on the possibility of fraudulent financial statements. The population in this study are banking companies listed on the Indonesia Stock Exchange. The method used in this study is a quantitative method using secondary data which is measured using ratios and statistical processing. The research results show that the audit committee effectiveness variable partially does not significantly influence the possibility of fraudulent financial reporting. The reason underlying the results of this study is that the independence contained in the audit committee has not contributed to avoiding the likelihood of fraudulent financial reporting in a company. External auditor quality does not significantly influence the possibility of fraudulent financial reporting. This is because most companies use the services of non-Big Four Audit Firms to audit their financial statements. Simultaneously, it can be stated that the effectiveness of the audit committee and the quality of the external auditors significantly influence the possibility of fraudulent financial reporting. It is also concluded that the predicting power of the model is high.

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KEYWORDS:
Financial Statement Fraud, Effectiveness of Audit Committee and External Auditors Quality

I. INTRODUCTION

Financial statements are a form of presentation of information by a company or entity to users of financial statements as a basis for decision making. The financial statements prepared by management must reflect relevant and reliable information because the financial statements will be used by users of financial statements in the decision-making process. Audit of financial statements by an independent third party can improve the quality of financial statements as reported by management (Dopuch and Simunic 1982; Watts and Zimmerman 1986) and can improve the quality of financial information so that investors will get value from their securities trading.

The government through the regulatory body has issued Regulation Number IX.I.5 attachment to the Decree of the Chairman of Financial Services Authority Number: Kep-643/BL/2012 concerning the establishment and guidelines for the implementation of the work of the audit committee. The effectiveness of the audit committee can be measured through several characteristics of the audit committee, among others: the independence of the audit committee in this case is assessed based on the absence of a link between the audit committee and the position or operational position in the company where the audit committee is located. To reduce or minimize fraud committed by management so that the reports made by management are more reliable (trustworthy, neutral), it is necessary for an independent party to conduct an audit. This is where the importance of the role of public accountants (independent auditors), namely as parties who examine and provide professional opinions on information made by company management. Public accountant is a profession that provides audit services on company financial statements. Through the provision of this service, public accountants help both management and outsiders as users of financial statements to objectively determine whether the company's financial statements are reliable or not. In addition, with the public accounting profession, parties outside the company can trust the decision to assess the trustworthiness of the financial statements presented by company management, so that public accountants are a profession trusted by the public.

In Indonesia, there are several cases of fraud against financial reporting in Banking industries, one of which is the case that befell PT Bakrieland Development Tbk (ELTY) in

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2013 which did not disclose actual long-term obligations. The company had bond debt of US$ 155 million and could not pay it at maturity. Finally, the Financial Services Authority (OJK) urged the company to immediately provide open reports to the public, because as a public company it should disclose all information related to the company. Based on this phenomenon, it is necessary to question how far the supervision of financial reporting disclosure in Indonesia. Thus, based on the background described above, we propose to test the accuracy of two variables which surrogate of governance; audit committee and external auditors as indicators of manipulated financial statements.

II. THEORY AND HYPOTHESIS

According to Jensen and Meckling (1927) in Indira Yuni & Setiawan (2019), agency theory is a relationship based on a contract between the principal as the authorizer and the agent who is the authorized party. Likewise with agency theory where the principal and agent have their respective interests. The difference in interests is what causes the conflict of interest between the principal and the agent. In addition, there is information asymmetry between the two parties because agents want high compensation, so it is likely that moral hazard will occur by agents. In these asymmetric conditions, it can lead to opportunistic behavior by management. This opportunistic management behavior further encourages the possibility of fraud in financial reporting, management can act freely to take actions that can affect the accounting numbers presented in the financial statements. To overcome these acts of fraud, the implementation of good corporate governance in a company is required and one of the most important parts in improving the structure and practice of good corporate governance is by forming committees under the board of commissioners, one of which is by forming an audit committee (Husaini, 2009: 39).

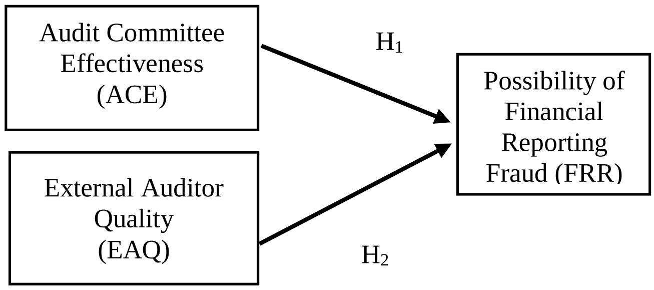
Independence means free and without being tied to other people. Thus, the need for an independent audit committee aims to maintain integrity and an objective view in the report and preparation of recommendations submitted by the audit committee, because independent individuals tend to be fairer and more impartial and objective in dealing with a problem (FCGI, 2022). The existence of an independent audit committee is expected to reduce the possibility of fraudulent financial reporting because an independent audit committee will not be easily influenced by other parties in the company. Based on research conducted by Uzun et.al (2004) which states that increasing the independent audit committee reduces fraudulent financial reporting, the hypothesis can be formulated as follows:

H_1: The audit committee has a negative effect on the possibility of fraudulent financial reporting.

The financial statements that have been made by management will be audited by an external auditor as an effort by the company so that the financial statements that have been made can be trusted by outsiders. The external auditor in carrying out its duties and functions is to provide assurance to shareholders that the financial statements presented by management are fair, free from material misstatement and in accordance with applicable financial accounting standards. Thus, the role performed by the external auditor is expected to be able to detect the possibility of fraud in financial reporting. According to De Angelo (1981) in Dwiputri (2013), a large public accounting firm has the ability to specialize and innovate through technology so that it is possible to find fraud in the company in other words, a large public accounting firm has sufficient resources to correct errors in the financial statements. From this description, the following hypothesis can be formulated:

H2: The quality of the external auditor has a negative effect on the possibility of fraudulent
financial reporting.

From the explanation above, a conceptual framework can be formulated as follows:



III. RESEARCH METHOD

3.1. Population and Sample

The population in this study are banking companies listed on the Indonesia Stock Exchange for the 2019-2021 period. Sample selection using purposive sampling method, the use of criteria in purposive sampling is as follows:

1. Banking companies listed on the IDX consecutively during 2020-2021
2. Publish complete financial statements that have been audited by an independent auditor in the 2019-2021 period, consisting of an auditor's opinion report, statement of financial position, income statement, statement of changes in equity and cash flow statement and notes to financial statements.
3. Companies that report the number of meetings agenda audit committee members in 2020- 2021.
4. Financial statements are presented in rupiah
5. The End of Financial Report is December 31.

3.2 Operational Definition

3.2.1 Dependent Variable (Possible Financial Reporting Fraud)

One method that can be used in detecting the possibility of fraudulent financial reporting is measured using the Beneish

M-Score Model. The Beneish M-Score Model is a method that helps reveal companies that may commit financial reporting fraud (Beneish, 2012), namely, to categorize companies that commit fraud and non-fraud. This method is a method to measure the high and low probability of a company manipulating its earnings (Beneish, 2012). This analysis can be measured based on 8 measurement dimensions, namely: Days Sales in Receivable Index (DSRI), Gross Margin Index (GMI), Asset Quality Index (AQI), Revenue Growth Index (RGI), Depreciation Index (DEPI), Sales General and Administrative Expenses Index (SGAI), Leverage Index (LVGI) and Total Accruals to Total Assets (TATA). After calculating each variable, it is then formulated into the Beneish M Score Model formula, where the Beneish M Score Model formula is a standard formula as shown below:

$$\text{M-Score} = -4.84 + 0.920\,DSRI + 0.528\,GMI + 0.404\,AQI + 0.892\,RGI + 0.115\,DEPI - 0.172\,SGAI - 0.327LVGI + 4.697\,TATA$$

The number -4.84 is a constant and the eight financial ratio variables are multiplied by each constant. If the Beneish M-Score is greater than -2.22 then the financial statements are indicated to have been manipulated or indicated that the company is committing possible financial reporting fraud. If the Beneish M-Score is smaller than -2.22 then the financial statements are indicated to be not manipulated or indicated that the company does not commit possible fraudulent financial reporting (Beneish, 1999). The variable of the possibility of fraudulent financial reporting is a dummy variable so that companies that commit possible fraudulent financial reporting are given a score of 1 while companies that do not commit possible fraudulent financial reporting are given a score of 0.

3.2.2 Independent Variable

The first independent variable in this study is the effectiveness of the audit committee. According to Arief (2009: 25) the audit committee is a committee that exists to do work independently, is not influenced and is formed by the board of commissioners. The effectivity of the audit committee is measured by the percentage of the audit committee that comes from independent commissioners compare with total audit committee (Husaini, 2012). Then the second independent variable is the quality of the external auditor (KAE) which is an achievement of public trust held by the KAP. Good auditor reputations such as the Big 4, these auditors tend to produce good audit quality so that their reputation remains good. Thus, the quality of external auditors can be measured by whether the KAP is included in The Big Four. The KAP affiliated with The Big Four in Indonesia are KPMG, Ernst, PWC and Deloitte Touche Tohmatsu. So that the external auditor quality variable in this study is measured by a dummy variable where, companies that use external auditors who are members of The Big Four KAP are given a score of 1 and companies that use external auditors who are members of non-The Big Four KAP are given a score of 0 (Dwiputri, 2013; Husaini, 2012).

3.3 Data Analysis

The research method used in this research is regression to determine the relationship between variables in a structured way in order to provide the right answer for research questions. The causal research is a study that involves data collection actions to determine whether there is a relationship and the level of relationship between variables significance or not. The data source for this research was obtained from the internet through the official website of the Indonesia Stock Exchange (IDX). The secondary data are annual report data and or governance report. The object of this research is banking companies listed on the Indonesia Stock Exchange for the period 2020 and 2021.We use multiple regression to test the hypothesis.

3.4.Multiple Linear Regression

The Equation to test the hypothesis is shown below:

$$FRR = \alpha + \beta_1 ACE + \beta_2 EAQ + \varepsilon$$

Where:

α : Constanta

Y : The possibility of financial reporting fraud. 1 for manipulated; 0 otherwise

$\beta_{1,2}$: Coefficient

ACE : Audit Committee Effectivity

EAQ : External Audit Quality

ε : *Error*

IV. RESULTS AND DISCUSSION

4.1 Statistics Descriptive

Table 4.1. Descriptive Statistics

	FRR	ACE	EAQ
N	86	86	86
Mean	.7791	.8372	.5116
Std. Deviation	.41731	.37134	.50280
Minimum	.00	.00	.00
Maximum	1.00	1.00	1.00

Based on table 4.1 above, it is known that the number of samples in this study were eighty six. Mean of financial reporting is 0.779, it is a mean in average the samples are manipulated firms (> -2.22). The audit committee effectivity is measured by the number of independent members, and the result show that our samples have the independent members more than 50%. This condition show that in average, they have good corporate governance, but unfortunately, they are also categorize as manipulated firms.

4.2 Frequency Analysis

Until analysing and explaining the regression findings, a systematic analysis was performed to screen the amount and ratios of financial statements among all organizations that are expected to have financial failures (fraudulent financial statements) and those that are expected to be free from fraudulent financial statements. The findings in **Table 4.3.** reveal that the overall amount of businesses with manipulated scores was 67 with a percentage (78 %) and 19 companies with non-manipulated scores (22%).

Table 4.3. Frequency Analysis

	Frequency	Percent
Financial statement for companies that are predicted to manipulated (M-score more than -2.22)	67	26.9%
Financial statement for companies that are predicted to non-manipulated (M-score less than -2.22)	19	32.1%
Overall	86	100%

4.3 Classification Table

Table 4.4. Prediction Table

Observed		Predicted Y		Percentage Correct
		0.00	1.00	
Y	0.00	0	19	0
	1.00	0	67	100%
Overall Percentage				77.9

*The cut value is 0.5

For the case of companies that are unlikely to commit financial reporting fraud from a total of 86 companies, the logistic model incorrectly predicts 19 non-manipulated firms observations so that the model accuracy is 0%. Furthermore, for 67 companies that may commit financial reporting fraud, the logistic model correctly predicts all observations so the accuracy of the model in predicting manipulated financial report is 77.9%.

4.4. Regression Results

Table 4.5. Regression Results

Variables	Prediction	Coefficients	t-test	p-value	Conclusion
ACE	-	-2.081	-1.964	0.021 **	Significance
EAQ	-	-19.641	-1.413	0.080 *	Significance
Adj. R^2	0.65%				
F-test	3.978 (0.022)				

**sig. < 5; *sig.<10%

The results confirm that governance, audit committee activity and audit quality, significantly influence the tendency of banks to commit financial statement fraud. The existence of an audit committee and a quality audit firm can significantly reduce the level of financial statement manipulation in the Listed Bank firms in Indonesia. As, we consider many regulations of governance in banking that have been enacted, empirically effectively improve the fairness of published financial reports.

V. CONCLUSION

Based on the results of data analysis, it can be concluded that partially the audit committee effectiveness variable does not have a significant effect on the possibility of fraudulent financial reporting. The reason underlying the results of this study is that the independence contained in the audit committee has not contributed to avoiding the possibility of fraudulent financial reporting in a company. This is due to the appointment of audit committee members only because of the law that requires an audit committee in the company (Abdullah and Nasir, 2004). In addition, the audit committee is considered unconvincing to be able to carry out its functions effectively because when the audit committee still gets benefits from the company, its independence is difficult to realize (Husaini, 2012). The number of meetings or meetings of the audit committee has no significant effect on the possibility of fraudulent financial reporting. This is because the meetings or meetings held are only intended to fulfill the rules or regulations set by the Indonesian Financial Services Authority, and ultimately have an impact on the ineffectiveness of the meetings or meetings held. The existence of problems that are not revealed in the financial reporting process as a result of the lack of activeness of the audit committee, management, and external auditors in attending meetings, causing problems in the financial reporting process to not find a good solution (Pamudji and Trihartati, 2010).

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