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Financial Stability, Monitoring, and Replacement Directors on Fraudulent Financial Reporting

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Abstract

An issue of concern is fraudulent financial reporting has the potential to cause significant economic losses to investors and the government, as well as loss of investor trust because it may lead to investors making poor investment decisions. With fraudulent financial reporting as a dependent variable, this study's primary goal is to investigate the empirical financial stability, monitoring, and replacement of company directors, all of which are used as proxies for the pressure, opportunity, and capability elements of fraudulent financial reporting. The banking industry makes up the majority of the study's participants. Purposive sampling was used to select 123 companies for the research sample; panel data regression was used as the statistical method, and EViews 10 was used as the statistical processing software. There was a correlation between fraudulent financial reporting and monitoring in this study, but not between financial stability and the replacement of board members of directors.

Keywords: *Fraudulent Financial Reporting, Banking Companies*

1. Introduction

A misstatement in reported financial statements is considered fraud (Arens et al., 2017). There are two types of fraud: misleading financial reporting (containing fraud) and mistreatment of assets (Hery, 2017). Financial reporting fraud is a one of the types that auditors perceive because the amount involved is frequently material, and financial statements are usually the most problematic (Messier Jr. et al., 2017).

One form of fraud that has a long-term impact on the company is fraudulent financial reporting or financial statements. Financial statements can present data and information that companies can use for decision making to ensure the company's sustainability; therefore, if the financial statements given are of poor quality and do not adhere to financial accounting rules, the decisions made by financial statement users will be inaccurate, detrimental to many, and impact company's sustainability.

Based on the ACFE (Association of Certified Fraud Examiners) Report to The Nation survey in 2018 and 2020, financial statement fraud is the rarest fraud, as much as 10% in both 2018 and 2020 compared to asset misappropriation as much as 89% and 86% in 2018 and 2020, but fraud in financial statements causes the most losses of USD 800,000 and USD 954,000 in 2018 and 2020; furthermore, the financial and banking sectors have the highest number of fraud cases (ACFE, 2018 and 2020).

In Indonesia, in particular, the following is an example of fraud case of fraudulent financial statements, which involved a mark-up on financial statements. The Otoritas Jasa

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Keuangan (OJK) (Financial Services Authority) disclosed the banking crime conducted by the Commissioner of Bank Perkreditan Rakyat Multi Artha Mas Sejahtera (BPR MAMS), in which had been started with the OJK's supervision of BPR MAMS's activities, followed up by Satuan Kerja Penyidikan Sektor Jasa Keuangan (Financial Services Sector Investigation Unit) of OJK. The occurrence of this fraud related to BPR MAMS was carried out by the commissioner of BPR MAMS with the initials H with an amount of IDR 6.280 billion, which was used to benefit one's own interests. H's modus operandi as Commissioner of PT. BPR MAMS is by making false records in the process of reporting and business activity report documents, transaction reports, and intentionally causing non-recording in the books or financial statements and records or business activity reports. The impact of this fraud is PT. BPR MAMS, having its address at Revo Town, Bekasi City, has had its business license revoked by OJK since August 26, 2016. This closure was carried out because it complies with Bank Indonesia Regulation No. 11/20/PBI/2009, regarding the Follow-up to the Handling of Rural Banks under Special Supervision Status where BPR MAMS was assigned the status of Special Supervision.

Financial stability is one of the characteristics that can influence fraudulent financial reporting. Financial stability is a variable that represents pressure. It is reasonable to conclude that economic pressure can impact financial stability. The economic pressure makes both economic conditions and income unstable. According to (Arens et al., 2019), the economic, industry, or operational conditions affect the financial stability or profitability of the organization. For example, a considerable change in customer demands and rising business failure in an industry or the economy as a whole. Financial stability is one part of the economic system. The high level of economic growth shows good stability in a series of economic systems (Iramayasari & Adry, 2020).

Monitoring is one of the characteristics that can influence fraudulent financial reporting. (Daulay et al., 2017) said that monitoring is a systematic attempt to establish deployment standards in conjunction with planning objectives, create a feedback information system that compares actual operations to preset criteria, identify and measure deviations, and take the required corrective action to guarantee that all corporate resources have been utilized most effectively and efficiently in accomplishing company goals. The mentioned monitoring definition implies that monitoring is a process of essential elements. (Messier Jr. et al., 2017) said that monitoring is improbable to be effective if detected control inadequacies are not promptly conveyed to those with management or oversight responsibilities.

Replacement of company directors is one of the characteristics that can influence fraudulent financial reporting. According to (Kranacher & Riley, 2019), the greatest frauds are committed by intelligent, experienced, and imaginative individuals who have a thorough knowledge of business controls and vulnerabilities. Replacement of company directors is a variable used to describe the capability factor. According to (Amat, 2019), the elements that define someone who can commit fraud can be: 1. Training (education level, computer skills, financial techniques, accounting, etc.). 2. Experience. 3. Network connection. And 4. Position in the company. For example, certain positions allow interference in contracts, account formulation, etc. This study was motivated by the high prevalence of fraudulent financial reporting in Indonesia, particularly in the financial and banking sectors and the ACFE's 2018 and 2020 Reports to the Nation, which stated that the banking and financial sectors have numerous fraud cases. Additionally, the purpose of this study was to conduct a more thorough examination of Crowe's fraud pentagon theory (Crowe, 2011) and its ability to investigate and provide additional explanations for the effect of fraudulent financial reporting. This study examines only a few of the proxy variables' elements.

Researchers have identified the different contexts of this research with previous research, such as the research period, the small number of similar studies conducted in the banking sector, the distinction to other studies conducted in the banking sector because it used the Beneish Ratio Index for measuring Fraudulent Financial Reporting variables, and simultaneously used panel data regression methods as a method of data analysis along with E-Views as a tool to process data.

2. LITERATURE REVIEW

2.1 GONE Theory

According to (Jack Bologne, 1993), The GONE theory is an improved version of the Triangle Fraud approach, which states that Pressure, Opportunity, and Rationalization are the reasons why a corruptor commits fraud. The four factors are 1) Greed, similar to the greed of corrupt actors. 2) Opportunity, a system that facilitates corruption. 3) Need, a psychological condition in which there is never enough and always full of endless needs. 4) Exposure, sanctions imposed on corrupt actors that have no deterrent effect on the actors or other individuals. The greed is not an essential human trait. The human possibility has evolved with the level of greed as a mechanism for survival and can happen to anyone; hence adequate supervision or monitoring is needed within the company in order to reduce the opportunity for agents or management to misbehave and harm the company (Larasati et al., 2020).

2.2 Crowe's Fraud Pentagon Theory

Fraud pentagon is a newly updated hypothesis that explores more profound the variables that lead to fraud. This hypothesis was advanced by Crowe Howarth in 2011. This theory develops Cressey's fraud triangle model, namely: three factors that influence fraud are opportunity, motivation, and rationalization. These three factors have the same degree of influence on each other. This pentagon fraud theory also includes two additional fraud variables, namely competence and arrogance.

3. Hypotheses Development

3.1 Financial Stability

Financial stability or profitability are jeopardized due to adverse economic, industry, or operating conditions affecting the entity, such as increased competition or saturation of the market and accompanied by shrinking margins, there is a strong tendency toward rapid change, whether technological advancements, obsolescence of a product, or interest rates, demand from consumers is declining significantly, and failures of businesses are increasing within the industry and across the economy, business failures result in threats of hostile bankruptcy, foreclosure, or takeover, excessive growth or profitability, particularly in comparison to similar businesses, and new accounting standards, legislation, or regulations describe factors affecting a business's financial stability (Messier Jr. et al., 2017). A correlation between financial stability and fraudulent financial reporting was found by (Ozcelik, 2020; Septriyani & Handayani, 2018; Tjen et al., 2020) obtaining the results that financial stability has a positive effect on fraudulent financial reporting.

According to (Corbacho & Peiris, 2018) the definition of financial stability is a condition in which the financial system can provide good financial services and is also resistant to shocks. The financial system provides essential services such as taking deposits and investments for savers, loans and securities for investors, liquidity and payment services for both, and risk diversification and insurance services. Financial instability hinders some (or all) of these key services.

3.2 Monitoring

One of the consequences of ineffective supervision or ineffective monitoring is the occurrence of fraudulent practices since it provides a chance for agents or managers to be defiant. If a company has more than one independent board of commissioners, the greater the oversight, which helps keep fraud minimum (Skousen et al., 2008). As per OJK regulation No. 57/POJK.04/2017, a company's independent commissioners must account for at least 30% of its total commissioners. In accordance with (Tessa G. & Harto, 2016), effective monitoring is a condition in which a company owns and operates an effective internal control system.

A more significant number of commissioners can minimize fraud. Still, independent commissioners' primary duty is to oversee the principles of Good Corporate Governance (GCG), which is regulated in POJK No. 57/POJK.04/2017 to protect the interests of investors, stakeholders, and the company itself. As described above, one of the consequences of lack of corporate oversight is the occurrence of fraudulent practices; as a result, agents or managers may act defiantly by committing fraud. Correlation between ineffective monitoring and fraudulent financial reporting was found by (Agusputri & Sofie, 2019; Chen et al., 2016; Mardiani et al., 2017) obtaining the results that monitoring has a positive effect on fraudulent financial reporting. Therefore, if a company has more than one independent board of commissioners, the greater the level of supervision of a company so that there is less possibility of fraudulent financial reporting.

3.3 Replacement of Company Directors

Replacement of directors is a variable used to describe the capability factor. (Wolfe & Hermanson, 2004) argue that if no one can carry out the fraud in detail, fraud will not occur. Based on the description above, the fraudster must have the capability to commit fraud. However, a stress period may be caused by the replacement of company directors (Septriyani & Handayani, 2018). Generally, companies make replacement of directors or election of new directors to enhance the performance of older directors who are perceived to be less capable. (Agusputri & Sofie, 2019).

Correlation between replacement of company director and fraudulent financial reporting was found by (Kabila & Suryani, 2019; Sunardi & Amin, 2018; Utami & Pusparini, 2019) obtaining the results that replacement of company directors has a positive effect on fraudulent financial reporting.

3.4 Fraudulent Financial Reporting

There is a distinction between asset misappropriation, alternatively referred to as defalcation or employee fraud, and fraudulent financial reporting, alternatively referred to as management fraud. Asset misappropriation occurs when a clerk steals cash during a sale and fails to record the transaction in the cash register. Fraudulent financial reporting occurs when sales are intentionally overstated near the balance sheet date in order to increase reported earnings. Typically, management commits financial reporting fraud, sometimes without the knowledge of employees. Management has the ability to make accounting and reporting decisions without the knowledge of employees. A case in point is the omission of a critical footnote disclosure about pending litigation (Arens et al., 2017).

According to (Noval, 2018), most financial statement fraud cases involve attempts to overstate income, either by overstating assets and income or by erasing liabilities and expenses. Companies may also intentionally understate profits to conceal their actual financial position. In non-public companies, this is done to lower their income tax liability. Companies can also purposefully reduce revenues when they gain high profits to build up profit margins and profit reserves.

To substantiate the theory, the following image depicts the research model.

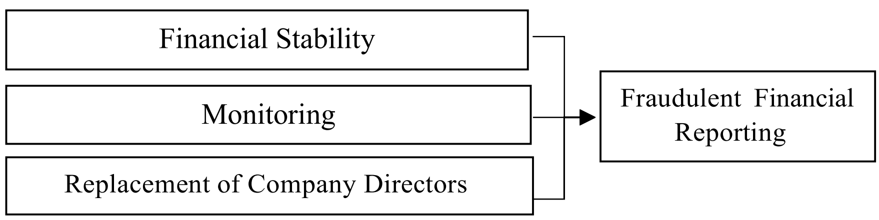

Fig. 1. Research Model

4. METHODS

The data analysis method that the researchers chose was the quantitative method. The analytical technique that the researcher applied for hypothesis testing is panel data regression analysis assisted by EViews version 10 software. Panel data regression technique, as described by (Ghozali, 2018), combines time-series and cross-sectional data and offers several advantages, namely presenting data more informatively, more varied, the level of collinearity is low between variables, the degree of freedom is more significant, it also increases efficiency.

The population of this study consists of banking sectors that are publicly traded on the IDX between 2018 and 2020, and data (criteria) were picked using a purposive sampling technique. The initial population obtained was 43 companies, but after being selected based on the established criteria, the final sample was 41 companies. Then the observations were made for three years multiplied by 41 companies, resulting in the number of observations obtained being 123 observations.

The Beneish Ratio Index (Messod Beneish, 1997) was used to measure the fraudulent financial reporting variable. Beneish Ratio Index has a measurement formula as follows: = -4.840 + 0.920 multiplied by the index of days sales in receivables + 0.528 multiplied by the index of gross margin + 0.404 multiplied by the index of asset quality + 0.892 multiplied by the index of sales growth index + 0.115 multiplied by the index of depreciation – 0.172 multiplied by the index of sales general and administrative expenses – 0.327 multiplied by the index of leverage + 4,697 multiplied by the index of total accruals to total assets) (Gaspersz, 2013).

A company has a tendency to manipulate or be a manipulator if the calculated score is above -2.22. Meanwhile, if the score is less than -2.22, it is either not manipulating or belongs to a group of non-manipulating companies (Santosa & Ginting, 2019). In this study, the growth rate of change in assets (ACHANGE) is used as a proxy of financial stability due to fraudulent financial reporting can arise because the company's management is under pressure to show that the company has been able to manage assets properly. Asset management aims to increase bonuses and generate high returns for investors, management will use financial statements as a tool to cover up the company's financial stability (Hanifa & Laksito, 2015). A percentage of the total independent commissioners is used to calculate the monitoring ratio (BDOUT), and replacement of company directors is proxy using (DCHANGE) with the provisions of code one (1) if the company replaces directors during the observation period, and if there is no replacement in directors during the observation period, the code is zero (0).

5. RESULTS

5.1 Descriptive Statistics Test

The sample description and the description of the research variables are determined before testing the hypothesis and defined by all variables in this study. After obtaining the data, it will be reviewed descriptively in terms of the condition of each study variable. The descriptive statistical testing used in this investigation is summarized in Table 1, which includes a description of the statistical variables used.

Table 1. Descriptive Statistical Analysis Results

	ACHANGE	BDOUT	DCHANGE	FFR
Mean	0.119184	0.531314	0.455285	-1.064297
Maximum	1.194090	1.000000	1.000000	37.14768
Minimum	-0.340860	0.250000	0.000000	-10.24181
Std. Dev.	0.224436	0.133466	0.500033	5.297458
Observations	123	123	123	123

ACHANGE has a mean of 0.119184 or 12%. It indicates that, on average, 13% of banking sector firms have financial stability. In 2020, the sample with the lowest value, -0.340, is owned exclusively by the BEKS code, while the sample with the highest value, 1.194, is owned exclusively by the AMAR code 2018. According to PT Bank Pembangunan Daerah Banten Tbk's (BEKS) 2020 financial report, asset growth decreased by IDR 2,760,047 (in millions of rupiah) or 34% in 2020 compared to the previous year. The decrease was primarily due to a decrease in third-party loans, which resulted in net allowance impairment losses of IDR 2,242,526 (in millions of rupiah) or 43%. While the financial statements of PT. Bank Amar Indonesia (AMAR) in 2018 indicated that asset growth increased by IDR 1,010,375 (in millions of rupiah) or 119 percent in 2018. The increase was primarily due to an IDR 961,341 (in millions of rupiah) increase in net loans (loans – net). While the average value of asset growth is 0.120, which indicates that asset growth is still relatively low, firms experiencing below-average industrial growth have a proclivity for manipulating financial statements to improve company prospects.

The average value of BDOUT is 0.531314 or 53%. It equates to 53% of banking sector firms being supervised. The sample with the lowest value, 0.250, corresponds to four samples out of 123, while the sample with the highest value, 1,000, corresponds to two samples out of a total of 123. While the average proportion of commissioners is 0.531, indicating a relatively high level of supervision by independent commissioners, the average company has more than one board of commissioners. The more boards of commissioners a company have, the greater the level of supervision and the possibility of minimizing fraudulent practices.

DCHANGE has an average value of 0.455285 or 45%. It indicates that an average of 45% of companies in the banking sector have a replacement of directors. The sample with the lowest score of 0.000 is the value of 67 samples out of 123; it shows that 67 samples did not replace directors during the 2018-2020 period. While the rest, which is 56 samples with the highest score of 1,000, are companies that replace directors during the 2018-2020 period.

Fraudulent Financial Reporting has an average value of -1.06 percent and an M score of -2.22 for the criteria for fraud benefit. The fact that the mean exceeds the criteria indicates that, on average, there are more firms that manipulate than firms that do not manipulate. The manipulator sample contains 64 samples, while the non-manipulator sample contains 59 samples out of 123. It demonstrates that the difference between manipulator and non-manipulator banking sector companies in Indonesia between 2018 and 2020 is not statistically significant because the difference is only five samples out of 123 samples or a difference of 5%.

5.2 Chow Test Results

The probability value in the table below is 0.0334, which is below than significant level of 0.05. Researchers concluded that the selected model for the Chow test is Fixed Effect Model (FEM).

Table 2 The Results of Chow's Testing

Redundant Fixed Effects Tests
Equation: Untitled
Test cross-section fixed effects

Effects Test	Statistic	d.f.	Prob.
Cross-section Chi-square	57.884839	40	0.0334

5.3 Hausman Test Results

The probability value in the table below is 0.0106, which is below than significant level of 0.05. As a result, researchers concluded that the selected model is FEM for the Hausman test. In selecting the estimation model for this study, the Lagrange Multiplier test is not needed because the Chow test and Hausman test in this study demonstrates that the FEM is the most appropriate model.

Table 3 The Results of Hausman's Testing

Correlated Random Effects - Hausman Test
Equation: Untitled
Test cross-section random effects

Test Summary	Chi-Sq. Statistic	Chi-Sq. d.f.	Prob.
Cross-section random	11.214922	3	0.0106

5.4 Coefficient of Determination Test

Table 4 Coefficient of Determination (R2) Test Result

R-squared	0.398691

Adjusted R-squared	0.071397

The R2 test generated an R-squared with the value of 0.399 or 39,9%. These results indicate that variations in the variables of financial stability, monitoring, and replacement of directors can explain 39,9% of variations in the fraudulent financial reporting variable. The presence of 60,1% left indicates that other variables can explain the variation in fraudulent financial reporting that is not included in panel data analysis utilized in this study.

5.5 Simultaneous Test (F)

Table 5 Simultaneous Test (F)

F-statistic	1.218143
Prob(F-statistic)	0.021785

The value generated by the simultaneous test (F) is 1,218, with a P-value of 0.021785. These data demonstrate the feasibility of the regression model used in this test and are valid because 0.021785 is less than the 5% significance level.

5.6 Panel Data Regression Test

The panel data regression analysis produced the following conclusions:

Table 6 Panel Data Regression Test

Variable	Coefficient	Std. Error	t-Statistic	Prob.
C	2.312138	0.670941	3.446109	0.0009
ACHANGE	0.064819	0.234121	0.276861	0.7826
BDOUT	2.993305	1.225774	2.441970	0.0168
DCHANGE	0.033501	0.252187	0.132842	0.8947

ACHANGE has a coefficient of 0.0648, is positive, and a probability of 0.7826 or greater than 0.05. BDOUT has a coefficient of 2,9933, is positive, and has a probability of 0,0168 or less than 0.05. DCHANGE has a coefficient of 0.0335 is positive, with a probability of 0,8947 or greater than 0.05. The result explains that correlation to fraudulent financial reporting exists only in monitoring.

6. DISCUSSION

There is more than a 0.05 significance level for financial stability. The result explains that H1 is rejected. Banks are institutions that are less likely to experience financial problems. Banks that already have good financial capabilities do not need to use unstable financial reasons to manipulate financial statements. (Ayadi, 2020) explained that asymmetric information concerns can be resolved by banks using risk analysis and supervisory advantages, lowering the likelihood of adverse selection and moral hazard. Although this study discovered that asset growth is relatively low, the financial performance of a bank cannot be determined solely by the assets that exist in the bank, which is regulated in Bank Indonesia No. 6/10/PBI/2005, concerning the assessment and method of measuring the soundness of a commercial bank using CAMEL (Capital, Asset, Earnings, and Liquidity) analysis, mentioned analysis is used to assess and measure the soundness of a commercial bank. This research is validated by (Fitriana et al., 2021; Quraini & Rimawati, 2019; Sasongko & Wijayantika, 2019). In contrast, the result of this study contradicts those of (Ozcelik, 2020; Septriyani & Handayani, 2018; Tjen et al., 2020).

The monitoring has a significant level of less than 0.05. The results explain that H2 is accepted. The result confirms that ineffective or inadequate supervision will have an impact on the output of financial statements, which leads to financial statements can contain fraud. On the other hand, if the company has adequate and good supervision, fraud in financial statements will not happen. This research does show that the number of banks with more independent commissioners are less than the number of banks with fewer independent commissioners. However, this study does not have sufficient evidence because this proxy is seen only from the percentage of independent commissioners in the company. Still, there are other factors, such as whether the independent commissioners apply the principles of GCG as the duties of independent commissioners. This research is validated by (Agusputri & Sofie, 2019; Chen et al., 2016; Mardiani et al., 2017). In contrast, the result of this study contradicts those of (Fadillah et al., 2020; Putriyanti & Cahyati, 2020; Sunardi & Amin, 2018).

The replacement of company directors has a significant level of more than 0.05. The result explains that H3 is rejected. The replacement of company directors is not only associated with fraud but also is carried out to recruit more knowledgeable directors than their predecessors. The replacement of incompetent directors is considered effective because it enables the company's performance to improve (Septriyani & Handayani, 2018). In addition, there is a possibility that a replacement of company directors will be made if the previous directors retire or die. This research data shows that 67 samples out of 123 did not replace directors during the 2018-2020 period, which means that few companies appointed replacement directors during the study period. This research is validated by (Agusputri & Sofie, 2019; Putriyanti & Cahyati, 2020; Septriyani & Handayani, 2018). In contrast, the result of this study contradicts those of (Kabila & Suryani, 2019; Sunardi & Amin, 2018; Utami & Pusparini, 2019).

7. CONCLUSION

In summary, the only variable that correlates with fraudulent financial reporting is the monitoring variable. It can happen because ineffective or weak supervision will affect the output of the financial statements produced, which leads to financial statements can contain fraud. On the other hand, if the company has effective and good supervision, fraud in financial statements will not happen. In this case, it can be assumed that this research sample does not have good monitoring. On the contrary, financial stability and the replacement of company directors do not correlate with fraudulent financial reporting. The reason is that banks used in this research are already listed on the capital market. It is rare for a bank to experience financial instability because the banking industry is different from other industrial sectors, which can experience financial difficulties at any time, and it is possible to happen that the replacement of company directors certainly has a good purpose and has gone through careful consideration; hence it is unlikely a replacement of directors can cause fraudulent financial reporting.

This research provides implications for the government, all shareholders, and other parties who require information in evaluating the viability of reporting company financial statements while considering the elements that impact it. The research findings may have implications for the company and its management when publishing its financial statements. Shareholders, regulators, and other stakeholders can assess the magnitude of the risk in the company to prevent fraud that is problematic to numerous parties. It is advised that more studies be conducted in other areas, such as the mining sector, financial sector, and others.

8. LIMITATION

Considering limitations of time and data, the researchers examined only a small sample of banks during a three-year period. The study results could have obtained different results if more samples were tested, other proxies were used for measuring Fraudulent Financial Reporting variables, and other proxies were used for measuring Financial Stability. Further research, if using the banking sector as population, is necessary to consider that banks' financial performance is not appropriate to be measured against growth assets because banks' financial performance cannot be determined solely by their assets.

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