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Effect of Financial Stability, External Pressure, Change in Director, Effective Monitoring, Change in Auditor, and Arrogance on Financial Statement Fraud

(Empirical Study on Mining Companies Listed on the Indonesia Stock Exchange in 2018-2020)

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Abstract: *Fraud is usually carried out by management or employees who are used to benefit their own wealth or to help others involved with it. Financial reporting that contains a fraudulent component can cause a decrease in the integrity of a data where the data presented can mislead investors and other users of financial statements. When there is a material error in the financial statements, the data contained in it becomes irrelevant as a basis for decision making because the analysis carried out is not based on actual data. This study aims to empirically examine the effect of the pentagon fraud in explaining the incidence of financial statement fraud. This study consists of six variables, namely financial stability, external pressure, change in director, effective monitoring, change in auditor, and arrogance. The dependent variable, namely financial statement fraud, was measured using the Beneish M-Score. There are several financial ratios used in the M-Score detection, namely day's sales in receivable index (DSRI); gross margin index (GMI); asset quality index (AQI); sales growth index (SGI); depreciation index (DEPI); sales, general and administrative expenses (SGAI); leverage index (LVGI), and total accrual to total assets (TATA).The company can be said to be manipulating if the M-Score>-2.22. The results of the M-Score are then translated into a dummy variable where a value of 1 means committing fraud while a value of 0 means not committing fraud. The research sample is mining companies listed on the Indonesia Stock Exchange in 2018-2020. The sampling method in this research is purposive sampling method, namely taking samples based on certain criteria, so that the final results obtained are 105 samples. This study used logistic regression analysis. Based on the results of the first and fifth regression models, namely financial stability and change in auditors had a positive effect on financial statement fraud, while external pressure, effective monitoring, and arrogance had no effect on financial statements fraud.*

Keywords: *Financial Statement Fraud, Beneish M-Score, and the Pentagon Fraud*

I. INTRODUCTION

Financial reports are an important medium for companies because they contain an overview of the company's performance in a certain period that is useful for decision-making considerations of executives. Therefore, the company's management will do everything that can be achieved to generate good profits so that good performance is reflected as well. The business world has progressed rapidly from time to time. However, this progress is not matched by adequate control. This is indicated by the existence of cases of fraud or *fraudulent* financial statements committed by a handful of companies.

According to O'Gara (2004) *fraud* is fraud includes a series of irregularities and illegal acts characterized by intentional fraud. *The Association of Certified Fraud Examiners* (ACFE) defines *fraud* as a deliberate and unlawful act for a specific purpose. Overall, *fraud* is a fraud with unexpected elements, deceit, cunning, untruth and presenting something that is not in accordance with circumstances that are detrimental to other parties for personal gain Sudarmanto(2020).

Fraud is usually carried out by management or employees who are used to benefit their own wealth or to help others involved with it. According to the classification described by Jones, P and J. Bates(1990) which states that *fraud* in the form of *Theft Act* 1968 is embezzlement that includes various kinds of fraud, including fraud committed intentionally, falsification of accounts, bad practices, embezzlement or theft and corruption.

Financial reporting that contains a fraudulent component can cause a decrease in the integrity of a data where the data presented can mislead investors and other users of financial statements. When there is a material error in the financial statements, the data contained in it becomes irrelevant as a basis for decision making because the analysis carried out is not based on actual data. Thus, the information presented can have a negative impact on various parties such as owners, creditors, employees, auditors and even competitors.

The ACFE survey in the *Report to the Nation* (RTTN) 2020 stated that fraudulent acts in financial statements have the smallest frequency but have a large impact on losses with an average loss value of US$ 954,000. ~~the~~ The mining and energy sectors are ranked in the top two with the highest average losses due to *fraud.*

The Enron scandal is *fraud* in the mining sector. The accounting case is estimated to have caused losses of US$50 billion, plus losses to investors of US$32 billion and thousands of employees losing their pension funds of about US$1 billion. Enron is known to be the 12th largest contributor to President George Bush's campaign funds. This collusive practice gave *privilege* and convenience to take part in formulating minimal policies in the energy sector majalah.tempo.co(2002). Meanwhile, in Indonesia, there were several cases of fraudulent financial statements that caught the public's attention, including those committed by PT Garda Tujuh Buana Tbk (GTBO) in 2012 which was accused of manipulating financial statements due to indications of inappropriate 2012 financial statements. PT Timah Tbk (TINS) in 2015 was also suspected of reporting fictitious financial statements for the first semester of 2015.

The theory used in this study is the *fraud pentagon theory,* where *the fraud pentagon* is a complement to the *fraud triangle* and *fraud diamond.*

II. LITERATURE REVIEW AND HYPOTHESIS DEVELOPMENT

Agency Theory

Agency theory according to Jensen and Meckling (1976) is that, there is a relationship between the *principal* and *agent*, in which the principal delegates the agent (manager) to manage and make decisions for the company. In agency theory, the *principal* is the investor, while the *agent* is the company manager. This delegation makes *agent* (manager) aware of all information (good and bad) in the company. Information that is fully known by the *agent* makes *agent* opportunistic. This opportunistic or selfish nature causes managers not to disclose all known information in order to get bonuses/rewards from principals. This completely undisclosed information is called information imbalance. An example of this information asymmetry is *financial statement fraud*, such as *agent* not revealing that this year the company lost, the *agent* made a way to keep the company profitable that year. The elements that make *agents* act like this are *pressure, opportunity, rationalization, capability,* and *arrogance.*

Fraud

Fraud is basically a series of *irregularities* and *illegal acts* committed by outsiders or insiders in the company to gain benefits and harm others.

According to IAPI (2013) *fraud* is an intentional act by at least one or more individuals in management or those charged with governance, employees, and third parties that involves the use of deception to obtain an unjustified or unlawful advantage. Albrecht et al. (2012) expressed fraud as a common occurrence and includes various ways that individuals/groups exploit others without caring about other individuals through false information. There are various ways to commit fraud, including surprise, cunning, crime, and fraud.

According to The Association of Certified Fraud Examiners ACFE(2018) there is a framework that describes a fraud scheme. ACFE is a professional association engaged in the examination of fraud, classifying fraud into three levels called the Fraud Tree, namely:

*1.*AssetMisappropriation

Assets misappropriation includes misuse/theft of assets or assets of the company or other parties. This is the easiest form of fraud to detect because it is tangible or can be measured/calculated (defined value).

2. False Statements or False Statements (*Fraudulent Statements)*

Fraudulent statements include actions taken by the authorities or leaders of a company or government office to hide the actual financial condition by carrying out *financial engineering* in the presentation of its financial statements to gain profits or may be analogous to the term *window dressing*.

3.Corruption

type *fraud* is the most difficult to detect because it involves cooperation with other parties such as bribery and corruption, where this is the most common type in developing countries where law enforcement is weak and there is still a lack of awareness of good governance. so that the integrity factor is still questionable. *fraud* often cannot be detected because the parties working together enjoy the benefits *(mutualism symbiosis)*. This includes abuse of authority/ *conflict of interest*, bribery, *illegal* tips or receipts *(illegal gratuities)*, and *economic extortion.*

Financial Statement Fraud (Fraud Financial Statements)

Fraud Financial statement is defined as intentional acts and acts, errors or omissions of material reality, or misleading accounting information, and if considered with all the information that has been made, will subsequently cause the reader to change judgment or decision The American Institute of Certified Public Accountants-AICPA(2002). These acts and actions are intentionally carried out knowingly to misuse all that is owned collectively for the benefit of individuals and groups who then at that time present false information to cover up the abuse. *Fraud* is different from unintentional *error*. If a person accidentally enters incorrect information while recording a transaction, then it cannot be considered a *fraud* because it was done unintentionally. *Fraud* in financial statements is a deliberate carelessness in the disclosure of financial reporting where the financial statements presented are not in accordance with applicable accounting standards.

According to IFAC(2009), fraudulent financial reporting can be done by taking actions such as:

- Manipulation, falsification, or alteration of accounting records, supporting documents of the prepared financial statements.
- Intentional omission or omission in information that is significant to the financial statements.
- Doing intentionally misuse of principles relating to the amount, classification, presentation, or disclosure.

Fraud Pentagon Theory

Crowe (2011) suggests that *fraud* is based on five (5) sides, namely pressure, capability, opportunity, rationalization, and arrogance. *The measurement of each variable is financial statement fraud proxied by M-Score, fraud pentagon using proxies from each element, namely pressure proxied by financial stability (FSP) and external pressure (EPP), capability proxied by change in director (DCHANGE), opportunity proxied by effective monitoring (EMO), rationalization proxied by change in auditor (AUDCHANGE), and arrogance proxied by the number of CEO images in the annual report (CEOPIC).* According to Crowe (2010), there are two additional elements, namely competence and arrogance due to:

- Significant changes to the way the business operates.
- The corporate ladder structure common in the 1950s has given way to an organizational matrix, in which individuals with greater autonomy have the authority to effect change in various areas of the organization.
- Today's corporate culture also celebrates wealth and fame to a greater degree than it used to be 60 years ago.

1. Financial Stability

Financial stability describes the financial condition of a company. The company's financial condition or condition may be affected by the entity's economic, industry or operating conditions. This triggers a pressure for management to show the condition of the company in a stable position with the aim that the value of the company is maintained (Skousen, 2009). The company's total assets can reflect the company's financial stability. From this explanation, the first hypothesis can be proposed as follows.
H1: *Financial stability* has an effect on *financial statement fraud*

2. External Pressure

Aprilia(2017) says that pressure from external parties will cause management to seek loans from other parties, so that companies can compete competitively. This pressure eventually became a trigger for the management to engineer the company's financial statements. Usually the management will do more various ways to get a loan and will try to display or provide perfect financial reports so that their performance is considered good. From this explanation, the second hypothesis can be proposed as follows.

H2: *External pressure* has an effect on *financial statement fraud.*

3. Change in Director

how much power and limits a person has in committing *fraud* within the company. Wolfe.DT and Hermason.DR(2004), explained that the change of directors is a form of conflict of interest. The change of directors is one of the factors driving the occurrence of *financial statement fraud*, considering the impact of the change is the management's efforts to improve the results of the performance of the previous directors by changing the company's organizational structure or recruiting new directors who are considered to have better abilities than the previous directors. Based on the description that has been submitted, the third hypothesis can be formulated as follows.

H3: *Change in director* has an effect on *financial statement fraud.*

4. Effective Monitoring

monitoring is a situation where the company has an effective supervisory unit to monitor the performance of the company's management. The results of the study Herdiana.R and Sari.SP(2018) and Jones, P and J. Bates(1990) show that *effective monitoring* has an influence on *fraud* , especially if management intends to take inappropriate actions by exploiting system deficiencies or weaknesses. company internal control. Based on the results of previous studies, the fourth hypothesis can be proposed as follows.

H4:*Effective monitoring* has an effect on *financial statement fraud.*

5. Change in Auditor

Rationalization is a justification that arises in management's mind when fraud has occurred. This thought will arise because they do not want their activities to be known so they justify the manipulation that has been done. This action is taken so that they remain protected and free from punishment Aprilia(2017). Auditors have an important task to oversee the company's financial statements, where the assessment provided by the auditor can be used as a basis for assessment by users of financial statements. Therefore, the change of auditors by the company can also be considered as a form to eliminate the *fraud trail* found by the previous auditor. From this explanation, the fifth hypothesis can be formulated as follows.

H5:*Change in auditor* has an effect on *financial statement fraud.*

6. Arrogance

Arrogance or egoism is an attitude of superiority or greed from people who believe that internal control does not apply personally. The number of images of the Chief Executive Officer (CEO) displayed in the company's annual report can show the level of arrogance or superiority of the CEO. This is also supported by research results Chyntia Tessa. G and Puji Harto(2016), which show that the higher the quantity of CEO photos displayed in a company's annual report, the higher the level of CEO arrogance or egoism in the company. Through this elaboration, the sixth hypothesis can be proposed as follows.

H6: Arrogance has an effect on *financial statement fraud.*

III. METHOD

This study uses quantitative data which is data in the form of numbers. The related data is obtained from the Capital Market Reference Center through the www.idx.co.id website, which is in the form of the Financial Statements of Mining Companies on the Indonesia Stock Exchange (IDX) from the period 2018 to 2020. The population used in this study is mining companies registered in the Indonesia Stock Exchange. Indonesia Stock Exchange from 2018 to 2020, there are as many as 52 companies. This study used audited financial statements as objects. Samples were taken using purposive sampling method, where samples were taken according to predetermined criteria. Based on the sample criteria that have been determined in this study, the research sample obtained is 35 companies per year. So that the total sample used is 105 for the period 2018-2020. After testing the method, there were 12 companies that did not report an annual report for 2018-2020 in a row. Then, there are 5 companies that do not disclose data related to research variables and incomplete financial statements.

Table 1. Operational Definition

No	Variable	Indicator
1	Financial Statement Fraud (M-Score)	Code 1, if committing fraud Code 0, if not committing fraud
2	Financial Stability (FSP)	FSP = Total Assets(t) – Total Assets(t-1) Total Assets(t-1)
3	External Pressure (EPP)	EPP = Total Liabilities Total Assets
4	Change in Director (DCHANGE)	Code 1, if you change directors during 2018-2020 Code 0, if you don't change directors 2018-2020
5	Effective Monitoring (EMO)	Number of Independent Board of Commissioners Total Board of Commissioners
6	Change in Auditor (AUDCHANGE)	Code 1, if changing KAP during 2018-2020 Code 0, if not changing KAP during 2018-2020
7	Arrogance (CEOPIC)	Number of CEO images in the annual financial statements for 2018-2020

IV. RESULT AND DISCUSSION

Descriptive Statistics

Descriptive statistical analysis is used to determine the description of a data seen from the minimum value, maximum value, average value (*mean*), and standard deviation value. The minimum value is used to determine the smallest value of a data related to research. The maximum value is used to determine the greatest value of a data related to research. The average value is used to determine the average value of the data related to the study. The standard deviation is used to find out how much the related data has variation from the average. Descriptive statistical test results can be seen in the table below:

Table 2. Descriptive Statistical Analysis

Descriptive Statistics

	N	Minimum	Maximum	Mean	Std. Deviation
FSP (X1)	103	-0,52	0,62	0,0518	0,17210
EPP (X2)	103	0,09	1,29	0,5375	0,23702
DCHANGE (X3)	103	0	1	0,50	0,502
EMO (X4)	103	0,20	0,67	0,3934	0,09158
AUDCHANGE (X5)	103	0	1	0,25	0,437
CEOPIC (X6)	103	1	6	2,39	0,931
M SCORE (Y)	103	0	1	0,37	0,485
Valid N (listwise)	103				

Source: SPSS Output

The largest mean value is found in the Arrogance (CEOPIC) variable, which is 2.39, while the Financial Stability (FSP) variable has the smallest mean value, which is 0.0518. The highest maximum value is found in the Arrogance (CEOPIC) variable, which is 6. The largest minimum value is in the Arrogance (CEOPIC) variable, which is 1. The largest standard deviation value is in the Arrogance (CEOPIC) variable of 0.931, which means that the Arrogance (CEOPIC) variable has a risk higher for changes compared to other variables, while the smallest standard deviation value is found in the Effective Monitoring (EMO) variable, which is 0.09158, this indicates that the Effective Monitoring (EMO) variable has a low level of risk. The overall sample obtained was 105 samples over a 3 year period, but after the regression process there were some data that had extreme values or outliers as much as 2 outlier so that they had to be removed and the final sample was obtained as many as 103 samples.

The results of model testing using Hosmer and Lemeshow's Goodness of Fit Test showed a Chi-Square value of 6.189 and a significance value of 0.626 (more than 0.05), which means that this research model is feasible and fits the observation data. These results are supported by the value of -2LogL on Block Number 1 of 123.775 while on Block Number 0 of 135,627. The decrease that occurs in -2LogL shows a good thing because the regression model is already fit with the data. The overall percentage of the research model is 67%. The value of the coefficient of determination of Nagelkerke R Square shows a number of 0.148, meaning that the variability of the dependent variable can be explained by the independent variable only by 14.8%, the rest is explained through other variables.

Hypothesis testing was carried out by logistic regression analysis and a significance level of 0.05 showed the following regression equation:

FRAUD = -0.208 + 2.851FSP – 1.423EPP - 0.420DCHANGE – 0.474EMO + 1.244AUDCHANGE + 0.132CEOPIC + e

The results of this research hypothesis testing can be seen in the table below:

Table 3. Hypothesis Testing Results

Hypothesis	Description	B	Significant	Description
H1	*Financial Stability*has positif effect on *Financial Statement Fraud*	2,851	0,041	Accepted
H2	*External Pressure* has a negative effect on *Financial Statement Fraud*	-1,423	0,165	Rejected

H3	*Change in Director* has a negative effect on *Financial Statement Fraud*	-0,420	0,378	Rejected
H4	*Effective Monitoring* has a negative effect on *Financial Statement Fraud*	-0,474	0,848	Rejected
H5	*Change in Auditor* has positif effect on *Financial Statement Fraud*	1,244	0,019	Accepted
H6	*Arrogance* has a negative effect on *Financial Statement Fraud*	0,132	0,586	Rejected

Financial Stability be positive influence on Financial Statement Fraud

Based on the results of the regression coefficient significance test, the *financial stability* using the FSP proxy has a regression coefficient of 2.851 and a significance value of 0.041. Because the result of the significance value is less than 0.05, this indicates that FSP has a positive effect on *financial statement fraud.* Based on the results of the study, it can be concluded that **H1 is accepted.** Companies that have good financial stability will ensure the security of the funds given to the company. Asset growth is one of the tools used to measure financial stability in a company. If a company's financial condition is unstable, then the company tries to cover up its instability by committing *fraud.* The results of this study are supported by proprietary research Skousen et al.(2008) which shows that *financial stability* (FSP) has a positive effect on *financial statement fraud.*

External Pressure has a negative effect on Financial Statement Fraud

Based on the results of the regression coefficient significance test, the *external pressure* using the EPP proxy has a regression coefficient of -1.423 and a significance value of 0.165. Because the results of the significance value are greater than 0.05, this indicates that EPP has a negative effect on *financial statement fraud.* Based on the results of the study, it can be concluded that the size of the external pressure value will not affect the potential for *fraud* , therefore **H2 is rejected.** External pressures arise due to excessive pressure on management where management is required to meet targets given by third parties. When management fails to fulfill its obligations to external parties, it can trigger the emergence of external pressure and can encourage *fraud.* One of the pressures that management often experiences is the need to obtain additional debt. The results of this study are supported by the results of research of Khoirun et al. (2019) which shows that *external pressure* (EPP) has no effect on *fraudulent financial statements.*

Change in Director has a negative effect on Financial Statement Fraud

Based on the results of the regression coefficient significance test, the *change in director* using the DCHANGE proxy has a regression coefficient of -0.420 and a significance value of 0.378. Because the result of the significance value is greater than 0.05, this indicates that DCHANGE has a negative effect on *financial statement fraud.* Based on the results of the study, it can be concluded that **H3 is rejected.** A high position or position is one of the reasons for committing *fraud. A*change in the board of directors may indicate *fraud* caused by that person so the company decides to replace him with a more competent one. However, in reality the change of directors has no effect on *financial statement fraud.* This is because the change of directors in a company does not intend to take advantage of his position to commit crimes but is caused by other things. Change of directors can also be done because the directors are less competent in carrying out their performance. The results of this study are supported by the results of research conducted by Alfa and Dian (2018) which shows that *change in director* (DCHANGE) has no effect on *financial statement fraud.*

Effective Monitoring has a negative effect on Financial Statement Fraud

Based on the results of the regression coefficient significance test, the *effective monitoring* using the EMO proxy has a regression coefficient of -0.474 and a significance value of 0.848. Because the results of the significance value are greater than 0.05, this indicates that EMO has a negative effect on *financial statement fraud.* Based on the results of the study, it can be concluded that **H4 is rejected.** The higher the ratio of independent commissioners in a company, the more effective *monitoring* formed by the company. The number of independent commissioners in a company, the *monitoring* or supervision system in the company will be assessed as good and also the performance of a professional board of commissioners is able to influence the supervision carried out, this shows that the potential for *fraud* is getting lower. The results of this study are supported by research conducted by Khairun et al. (2019) which states that *effective monitoring* has no effect on *fraudulent financial statements.*

Change in Auditor has a positive effect on Financial Statement Fraud

Based on the results of the regression coefficient significance test, the *change in auditor* using the AUDCHANGE proxy has a regression coefficient of 1.244 and a significance value of 0.019. Because the result of the significance value is less than 0.05, this indicates that AUDCHANGE has a positive effect on *financial statement fraud.* Based on the results of the study, it can be concluded that **H5 is accepted.** The more frequent *voluntary auditor changes,* the occurrence of *financial statement fraud* . This is because the change of auditor is able to hide the fraudulent financial statements that have been found by the previous auditor.The results of this study are supported by research conducted by Ulfah et al. (2017) which states that auditor turnover has a significant effect on *fraudulent financial reporting.*

Arrogance has a negative effect on Financial Statement Fraud

Based on the results of the regression coefficient significance test, the *arrogance* using the CEOPIC proxy has a regression coefficient of 0.132 and a significance value of 0.586. Because the results of the significance value are greater than 0.05, this indicates that CEOPIC has a negative effect on *financial statement fraud.* Based on the results of the study, it can be concluded that **H6 is rejected.** A feeling that makes a person feel the greatest (superiority), greed, and confidence that he will not be affected by internal control is the nature of arrogance. Things like this will have a bad impact on the company, because they will dare to commit *fraud* which will ultimately harm the company. Arrogance can be seen from how often the CEO's photo appears in the annual financial *report*. The more often the CEO's photo appears, it will show that the CEO is better known to the public and shows that his position is strong. However, the results of this study indicate that the number of CEO photos that appear in the annual financial *report* has no effect on the occurrence of *financial statement fraud*. The results of this study are supported by the results of research conducted by Nisa et al.(2019) which states that the *frequent number of CEO's picture* does not affect the possibility of *fraudulent financial statements.*

V. CONCLUSION

This study aims to empirically examine the effect of *financial stability, external pressure, change in director, effective monitoring, change in auditor,* and *arrogance* on *financial statement fraud* in mining companies listed on the Indonesia Stock Exchange in 2018-2020. Based on the results of the tests and discussions that have been carried out in this study, the following conclusions can be drawn:

1. variable *financial stability* has a positive effect on the occurrence of *financial statement fraud.*
2. variable *external pressure* has no effect on the occurrence of *financial statement fraud.*
3. variable *change in director* has no effect on the occurrence of *financial statement fraud.*
4. variable *effective monitoring* has no effect on the occurrence of *financial statement fraud.*
5. variable *change in auditor* has a positive effect on the occurrence of *financial statement fraud.*
6. variable *arrogance* has no effect on the occurrence of *financial statement fraud.*

This study seeks to find a measure of the arrogance factor in the fraud pentagon, althoug it is limited to the information available in the annual report. Future research can use a broader measurement using dualism position further research can using different industry classifications, fraud detection can show different characteristics of fraud.

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