PROSIDING

Business and Management | Bank and Finance | Economy, Ziswaf and Insurance

Fakultas Ekonomi
dan Bisnis Islam (FEBI)
UIN SUNAN KALIJAGA

ISIEB 2018

International Seminar on Islamic Economics and Business

"Building Synergy between Halal Sector and Islamic Financial Industry in the Disruption Era: Opportunity and Challenge"

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ECONOMY , ZISWAF & INSURANCE

Ekonomi Pembangunan, Ekonomi Sosial
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Resiko Keuangan dan Non Keuangan

FRAUD DETECTION THROUGH FINANCIAL STATEMENT IN ISLAMIC BANKS WITH FRAUD PENTAGON THEORY

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ABSTRACT:

This aim of this research was to detect fraud in financial statements with Fraud Pentagon Theory. Fraud pentagon theory (Crowe, 2011) is development of previous fraud theory. There are fraud triangle by Cressey (1953) and fraud diamond theory by Wolfe and Hermanson (2004). This research used an Islamic Banks listed on OJK as a sample with purposive sampling method for choosing the sample. The number of samples obtained are 55 samples analized by panel data regression using Eviews9. The result of this research showed that two variables of fraud pentagon theory, consisting pressure (financial stability) and opportunity (nature of industry), effect to detect financial statement fraud. While, another variable pressure (financial target, external pressure), Opportunity (ineffective monitoring), rationalization (change in auditor, total accrual to total asset ratio), competence (director change, work experience), arrogance (frequent number of CEO's picture) can not effect to detect financial statement fraud.

Keywords: financial statement, fraud triangle, fraud diamond, fraud pentagon, Islamic Banking

mandiri syariah BRIsyariah Pegadaian Wardah

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Yayu Putri Senjani

As Presenter

in the International Seminar on Islamic Economics and Business (ISIEB)

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Yogyakarta, 14th of November 2018
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Dr. H. Syafiq M. Hanafi, M.Ag.

Fakultas Ekonomi
dan Bisnis Islam (FEBI)
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ABSTRACT

This aim of this research was to detect fraud in financial statements with Fraud Pentagon Theory. Fraud pentagon theory (Crowe, 2011. Islamic Banks listed on OJK as a sample in this research and was choosed by purposive sampling method. There are 55 samples analized by panel data regression using Eviews9. The result of this research showed that pressure (financial stability) and opportunity (nature of industry) have effect to detect financial statement fraud. While, another variable pressure (financial target, external pressure), Opportunity (ineffective monitoring), rationalization (change in auditor, total accrual to total asset ratio), competence (director change, work experience), arrogance (frequent number of CEO's picture) have not effect to detect financial statement fraud.

Keyword: financial statement, fraud pentagon, Islamic Banking

Introdcution

Financial reporting is important in disseminating financial information about an organization or a company. Financial reporting reflects management's accountability and efficiency in managing financial resources and expenses. The main purpose of financial statements is to provide information on financial position, performance, and changes in financial position as an entity that is useful to make economic decisions (Murhadi, 2013).

The information asymmetry occured between capital owners and management can encourage management to conduct earnings management behavior (Siddiq et al., 2017). The more open access the company management has to the company's financial information, the greater the opportunity for earnings management. Where these actions are closely related to fraud (Sulistyowati, 2013). Manipulation or falsification of accounting records and supporting documents, and not presenting or deliberately eliminating events, transactions, important information, and applying incorrect accounting principles, including fraudulent actions in financial reporting which are often called fraudulent financial reporting (Hutomo, 2012) .

Earnings management have done in several cooperations in the world. Enron, Merck, World Com and the majority of other companies in the United States are the company maked accounting scandals in earnings management (Cornett et al., 2006). There are cases in Indonesia. For example, PT. Lippo Tbk and PT. Kimia Farma Tbk also involves financial reporting which starts from the detected manipulation (Gideon, 2005). The Association of Certified Fraud Examiners (ACFE, 2014) shows that every year companies lose 5% of their income due to fraud. When viewed in the 2013 Gross World Product, the potential for global losses due to fraud reached almost 3.7 trillion USD. Companies engaged in the financial and banking and manufacturing sectors, have the highest number of fraud cases compared to those in the mining and real estate industry sector (Kumalasari, 2015).

Major cases of fraud in the banking world in Indonesia include the BRI Tarmini Square burglary case in the amount of Rp. 29 billion, Bank Mandiri's burglary valued at Rp. 18 billion, burglary of BNI Depok Branch. Disbursement of deposits without the owner's knowledge happening at BPR Pundi Artha Sejahtera, the break-in of Bank Danamon valued at almost Rp. 3 billion, embezzlement of Bank Panin's customer funds worth Rp. 2.5 billion (Basuki and Yulia, 2016). Then, there was an endless Century Bank scandal involving a series of famous people in Indonesia, and a case of burglary of PT Elnusa Tbk's funds found at Bank Mega. In this case it was revealed that PT Elnusa Tbk found it difficult to withdraw its deposit funds amounting to 111 billion rupiah plus 6% interest per year contained in Bank Mega (Yovanda, 2016).

Fraud will always occur if there is no prevention and detection. According to Cressey's theory (quoted by Skousen et al., 2009), there are three conditions presenting in acts of fraud. It consists of pressure, opportunity, and rationalization which are referred to as fraud triangle. Then Wolfe and Hermanson (2004) improve fraud prevention and detection by introducing the fourth element, "capability". And most recently there is a theory developed by Crowe (2011) by adding fraud risk factors in the form of "arrogance".

This study is intended to analyze and find empirical evidence about the influence of fraud risk factors according to fraud pentagon there are Pressure, Opportunity, Rationalization, Capability and Arrogance on the Financial Statement Fraud.

Literature Review and Hypothesis Development

Fraud

According to Romney and Steinbart (2015) fraud is getting dishonest profit from others. According to the Association of Certified Fraud Examiners (ACFE), fraud is an act of fraud or error committed by a person or entity that knows that the mistake can result in some benefits that are not good for individuals or entities or other parties (Sukirman, 2013). Based on this understanding, in general fraud can be interpreted as an dishonest act committed by a person or entity to obtain personal benefits that can result in harm to individuals or other parties. Financial statement fraud can take many forms, such as explained in the earning management theory based on agency theory which can be explained by the pentagon fraud theory. These frauds are usually motivated by conflicts of interest between the shareholders and the company. (Sihombing, 2014). Fraud in Islamic perspective has a definition that is not much different from the definition in general. However, there is a foundation that reinforces the law and the nature of fraud. Fraud in Islam is a despicable and prohibited act. Because fraud will harm the parties related to the fraud. This is found in Q.S Al-Muthaffifin verses 1-3.

Pentagon Theory Fraud

One explanation of the fraud was conveyed by Crowe Howarth (2011). Pentagon fraud theory which is a refinement of the previous theory of fraud triangle and diamond fraud. Crowe (2011) developed the theory of pole fraud and diamond fraud by changing the risk factor of fraud in the form of capability to competence which has the same meaning. In addition there are additional risk factors in the form of arrogance (arrogance) (Siddiq et al, 2017). Fraud risk factors in pentagon fraud theory are:

1. Pressure, i.e. motivation and encouragement to commit fraud. Priantara (2013) argues that in general pressure arises because of needs or financial problems, but many are only driven by greed.
2. Opportunities; Sukirman and Sari (2013) explain that the formation of opportunities is because the perpetrators of fraud believe that their activities will not be detected. Opportunity in a company is caused by a lack of internal company supervision.
3. Rationalization, which is an attitude of justification for fraud that has been done. Fraud is done based on someone's rationalization,

meaning that the act is not a violation (Siddiq et al, 2017).

4. Competence is the expertise of employees to ignore internal controls, develop concealment strategies, and observe social conditions to meet their personal interests (Crowe, 2011 in Siddiq et al, 2017).
5. Arrogance is the nature of superiority over the rights owned and feel that internal control and company policies do not apply to him (Crowe, 2011 in Siddiq et al, 2017).

Hypothesis Development

1. Financial targets can detect fraudulent financial reporting

In carrying out its performance, company managers are required to perform the best performance so as to achieve the planned financial targets. Comparison of earnings to total assets or Return on Assets is a measure of operational performance that is widely used to show how efficiently an asset has worked (Skousen et al., 2009).

The results of research conducted by Widarti (2015) showed that return on assets (ROA) had a positive effect on financial statement fraud. However, from research conducted by Tessa and Harto (2016), financial targets that are proxied by ROA have no significant effect on financial statement fraud. Based on this description, the following hypotheses are proposed:

H1 : Financial Targets have an effect on detecting financial statement fraud

2. Financial stability can detect fraudulent financial reporting

When a company is in a stable condition, the company's value will rise in the eyes of investors, creditors, and the public. According to SAS No. 99, managers face pressure to commit fraudulent financial statements when stability and / or profitability are threatened by economic conditions, industry, or the situation of the operating entity (Skousen et al., 2009).

Research conducted by Tiffani (2015) shows that the percentage change in total assets (ACHANGE) has a positive effect on financial statement fraud. Unlike the one done by Tiffani, research conducted by Ratmono et al (2014) shows that the ACHANGE proxy has no effect on financial statement fraud. Based on this description, the following hypotheses are proposed:

H2: Financial stability has an effect on detecting financial statement fraud.

3. External pressure can detect financial statement fraud

Companies often experience a pressure from external parties. One pressure that is often experienced by company management is the need to obtain additional debt for external financing sources to remain competitive, including research funding and development or capital expenditure (Yulia and Basuki, 2016). External pressure is measured using a leverage ratio that is the ratio between total liabilities and total assets (Tessa and Harto, 2016).

Research conducted Sihombing (2014) results show that leverage ratios have a positive effect on financial statement fraud. In line with Sihombing (2014) research conducted by Yesiarani (2016), states that external pressure has an influence in detecting fraudulent financial statements. Based on this description, the following hypotheses are proposed:

H3: External pressure has an effect on detecting financial statement fraud.

4. Effective monitoring can detect fraudulent financial reporting

The occurrence of fraudulent practices is one of the effects of weak supervision or monitoring so as to provide an opportunity for agents or managers to behave violently by carrying out earnings management (Andayani, 2010). Fraud can be minimized by a good supervision mechanism. The independent board of commissioners is believed to be able to increase the supervision of the company (Yulia and Basuki, 2016).

Research conducted by Basley (1996) in (Yulia and Basuki, 2016) concludes that the inclusion of a board of commissioners from outside the company increases the effectiveness of the board in overseeing management to prevent fraud in financial reporting. Based on this description, the following hypotheses are proposed:

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

5. Nature of industry can detect financial statement fraud.

The second opportunity variable, the nature of industry, is the ideal state of a company in the industry. In the financial statements there are certain accounts whose balances are determined by the company based on an estimate, for example uncollectible accounts and obsolete inventory accounts (Yesiarani, 2016). Summers and Sweeney (1998) in Sihombing (2014), use a proxy for the nature of industry related to accounts receivable with a ratio of changes in trade receivables. Based on this description, the following hypotheses are proposed:

H5: Nature of industry has an effect on detecting financial statement fraud.

6. Change in auditor can detect financial statement fraud.

Change in auditor (change in auditor) is used by the company as a form of eliminating the trail of fraud (fraud trail) found by the previous auditor. This tendency encourages companies to replace independent auditors to cover up fraud committed in corporate financial reporting (Tessa and Harto, 2016). This statement is proven from the results of Kurniawati's research (2012) which states that with the resignation or change of auditors, it will affect the possibility of financial statement fraud. In contrast to Kurniawati, Sihombing (2014) proves in her research that auditor changes have no effect on the likelihood of fraud in the financial statements. Based on this description, the following hypotheses are proposed:

H6: Change in auditor has an effect on detecting financial statement fraud.

7. Rationalization of total accruals on total assets can detect financial statement fraud.

Rationalization (rationalization) is a justification for acts of fraud committed by perpetrators. Actors usually look for rational reasons to justify the actions taken (Sukirman and Sari, 2013). According to Vermeer (2003) in Yesiarani (2016), states that rationalization is an accrual principle related to management decision making and provides insight into rationalization in financial reporting. The statement was proven from the results of Sihombing's research (2014) which concluded that rationalization had a significant effect on financial statement fraud. Based on this description, the following hypotheses are proposed:

H7: Rationalization of total accruals on total assets has an effect on detecting financial statement fraud.

8. Substitution of directors as a variable in detecting financial statement fraud.

The change of directors is part of one element of the pentagon's fraud theory, capability. Capability has six components such as positioning (intelligence), intelligence (intelligence), confidence (confidence / ego), coercion (coercion skills), fraud (effective lying / deceit), and stress management (stress management). Substitution of directors is considered capable of describing the ability to manage stress. Changes in directors can cause stress periods that result in opening opportunities for fraud (Tessa and Harto, 2016).

Wolfe and Hermanson (2004) explain that changes in directors are a manifestation of conflict of interest. Based on the description, the following hypotheses are proposed:

H8: Changes in directors have an effect on detecting financial statement fraud.

9. Work experience as a variable in detecting financial statement fraud

Marinus et al. (1997) in Herliansyah et al. (2006) states that experience can be specifically measured by the time span that has been used for a job or task (job). The more extensive one's work experience, the more skilled a person is at doing work and the more perfect the pattern of thinking and attitude in acting to achieve the stated goals. In this case, work experience is closely related to the capabilities possessed by someone. This is also supported by the results of research conducted by Laurencia and Riyanto (2013), where in their research results, work experience influences employee performance which emphasizes the capabilities of an employee. Based on this description, the following hypotheses are proposed:

H9: work experience has an effect on detecting financial statement fraud.

10. Frequent number of CEO's picture as a variable in detecting Fraudulent financial reporting

What is meant by Frequent number of CEO's picture is the number of CEO photos displayed on the company's annual report. The large number of CEO photos displayed in a company's annual report can represent the level of arrogance or superiority that the CEO has. A CEO tends to want to show everyone the status and position he has in the company because they do not want to lose that status or position, this is in accordance with one of the elements described by Crowe (2011). In the research of Tessa and Harto (2016) the number of CEO photographs displayed in the financial statements is proven to influence the existence of financial statement fraud. Based on this description, the following hypotheses are proposed:

H10: Frequent number of CEO's picture has an effect on detecting financial statement fraud.

Research methods

The dependent variable in this study is financial statement detection fraud detection proxied by earnings management and calculated using the Modified Jones formula. Furthermore, the independent variable in this study is the pressure variable will be explained by the financial target which is proxied by Return on Assets (ROA), financial stability which is proxied by changes in assets for two years (ACHANGE), external pressure is proxied by the leverage ratio (LEV). The opportunity variable will be explained by ineffective monitoring proxied by the ratio of the number of independent commissioners (BDOUT), and nature of industry proxied by the ratio of total trade receivables (REC). The rationalization variable will be explained by change in auditor (AUD) and the ratio of Total Accruals to Total Assets (TATA). The competence variable will be explained by changes of directors (DCHANGE) made by the company during the observation period. The arrogance variable will be explained by the number of photos of the Chief Executive Officer (CEO) or the frequency number of the CEO's picture presented by the company in the annual report.

The population in this study is a Sharia Commercial Bank registered with OJK-Otoritas Jasa Keuangan (Financial Services Authority in Indonesia). The sample from this study was taken by purposive sampling method with the following criteria:

1. Registered on OJK in 2012-2016;
2. Publishing a complete annual report in 2012-2016 expressed in Rupiah (Rp);
3. Sharia commercial banks always listed Indonesian Stock Exchange in 2012-2016.

Based on the results of sample collection with the above criteria, there were 11 BUS (Bank Umum Syariah-Shariah General Bank) selected to be the sample. Of these samples studied for 5 years, a total of 55 samples were obtained.

The method to determine the effect of the pentagon fraud variable on the detection of fraudulent financial statements in Islamic banking using panel data. The panel regression model specifications in this study in general are as follows:

$$DA\_it = \alpha + \beta ROA + \beta ACHANGE + \beta LEV + \beta BDOUT + \beta REC + \beta AUD + \beta TATA + \beta DCHANGE + \beta EXP + \beta CEO's\ PICT + e$$

To determine which model will be used in this study, several tests will be conducted. There are three types of testing that can be done. The first is Chow Test used to determine between Pooled Least Square (PLS) / Common Effect and Fixed Effect (FE). Second, Hausman Test is used to determine between Random Effect (RE) and Fixed Effect (FE). The last, Lagrange Multiplier Test is used to determine between Random Effect (RE) and Pooled

Least Square (PLS) / Common Effect.

Results and Discussion

How far an independent variable determines or explains the change in the value of the dependent variable can be determined by the value of the coefficient of determination. Based on table bellowed, it can be seen that the Adjusted R-squared value shows the number 0.255135 or 25.51%. That is, all independent variables are able to explain the dependent variable by 25.51%, while the remaining 74.49% are explained by other variables outside the study.

Table 1
T Test Result

Variable	*Coeficient*	*Probability*
C	-0.023	0.755
ROA	-0.528	0.131
ACHANGE	**0.296**	**0.001**
LEV	-0.089	0.198
BDOUT	0.055	0.345
REC	**-0.016**	**0.041**
AUD	0.005	0.784
TATA	0.035	0.780
DCHANGE	0.024	0.210
EXP	0.001	0.513
CEO's PICT	-0.002	0.742

Financial target as measured by return on assets (ROA) has no influence on finances fraud statement. The results of this study support the research conducted by Tessa and Harto (2016). But the results of this study not in line with research conducted by Skousen et al. (2009) and Widarti's (2015) research which shows that ROA affect the financial statement fraud. It is because managers assume that the size of the ROA target the company is still considered reasonable and can be achieved. Manager doesn't assume that the ROA target is a financial target which is difficult to achieve so the size of the ROA target does not trigger the occurrence of fraudulent financial statements by management (Tiffani, 2015).

External pressure in the form of high credit risk due the size of the loan or debt encourages management to manipulate financial statements to be sure creditor. The higher the leverage ratio, the greater possible violation of the credit agreement through cheating (Tessa and Harto, 2016). Based on the results of the measurement of leverage ratios in banking sector companies, Credit risk is not a pressure for management to make fraud in preparing financial statements. That happened because the company is able to pay its debts (Tessa and Harto, 2016).

Ineffective monitoring as measured by comparison of the number of independent commissioners with the number the total board of commissioners (BDOUT) has no influence on financial statement fraud. The results of this study are in line with research conducted by Norbarani (2012). the greater the composition members of the board of commissioners who come from outside the company, is likely to cause decreased ability council to carry out the supervisory function. That can happen due to problems arising in coordination, communication and decision making. It is possible that placement or the addition of the members of the board of independent commissioners is just meet the formal provisions of the

IDX that requires it an independent commissioner of at least 30% of the amount the existing commissioners, while the majority shareholders (controllers / founders) still play an important role, so board performance does not increase or even decrease (Gideon, 2005).

Variable change in auditor does not have influence on financial statement fraud. means change auditors conducted by the company cannot be used for detect fraud committed by management in compiling financial statements. This research is in line with research that is conducted by Sihombing (2014). The average value in the descriptive analysis shows that The Sharia General Bang was used as a sample for years observations only 34.5% made auditor changes. Changes in auditors by public companies are not due want to erase traces of fraud found by auditors before, but because the company obeyed the Regulations Government Number 20 Year 2015 concerning the Practice of Public Accountants article 11 paragraph 1.

Rationalization variable does not have influence on financial statement fraud. The results of this study in line with research conducted by Skousen et al. (2009) but is inversely proportional to the results research by Sihombing (2014). Skousen (2009) says rationalization is an element the most difficult to indicate the measurement, because rationalization is the attitude of justification carried out by management, employees, or board of commissioners. Vermeer (2003) in Sihombing (2014) argues that total accruals constitute a reflection of overall company activity. Accrual rate companies will vary depending on management policies. In this case, the accrual value is not utilized by management for manipulate financial statements, but rather to display financial performance and position based on actual transactions.

The directors change does not have influence on financial statement fraud. That is because during the observation year as many as 49% of Islamic Commercial Banks became this research sample changes the composition of the directors. This research is in line with research that is conducted by Sihombing (2014) but contrary to research conducted by Wolfe and Hermanson (2004).

Change of directors do not have influence on financial statement fraud. The results of this study inversely proportional to the research conducted by Laurencia and Riyanto (2013). Work experience is considered to have no effect in existence fraud in financial reporting in commercial banks Sharia. This happened because the board of directors in the Bank. The Sharia General has practiced Islamic values.

Based on test results, the last variable which is not effect to fraud is arrogance formed CEO’s photo in annual report. It means that the number of photos displayed Banking companies in the financial statements can not indicates the high arrogance of CEOs in Islamic Commercial Banks. This effect is caused by the CEO's photo listed in the report finance aims to introduce the wider community primarily the stakeholders who are the CEO of the Sharia Commercial Bank. The photos showed in the annual report are photos of activities which proves that the CEO participated in company activities.

Even though some variables were found to not affect the dependent variable, this study showed 2 variables influenced financial statement fraud. Financial stability as measured by Asset Change (ACHANGE) and the measured nature of industry variable the Receivable ratio (REC) has an influence on financial fraud statement. This showed that the fraudulent financial statements at Islamic banks can still be affected by pressure (financial stability) and opportunity (nature of industry). While 3 factors in pentagon fraud theory have not been proven to influence fraud on Islamic financial statements in Indonesia.

Conclusion

Based on testing conducted, it can be seen that from 10 proxies that represent 5 variables in the Pentagon fraud theory, there are 2 proxies that represent 2 variables that have been proven to be influential in detecting fraud in the financial statements at Islamic Commercial Banks. There are The financial stability proxy represented the pressure variable and the nature of industry represented the opportunity variable. The other three variables have no effect in detecting fraud in the financial statements. The non-influence of these variables proves that the Sharia Commercial Bank has performed its performance in accordance with the rules, both the rules in the existing financial policies and the sharia rules.

This study has several limitations. First, researchers only used objects from the sharia commercial bank sector registered at OJK in the range of 2012-2016 where not all Sharia Commercial Banks were sampled. Second, the proxy used in measuring competence and arrogance variables is still limited. Third, measurement of financial statement fraud is only measured by the value of discretionary accruals from earnings earnings.

Based on these limitations, it is expected that further research will be done. First, expand the number of observations either by increasing the number of banks or increasing the span of research or using other company objects that are still based on sharia. Second, further research is expected to add a proxy so that it can represent existing variables. Third, further research can use other measurements besides discretionary accruals for the Financial Statement Fraud in order to provide alternatives and comparisons to improve the quality of future research studies.

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