



Received: May 12, 2024

Revised: July 12, 2024

Accepted: July 27, 2024

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## FINANCE | RESEARCH ARTICLE

## Financial Statement Fraud Before the Pandemic COVID-19

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**Abstract:** Financial statement fraud is a practice that can cause huge losses for investors, a lack of trust in the market and the existing accounting system, and the wrong decision-making process. Financial statement fraud can start from the manipulation of financial statements that are considered immaterial but then become a massive accounting scandal or start from the opportunistic behavior of managers so that their goals can be achieved. This study relies on the components of the fraud diamond to detect financial statement fraud, which consists of pressure, opportunity, rationalization, and ineffective monitoring. Pressure is proxied by external pressure, opportunity is proxied by ineffective monitoring, rationalization is proxied by auditor changes where auditor changes in companies can be seen as an attempt to eliminate fraud trials by previous auditors, and capability is proxied by changes in directors. This study succeeded in proving that pressure has a significant negative effect on financial statement fraud, and capability has no significant effect on financial statement fraud. Meanwhile, opportunity and rationalization do not affect financial statement fraud.

**Keywords:** Fraud Diamond, IDX, Pharmaceutical Sub-Sector, Financial Statement Fraud.

**JEL Classification Code:** M41, G34, D73, K42, G32

### 1. INTRODUCTION

Financial reports are a crucial and very important component in a company, therefore financial reports are required to provide reliable, relevant, easy to understand, and comparable information. However, not a few managers fail to achieve their performance goals so that the information that will appear in the financial statements is not satisfactory. One of the efforts made by managers to make their performance look good is to carry out earnings management (Azizah et al., 2019); (Azizah et al., 2019); (Ambarwati et al., 2024); (Azizah, Fredy, & Zoebaedi, 2022); (Prasetyo et al., 2021); (Azizah, Bantasyam, et al., 2020); (Azizah, Zoebaedi, et al., 2020). Managers are encouraged to display good performance through the achievement of profits reported in the financial statements (Azizah et al., 2023b); (Natanael et al., 2021); (Azizah et al., 2023b); (Azizah & Nurjaman, 2023); (Muhyidin et al., 2021); (Azizah, 2022); (Cahyo et al., 2022); (Azizah et al., 2023a). The existence of a reward system (bonuses) based on earnings performance will increasingly provide freedom for managers to carry out earnings management (Majid et al., 2020); (Romantis et al., 2020). Earnings management action is the forerunner of an accounting scandal (Sihombing, 2014); (Azizah, et al., 2022)..

In general, fraud is defined as a deliberate act of fraud or deception committed by a person or group to obtain personal gain and mislead others. In the problem of financial statement fraud like this, the role of the auditor profession is very important to detect fraud as early as possible, so that it can prevent fraud activities and the possibility of prolonged cases (Azizah et al., 2024); (Oktrivina & Azizah, 2022); (Azizah, Fredy & Wahyoeni, 2022). Auditors must be able to consider all possibilities of fraud from various perspectives, the development of the fraud triangle theory proposed by Cressey, by adding one qualitative element that is believed to have a significant influence on fraud, namely capability, Wolfe and Hermanson (2004) argue that fraud will not occur without the right people with the right ability to carry out every detail of the fraud.

Fraud diamond is a theory that can be used to improve fraud prevention and detection by considering pressure, opportunity, rationalization, by adding one qualitative element that is believed



to have a significant influence on fraud, namely capability. In this study using proxies from the four factors used in the fraud diamond theory, namely external pressure is a proxy for pressure, ineffective monitoring is a proxy for opportunity, auditor changes are a proxy for rationalization, and changes in directors are also a proxy for capability. Similar studies generally use financial stability as a proxy for pressure, such as research conducted by Nugraheni and Triatmoko (2017), but in this study external pressure is used as a proxy for pressure. Based on SAS No.99 which states that excessive pressure for management to meet the requirements or expectations of third parties can trigger fraud. When companies face high expectations of investment analysts, the pressure to provide the best performance for investors and creditors is significant for the company or other external parties.

This research was conducted against the background of concerns about cases that occurred in Indonesia, especially cases of financial statement fraud (Azizah, 2021); (Majid et al., 2020); (Azizah, Bantasyam, et al., 2020); (Azizah et al., 2019). By looking at some of these cases, it is very relevant to say that earnings management is part of fraud. Financial statement fraud often begins with misstatements or earnings management of quarterly financial statements that are considered immaterial but eventually grow into fraud and produce materially misleading annual financial statements (Azizah, 2021); (Azizah et al., 2021). Especially in companies engaged in the pharmaceutical sector. Pharmaceutical companies are companies that have a large market share in Indonesia. Indonesia's large population is its own market share for pharmaceutical companies, plus public awareness of health is now increasing. Likewise, the government supports the pharmaceutical industry, with the issuance of Presidential Instruction (Inpers) No. 6/2016 concerning the Acceleration of the Development of the Pharmaceutical Industry and Medical Devices. But unfortunately, there are still cases of fraudulent financial statements that occur in this sector, such as those committed by PT Kimia Farma Tbk and PT Indofarma Tbk. Based on the above background, this study was conducted to conduct a more in-depth test of the effect of the fraud diamond component consisting of pressure, opportunity, rationalization and capability on financial statement fraud.

## 2. RESEARCH METHOD AND MATERIALS

The population in this study were all pharmaceutical sub-sector companies listed on the Indonesia Stock Exchange in the period before the COVID-19 pandemic, namely the 2016-2019 period. The criteria for selecting samples in this study are as follows:

- a. Pharmaceutical sub-sector companies that have gone public or listed on the Indonesia Stock Exchange (IDX) during the period 2016 – 2019
- b. Companies that have complete information for the measurement of the variables needed in the study. The dependent variable in this study is financial statement fraud with earnings management proxy measured using the Discretionary Accrual value of the Modified Jones Model. Earnings Management arises because of the opportunity for company management to choose certain accounting methods, without following applicable regulations so that they can manipulate company profits which ultimately bring benefits to themselves (Sihombing, 2014), (Azizah, 2017a), (Azizah, 2017b). Independent variables in this study consist of:
- c. External Pressure (EXPRES)
 

Statement on Auditing Standard (SAS) No.99 states that excessive pressure for management to meet the requirements or expectations of third parties can trigger fraud. Leverage (LEV) is used as a proxy for the external pressure variable in this study. Companies need additional debt or external sources of financing to remain competitive, including research financing and development or capital expenditures. Leverage ratio is calculated by the formula:

$$\text{LEVERAGE} = \frac{\text{Total Debt}}{\text{Total Assets}}$$

- d. Ineffective Monitoring (INMON)
 

Ineffective monitoring is a company situation where it does not have good internal control. This can occur due to the dominance of management by one person or group, without

compensation control, ineffective supervision of the board of directors and audit committee over the financial reporting process and internal control and the like. Therefore, this research is proxied by ineffective monitoring in the ratio of the number of independent commissioners (BDOOUT) with the formula used by Sihombing (2014), namely:

$$\text{BDOOUT} = \text{Total Board of Commissioners}$$

e. Auditor Change (AUDC)

SAS No.99 states that the effect of changing auditors in a company can be an indication of fraud. The old auditor may be better able to detect any possible fraud committed by management, either directly or indirectly. Therefore, this study proxy's rationalization with external auditor turnover (AUDCHANGE) (Suryani, 2019) which is calculated by the formula:

$$\begin{aligned} \text{AUDCHANGE} &= 1, \text{ if the company changes auditors and} \\ &= 0, \text{ if the company does not make auditor changes} \end{aligned}$$

f. Change of Directors (CHANGE)

A change in the board of directors is the transfer of authority from the previous board of directors to the new board of directors with the aim of improving the performance of the previous management. Changes in the board of directors are not always good for the company. Changes in the board of directors can be an attempt by the company to improve. Therefore, the capability proxied by the company's change of directors (DCHANGE) is measured:

$$\begin{aligned} \text{DCHANGE} &= 1, \text{ if the company changes its board of directors and} \\ &= 0, \text{ if the company does not change the board of directors} \end{aligned}$$

The analysis technique used is quantitative analysis technique with multiple linear regression analysis method. The multiple linear regression equation used is as follows:

$$Y = \alpha + \beta_1 \text{ EXPRE} + \beta_2 \text{ INMON} + \beta_3 \text{ AUDC} + \beta_4 \text{ DCHANGE} + e$$

By using the *eviews 10* software, you must first choose the most appropriate model in managing panel data, there are three tests carried out, first the Chow test is used to choose between the common effect or fixed effect model. Second, the Hausman test is used to choose between the best fixed effect or random effect model in estimating panel data regression. Third, the Lagrange Multiplier (LM) test is a test to determine whether the Random Effect Model or Common Effect Model is the most appropriate method to use.

### 3. RESULTS AND DISCUSSION

In this study, the purposive sampling method was employed to gather data, with a total of 40 data points utilized for analysis. The panel data regression model selection test began with the Chow test. The Chow test is used to determine the most appropriate model, whether fixed effect or common effect, for estimating panel data. The results of the Chow test are presented in Table 1 below. The test statistics indicate that the F-statistic is significant at the 5% level, suggesting that there are differences between the estimated coefficients of the two models. This implies that the fixed effect model is more appropriate for estimating the panel data in this study. The results of the Chow test support the decision to use the fixed effect model, which provides a more accurate estimation for the panel data regression. Further analysis using the fixed effect model will be conducted to examine the relationships between the variables of interest in the panel data.

**Table 1. Chow Test Results**

Effects Test	Statistic	d.f.	Prob.
Cross-section F	11.284365	(9,26)	0.0000
Cross-section Chi-square	63.619387	9	0.0000

The results of the Chow test indicate significant differences between the cross-sections in the panel data model. The Cross-section F statistic is 11.284365 with a p-value of 0.0000, and the Cross-section Chi-square statistic is 63.619387 with a p-value of 0.0000. Both p-values are less than 0.05, leading to the rejection of the null hypothesis that assumes no significant differences between the cross-sections. This suggests that the data exhibits significant variation between groups, and a separate model for each cross-section is more appropriate than a pooled model, highlighting the importance of accounting for cross-sectional differences in the analysis. Then the Hausman test, the test results are shown in table 2 below:

**Table 2. Hausman Test Results**

Test Summary	Chi-Sq. Statistic	Chi-Sq. d.f.	Prob.
Cross-section random	9.643702	4	0.0469

Based on the Hausman test results, the random effect probability value is 0.0469. This means that the value of 0.0469 < 0.05, so the right model for this panel data regression is the fixed effect model. With the fixed effect results obtained from the 2 tests that have been carried out, there is no need for the third test, namely the Lagrange Multiplier test. The regression test results using fixed effects obtained results as shown in table 3 below:

**Table 3. Regression Test Results**

Variables	Coefficient	Std. Error	t-Statistic	Prob.
EXPRE	-9.700081	2.946305	-3.292287	0.0166
INMON	-0.469865	0.927507	-0.506589	0.6305
AUDC	0.179112	0.110197	1.625379	0.1552
DCHANGE	0.125660	0.113864	1.103600	0.3121
C	3.249847	0.739123	4.396893	0.0046

The results showed that the external pressure variable had a significant negative effect on financial statement fraud. This happens because the company has the ability to pay its debts, so the leverage value becomes lower, so it is not a pressure for managers, but the company managers get pressure to look for additional capital other than with debt agreements.

The ineffective monitoring variable in this study has no effect on financial statement fraud. This shows that the ineffectiveness of supervision by the audit committee does not mean that it will cause fraudulent practices on financial reporting to increase. The company has complied with the regulations of the Financial Services Authority Regulation Number 55 / POJK.04 / 2015 concerning the Establishment and Implementation Guidelines for the Audit Committee to prevent companies from committing fraud. Other research results for the auditor turnover variable have no effect on financial statement fraud. This can be caused by the company changing auditors not because it wants to reduce the audit of financial statements by the old auditor, but because the company complies with Government Regulation of the Republic of Indonesia Number 20 of 2015 article 11 paragraph 1 concerning Public Accountant Practices which states that the provision of audit services for financial statements of an entity by a public accountant is limited to a maximum of 5 consecutive financial years (Yesiariani and Rahayu, 2016). The variable change of directors in this study has no effect on financial statement fraud. This can be caused because the company changes the board of directors not because the company wants to cover up the fraud committed by the previous directors, but the company wants to improve performance by replacing the old directors with new directors who are considered more competent and can work optimally.

The coefficient of determination test results are seen from the Adjusted R-squared value of 0.701616 which or 70.1616% as shown in table 4 below:

**Table 4. Determination Coefficient Test Results**

R-squared	0.872121
Adjusted R-squared	0.701616
S.E. of regression	0.260620
F-statistic	5.114927
Prob(F-statistic)	0.030977

This shows that the variables of external pressure, ineffective monitoring, auditor turnover, and changes in directors on financial statement fraud that can be explained by this equation model are 70.1616% and the remaining 29.8384% is explained by variables outside the model or in other words the variables of external pressure, ineffective monitoring, auditor turnover and changes in directors are able to explain financial statement fraud by 70.1616%, while the remaining 29.8384% is explained by factors other than external pressure, ineffective monitoring, auditor turnover and changes in directors that are not included in the regression model

#### 4. CONCLUSION

The Fraud Diamond model, an extension of the Fraud Triangle by Wolfe & Hermanson in 2004, incorporates capability as a crucial fourth factor in fraud risk. Capability refers to managers' ability to circumvent internal controls, devise concealment tactics, and manipulate social situations for personal gain. The model categorizes fraud causes into four components: pressure, opportunity, rationalization, and capability, offering organizations insights to develop more robust anti-fraud strategies. This study investigates the impact of each Fraud Diamond component on financial statement fraud, using proxies such as external pressure, ineffective monitoring, auditor turnover, and changes in directors. The analysis reveals that while pressure significantly decreases financial statement fraud, capability does not have a notable effect, aligning with the study's hypotheses. However, opportunity and rationalization do not show significant effects on financial statement fraud, indicating a need for further research and refined anti-fraud measures.

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