FRAUD PENTAGON THEORY: DETECTING FRAUDULENT FINANCIAL REPORTING ON MANUFACTURING SECTOR

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ABSTRACT

The problem of fraudulent financial statements is increasingly being carried out by company's management therefore this study was conducted to obtain evidence regarding the factors that cause fraudulent financial statements based on the fraud pentagon theory. F-score is used to measure the level of fraudulent financial statements and the 5 factors that cause fraud are used as independent variables. 68 manufacturing companies were sampled using purposive sampling and hypothesis testing using multiple regression. The results showed that pressures measured using financial targets, opportunities measured by the nature of the industry had a negative effect on fraudulent financial statements. While capability as measured using director changes has a positive effect on fraudulent financial statements. Financial targets and the nature of industry have a negative effect because if the company's financial condition is in good condition, the company does not need to commit fraudulent financial statement. The change of director has a positive effect because the selection of an inappropriate director will make fraudulence financial statement increase to improve his own welfare. The findings demonstrated that the pentagon fraud theory is a predictor for fraud, particularly in the financial statements of the company. This research is expected to provide an overview of the factors that cause financial statement fraud so that companies can do things that can reduce the occurrence of fraudulent financial statements in the company.

Keywords: Fraud pentagon theory, Fraudulence Financial Reporting, F-Score, Financial Reporting

INTRODUCTION

Financial statements are reports that describe the company's financial condition that stakeholders use to determine the policies that will be taken by the company to achieve company goals, both short-term and long-term goals. Financial statements must be presented in a relevant manner and free from misstatement so that users of financial statements can make informed decisions. Information about company profits is information that is widely used in decision-making. The profit presented is often manipulated to cover the actual condition of the company.

Several businesses, from Kalbe Farma and Indofarma in 2001 to Tiga Pilar Sejahtera Food in 2017, have been engaged in this activity in Indonesia. By inflating sales by Rp 13.4 billion, inventory by Rp 23.9 billion, and supplies by Rp 8.1 billion, Kalbe Farma falsified its 2001 financial reports. In the 2001 financial year, Indofarma overestimated the value of work-in-progress inventory by Rp 28.87 billion. Tiga Pilar Sejahtera inflated sales by Rp 662 billion, fixed assets by Rp 4 trillion, and accounts receivable, inventories, and EBITDA by Rp 329 billion.

Although the company's financial statement showed positive performance as a result of the action taken, the information was neither accurate or relevant. Investors are going to lose from this action. The case is certainly detrimental to users of financial statements. Decision-making errors have a huge impact on them. Manufacturing firms in Indonesia frequently commit financial statement fraud, as shown by some of the previous examples. Therefore, manufacturing companies are chosen as research objects in this study.

Several theories are used to detect opportunities for fraudulent financial statements such as the fraud triangle, then developed into the fraud diamond, and also the fraud pentagon. This theory shows the factors that cause financial statement fraud. Companies that can detect fraud with this theory will certainly be able to reduce fraudulent financial statements. This research uses the fraud pentagon theory with 5 factors, namely pressure, opportunity, rationalization, capability, and arrogance. This fraud pentagon is the latest development of the fraud triangle. Research on financial statement fraudulence based on the pentagon fraud theory has been studied by several researchers and produced inconsistent results. This is motivated researchers to do research about the fraudulence of financial statements based on the pentagon fraud theory. The research problem in this study is whether the 5 factors in the pentagon fraud theory affect the fraudulence of financial statements.

Agency Theory

Agency relationship is an agreement between one person/group (principal) and involves another person (agent) (Jensen & Meckling 1976). Agency relationships can occur when a person/group referred to as the principal gives work to another person/group referred to as the agent to provide decision-making authority over a problem that occurs in the principal's business activities. The existence of principals and agents causes two different interests, so that it creates a conflict of interest.

Conflicts of interest that occur between principals and agents have an impact on the quality of financial statements. The conflict of interest causes each party to prioritize their personal interests, especially the agent as the party directly handling the company (Kartikasari *et al.* 2021). The agent as company management controls the company directly, thus making the agent know in detail about the conditions and information available in the company. With complete information known by the agent, it makes the agent easily take advantage of existing weaknesses to commit fraudulent financial statements without being known by the principal (Setiawati & Baningrum 2018).

Fraud Pentagon Theory

The theory of fraud begins with the fraud triangle theory developed by Cressey (1953), the fraud triangle theory consists of pressure, opportunity, and rationalization. Along with the times, the motives of fraud perpetrators are increasingly diverse, therefore in 2004 a fraud theory was developed which was named fraud diamond. The fraud diamond was developed by Wolfe & Hermanson (2004) by adding the capability element to the fraud theory. Crowe (2011) redeveloped the fraud theory which is a development of the fraud triangle theory and fraud diamond by adding an arrogance element as a form of refinement of the fraud theory, namely the fraud pentagon theory. arrogance is the behavior of someone who has the advantage of his rights so that he ignores applicable policies or regulations (Kusumawati *et al.* 2021).

Pressure and Fraudulence Financial Reporting

Pressure is the motivation for individuals or groups to commit fraud, pressure can be caused by various reasons. Examples are lifestyle and financial or non-financial problems experienced by fraudsters (Kusumawati *et al.* 2021).Pressure in the context of financial statement fraud can come from parties internal or external to the company. Pressure that comes from internal parties, for example, the financial targets that must be achieved by the company, while the pressure that comes from internal parties, for example, the financial targets that must be achieved by the company. Financial targets are defined as the company's goal to obtain a number of profits that have been determined by the management or directors of the company (Sari & Lestari 2020). Management is given a financial target by investors, if management can achieve financial targets can be met then the company management will get a bonus.

Financial targets that are set too high will cause excessive pressure on company management. The company will commit financial statement fraud if the financial target cannot be achieved (Haqq & Budiwitjaksono 2019). Noble (2019), Tarjo *et al.* (2021), Frischanita & Bernawati (2020), Nanda *et al.* (2019), and also Sagala dan Siagian (2021) state that financial targets that are difficult for companies to achieve are a factor in increasing financial statement fraud. This fraud is carried out so that the company appears to be achieving the financial targets expected by stakeholders.

External pressure is excessive pressure that management experiences to meet the requirements or expectations of third parties (Sari & Lestari 2020). When companies receive excessive external pressure, it can cause management to commit fraud on financial statements (Wahyudi *et al.*, 2021). One of the causes of external pressure is when the company wants to get funding from creditors, because providing loans to companies has risks, creditors consider whether the company can repay the debt when the debt is due. Tarjo *et al.* (2021), Maulidiana & Triandi (2019) state that external pressure has a positive effect on financial statement fraud. The pressure received by management from creditors causes management to try to convince creditors by presenting the company's financial condition in good condition. Based on the explanation above, the hypothesis are:

H1a Pressure as assessed by financial targets has a positive effect on the fraudulence of financial statements.
H1b Pressure as assessed by external pressure has a positive effect on the fraudulence of financial statements.

Opportunity and Fraudulence Financial Reporting

Opportunity is a situation that causes fraud to occur due to gaps and weak sanctions that allow fraudsters to carry out their actions. Fraudsters take advantage of weak internal controls within the company so that fraudsters can freely carry out their actions because there is little chance that the fraud can be detected (Jullani *et al.* 2020). Opportunities can be assessed by ineffective monitoring and the nature of the industry. Ineffective monitoring is a condition where a company does not have an effective monitoring system for company performance (Yulianti *et al.* 2019). The lack of effective supervision in the company can create opportunities for company management to make deliberate misstatements in the financial statements (Nanda *et al.* 2019).

The act of financial statement fraud can be minimized by a better supervisory system (Jullani *et al.* 2020). Therefore, an independent board of commissioners is needed to supervise the company that is impartial to anyone. The fewer members of the independent board of commissioners, the less effective supervision of company management, which triggers fraudulent financial statements (Harman & Bernawati 2021). Sari & Lestari (2020), Nanda *et al.* (2019) state that ineffective monitoring has a positive effect on fraudulent financial statements, these results are due to the number of independent commissioners not necessarily providing a guarantee for effective supervision of company operations, this occurs because of pressure on the independent board of commissioners so that supervision is not independent.

The nature of industry is the ideal condition of the company so that investors invest and creditors want to lend funds to the company (Christian & Visakha, 2021). The ideal condition of a company can be seen from assets that have transactions with material amounts. fraud can be committed by manipulating accounts receivable transactions so that the company's condition looks good (Nugroho *et al.* 2021). Large receivables indicate that the company has large sales and a large number of collectible assets. However, this is a fabrication made by the company to make it look good. Accounts that are often targeted in manipulating financial statements are uncollectible accounts and inventory accounts (Summers & Sweeney, 1998). Nature of the industry has a positive effect on fraudulent financial statements due to an increase in the number of receivables from the previous year indicating that the company's cash flow conditions are not good, therefore accounts receivable are often used as accounts used to commit fraudulent financial statements (Wahyudi *et al.*, 2021, Kurnia & Anis, 2017), Andrean dan Salim, 2021). Based on the explanation above, the hypothesis are:

H2a Opportunity as assessed by ineffective monitoring has a positive effect on the fraudulence of financial statements.
H2b Opportunity as assessed by nature of industry has a positive effect on the fraudulence of financial statements.

Rationalization and Fraudulence Financial Reporting

Rationalization, which means the act of justification, is carried out by the perpetrators of fraud. The perpetrators of fraud take justifying actions because they consider the fraud they commit to being a natural action when carried out (Christian & Visakha, 2021). Rationalization is carried out by fraudsters as a form of effort to hide their actions (Nanda *et al.*, 2019). One way of rationalization carried out by perpetrators of financial statement fraud is by changing auditors, changing auditors is carried out because the company considers that the new auditor will find it difficult to detect fraud that occurs, while the previous auditor is considered to know the ins and outs of the company so that it has the potential to find fraud committed by the company.

Harman & Bernawati (2021), Anggraini & Suryani (2021), Noble (2019) states that auditor changes have a positive effect on financial statement fraud. Companies try to cover up fraudulent acts committed by company management by changing external auditors. When the company changes the external auditor, the auditor takes longer to understand the company's financial condition to detect existing fraud. Based on the explanation above, the hypothesis are:

H3 Rationalization as assessed by auditor changes has a positive effect on the fraudulence of financial statements.

Capability and Fraudulence Financial Reporting

Capability is an individual or group that has the ability to commit fraud. According to Wolfe & Hermanson (2004), an individual's position in a company can present the ability to create fraud that other individuals in the company do not have. For example, a director can ask his employees to manipulate financial statements by manipulating revenue recognition or costs that the company must pay. Because a position in the organization can increase the opportunity for fraud that is difficult to detect, it is necessary for someone who has good integrity so that fraud can be minimized. Change of directors is the granting of authority from the previous director to the new director to improve company performance (Yulistyawati *et al.*, 2019). The change of directors is expected to be able to improve the company's performance if the directors selected have competence and capability, so that performance improvement is not done by fraudulence, but by running the company well (Nugroho *et al.*, 2021). Based on the explanation above, the hypothesis are:

H4 Capability as assessed by director changes has a negative effect on the fraudulence of financial statements.

Arrogance and Fraudulence Financial Reporting

Arrogance arises from a feeling of being superior to other people, so they tend to want to impose their wishes, and arrogant fraud perpetrators tend to ignore the rules (Marks 2012). Arrogance can cause perpetrators of fraud to feel impunity (Nanda *et al.*, 2019). The high level of arrogance possessed by a company leader creates opportunities for fraudulence financial reporting because the company leader feels that the existing rules do not apply to him (Kurnia dan Anis 2017). With the existence of political connections owned by the company's CEO, it will be easier in the administrative process, both in the form of ease of regulation or convenience if you want to borrow funds.

Arrogance can be seen from the company's political connection. With political connections, companies are given facilities to facilitate borrowing funds, thereby encouraging companies to borrow frequently (Sagala dan Siagian 2021). If a CEO is a politician or former politician, he has extensive partners to help run his business (Harman dan Bernawati 2021). CEOs tend to manipulate financial statements in order to maintain their reputation. With political connections, management's ability to reduce the possibility of fraudulent financial reporting is weakened, compared to when the CEO does not have political connections (Wang *et al.* 2017). Based on the explanation above, the hypothesis are:

H5 Arrogance as assessed by political connection has a positive effect on the fraudulence of financial statements.

From the explanation above, the influence of the fraud pentagon theory on fraudulence financial reporting can be seen from the model below:

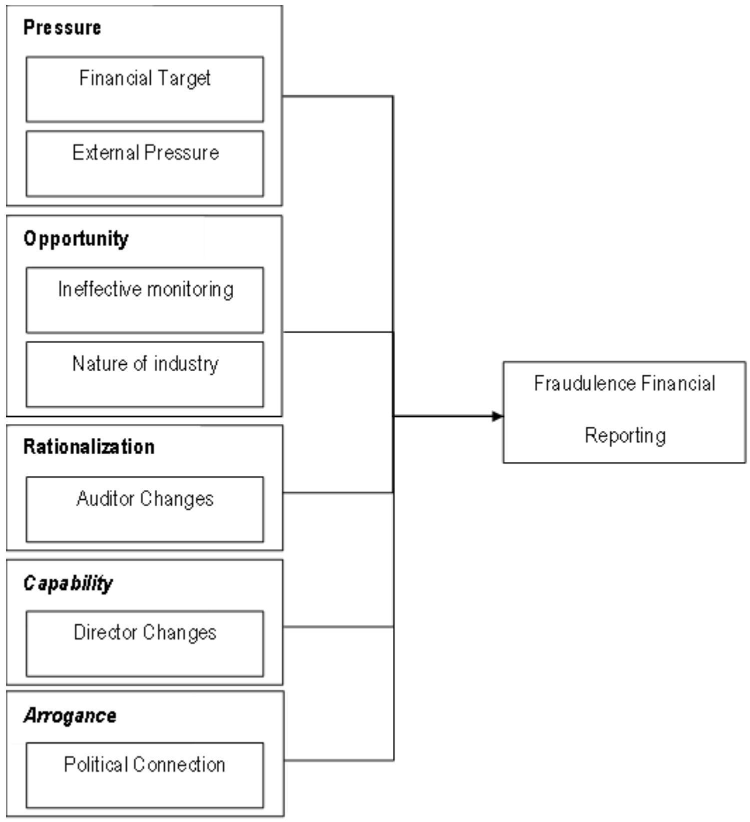

Figure 1. Research Framework

RESEARCH METHODOLOGY

Manufacturing sector companies listed on the Indonesian stock exchange during 2019-2021 are the study population. The research sample is 68 companies obtained by purposive sampling method. The hypothesis was tested using multiple regression. The following is a table for selecting the research sample:

Table 1. Sample Selection

Criteria	Total Companies
Manufacturing companies listed on the Indonesia Stock Exchange consistently from 2017 to 2021.	155
Manufacturing companies that do not consistently publish financial reports as of December 31 during the research period.	(8)
Manufacturing companies that submit financial reports do not use Rupiah during the research period.	(28)
Manufacturing companies that reported losses during the research period.	(51)
Total Companies	**68**
Research Period	3
Total Sample	**204**

Fraudulence financial reporting is proxied using the F-Score model, which was developed by Dechow *et al.* (2011).

F-Score = Accrual Quality + Financial Performance

The proxy used to measure accrual quality uses accrual RSST.

$$\textbf{RSST Accrual}= \frac{\Delta \textbf{WC}+\Delta \textbf{NCO}+\Delta \textbf{FIN}}{\textbf{\textit{Average Total Assets}}}$$

Financial Performance = Change in Receivable + Change in Inventory + Change in Cash Sales + Change in Earnings

Explanation:

WC = (Current assets – Cash – Short term investment) – (Current liabilities – Short term debt).
NCO = (Total assets – Current assets – Investment) – (Total liabilities – Current liabilities – Long term debt)
FIN = (Short term investment + Long term investment) – (Long term debt + Short term debt)

ATS = (Beginning total assets + Ending total assets)/2

Change in Receivable:

$$\frac{\Delta \text{ Receivable}}{\text{Average total assets}}$$

Change in Inventory:

$$\frac{\Delta \text{ Inventories}}{\text{Average Total Assets}}$$

Change in Cash Sales:

$$\frac{\Delta \text{ Sales}}{\text{Sales (t)}} - \frac{\Delta \text{ Receivable}}{\text{Receivable (t)}}$$

Change in Earnings:

$$\frac{\text{Profit (t)}}{\text{Average total assets (t)}} - \frac{\text{Profit (t-1)}}{\text{Average total assets (t-1)}}$$

Financial target measured by proportion of net income and return on assets, external pressure measured by leverage, proportion of total liabilities and total equity. Ineffective monitoring measured by proportion of independent commissioner, change of auditor and director measured by dummy, if there are change in auditor, director if there is a change in the auditors, the directors will be rated 1 and vice versa. Nature of Industry measured by

$$\frac{\text{Receivable}}{\text{Sales}} - \frac{\text{Receivable}_{t-1}}{\text{Sales}_{t-1}}$$

RESULT

The results of descriptive statistics for each variable and the results of hypothesis testing can be seen in the table below

Table 2. Descriptive Statistic

	N	Minimum	Maximum	Mean	Std. Deviation
F-Score	204	-26.33472	497.86952	2.39882	34.91085
Financial Target	204	0.00053	0.41632	0.08122	0.07319
External Pressure	204	0.00345	0.82674	0.37079	0.18350
Ineffective Monitoring	204	0.28571	0.83333	0.41887	0.10185
Nature of Industry	204	-0.34422	0.21931	-0.00472	0.04851

Table 3. Descriptive Statistic Auditor Changes

	Frequency	Percentage
No Auditor Changes	107	52,5
Auditor Changes	97	47,5
Total	204	100,0

Table 3. Descriptive Statistic Director Changes

	Frequency	Percentage
No Director Changes	133	65,2
Director Changes	71	34,8
Total	204	100,0

Table 4. Descriptive Statistic Political Connection

	Frequency	Percentage
No Connection	137	67,2
Have Connection	67	32,8
Total	204	100,0

Table 5. Hypothesis Result

Variable	Coefficient	t-Statistic	Prob.
C	-8.474750	-0.864456	0.3884
Pressure			
Financial Target	-61.08437	-1.863338	0.0639**
External Pressure	-19.32614	-1.622465	0.1063
Opportunity			
Ineffective Monitoring	36,93416	1.602231	0.1107
Nature of Industry	-364.2652	-8.432647	0.0000*
Rationalization			
Auditor Changes	6.083706	1.440637	0.1513
Capability			
Director Changes	9.568884	2.113087	0.0359*
Arrogance			
Political Connection	-1.252875	-0.266862	0.7899
F			11.8502
Prob (F-Statistic)			0.00000

* ** Significant on 1%, 5%, 10%

Based on the results of hypothesis testing, it is found that financial targets have a negative effect on financial statement fraud. This shows that companies that can achieve the high financial targets expected by investors do not need to commit fraudulent financial reporting to achieve these targets. This result is in accordance with Harman dan Bernawati (2021) which states that financial targets have a negative effect on fraudulent financial reporting.

The nature of the industry has a negative effect on fraudulent financial reporting. This shows that companies that have a small number of receivables will cause the company to manipulate to increase sales so that the reported profit will be even greater. This result is supported by Tarjo *et al.* (2021) which states that the nature of the industry has a negative effect on fraudulent financial reporting.

Change of directors has a positive effect on fraudulent financial reporting. This shows that the company makes changes to directors who can commit fraudulent financial reporting, thus causing higher fraud to be committed. If the change of director is not following the provisions, the change of director is one of the company's efforts to commit fraudulent financial statements. This result is supported by Kusumawati *et al.* (2021), Kartikasari *et al.* (2021) which states that the changes of director has a positive effect on fraudulent financial reporting.

CONCLUSION

This study aims to determine the factors of financial statement fraud using fraud pentagon analysis. Based on the results of tests that have been conducted on 204 manufacturing companies, it can be concluded that financial targets, the nature of the industry, and change of director have an influence on fraudulent financial statements. While the variables of external pressure, ineffective monitoring, auditor turnover, and political connections have no influence on fraudulent financial reporting. Due to the good financial condition of the company, fraudulent financial reporting does not need to be done. Meanwhile, the director's knowledge of the company's finances can be a gap for the directors to commit fraudulent financial reporting. The limitation of this study is the measurement of each dimension of the fraud pentagon which is still small so it provides poor results. Future research can add other measurements for each dimension of the fraud pentagon. This research implies that companies must pay attention to the factors in the fraud pentagon so that fraud does not occur.

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