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The Effect of Audit Committee Competence, Managerial Ownership, Company Size and Leverage, on Fraudulent Financial Reporting

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This research aims to determine the effects of audit committee competence, managerial ownership, firm size and leverage on fraudulent financial reporting. The population of this research is the set of manufacturing companies listed on the Indonesian Stock Exchange (IDX) in 2014-2016. The samples used are 51 companies with three years observation, chosen by a purposive sampling method. Logistic regression method is used to test the hypothesis. The results show that partially, audit committee competence has a significant negative effect on fraudulent financial reporting. Leverage has a significant positive effect on fraudulent financial reporting. Managerial ownership and company size have no effect on fraudulent financial reporting. However, audit committee competence, leverage, managerial ownership and company size are simultaneously affecting fraudulent financial reporting.

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Key words: *Audit Committee Competence, Managerial Ownership, Firm Size, Leverage, Fraudulent Financial Reporting*

Introduction

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The utility of financial statements, as a basis for decision-making by various parties, has required their freedom from material misstatements. Financial statements must be presented fairly and in accordance with generally accepted Financial Accounting Standards (FAS). Mistakes in financial statements can be caused by errors or fraud. Fraud is a misstatement of material facts by one party (agent) to another, with an intention to deceive and cause other parties who rely on that fact to suffer a loss (Hall, 2011).



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The *Association of Certified Fraud Examiners (ACFE)* groups fraud schemes into three categories: fraud in financial statements (fraud by management), corruption, and misuse of assets (fraud by employees). Based on a 2014 Association of Certified Fraud Examiners (ACFE) study, the most detrimental types of fraud are fraudulent financial statements which amounted to 73%, followed by corruption (18%) and misuse of assets (asset misappropriations), at 9% (Tarjo & Herawati, 2015). Fraudulence in financial statements is one factor that can cause a company to file for bankruptcy.

Apart from Enron, the most well-known case of fraudulent financial statement occurred in Japan. In 2015, Toshiba had inflated profits on its financial statement. This fraudulent statement lead to a profit overstatement of \$1.2 billion, which had been occurring since fiscal year 2008, and also involved company officials. In Indonesia, there have long been fraudulent financial statements. Several cases have happened; one was an inflated profit case that involved PT Kimia Farma, in an audit on December 31, 2001. A related case on fraudulent financial statement happened to PT Inovisi Infracom, Tbk (INVS). That concluded with the delisting of shares suspended for more than two years, because the IDX assessed eight questionable points in Inovisi financial reports.

Fraudulent practice in financial reporting is almost unavoidable. However, there are efforts to decrease the level of fraud in financial reporting. The case of manipulated financial reports by Enron and KAP Anderson has triggered the government of the United States of America to legislate the Sarbanes-Oxley Act (SOX), to protect and also restore investors' trust towards the accuracy of financial reports. Under Sarbanes-Oxley, companies are mandated to have a fully independent audit committee, with at least one of the committee member being a finance expert.

Previous studies about audit committee competence, and activities during the contract process, have concluded variously (Owens-Jackson et al., 2009); (Suprianto et al., 2017). Amolsakulchai (2015) studied companies listed in Thailand in relation to agricultural and food industries, technology groups, and industrial product groups. The study concluded that the number of audit committee members that have accounting or finance expertise does not affect the quality of financial reporting on all the three groups being studied. However, a study by Kusnadi, Leong, Suwardy, and Wang (2016) in Singapore resulted in the opposite view. The result suggested that an audit committee with accounting expertise has a significant effect on the quality of companies' financial reports. In other words, an audit committee with an accounting background can reduce fraudulence in financial reporting.

A study by Raghunandan, Rama, and Read (2001), in Huang and Thiruvadi (2010) concluded that an audit committee with, at least, one member from an accounting or financial background, will minimise the possibility of fraud. This is consistent with research conducted by Kusumaningtyas (2015), which concluded that audit committee competencies and their



activities can reduce the act of profit management by managers. This happens because audit committee members who have financial knowledge and expertise will have the ability to detect the occurrence of profit manipulation by management.

A study by Prasetyo (2014) concluded that managerial ownership has a negative effect on fraud in financial reporting. Owens-Jackson et al. (2009) found empirical evidence that company size positively affected fraudulent financial reports. This is consistent with Moses (1987) who found bigger companies will also cause a bigger push to profit sharing as compared to smaller companies, because the bigger companies are subjected to inspection (a stricter supervision by the government and general public). However, research by Beasley, et al. (1999) found that companies which undertook fraud are usually smaller, due to the lack of internal control.

Leverage research was conducted by Tarjo and Herawati (2015). They found that leverage does not have a significant effect on financial fraudulent detection. They also revealed that leverage does not result in the ability to detect financial fraud. The study conducted by Wang, Chen, Chin, and Zang (2017) showed the opposite. The level of leverage has a significantly positive effect towards fraud indication.

A survey conducted by the Association of Certified Fraud Examiners (ACFE) in 2016 revealed that manufacturing is one of the industries that committed the most fraud, due to the existence of post inventory, which is vulnerable to fraud.

Influence of Audit Committee Competence on Financial Reporting Fraud

The Sarbanes-Oxley Act requires the audit committee to be fully independent, and that at least one member has expertise in finance. This is in line with the Regulation of the Financial Services Authority Number 55 / POJK.04 / 2015 concerning the Formation and Guidelines for the Implementation of the Audit Committee.

In 2016, the Research Association of Certified Fraud Examiners (ACFE) proved that the accounting department performed more fraud, which amounted of 16.6% compared to other business units. Therefore, the audit committee that has expertise in accounting or finance is needed to review the financial information that the company will issue to the public, such as financial statements, and other reports related to the company's financial information and monitor the company's performance.

Research conducted by Beasley (1996) suggests that the existence of an audit committee can indicate an improving quality of monitoring, and significantly influences reduction in the likelihood of fraudulent financial statements. This is in line with the research conducted by



Kusumaningtyas and Farida (2015), which concluded that Audit committee competence has a significant negative effect on earnings management.

H₁: Audit committee competence negatively affects financial reporting fraud

Effect of Managerial Ownership on Financial Reporting Fraud

According to agency theory, the principal authorises the agent (manager) to run the company. Therefore, the manager is responsible for strategic decision-making in the day-to-day operations of the company that will be accounted for to the shareholders (principal). However, in implementation, there are differences in interests between agents (managers) and principal. Managers have an interest to prosper themselves with large salaries and bonuses, while owners have an interest in obtaining high returns from their investments in the company. Agency conflicts occur between shareholders and professional managers due to the separation of ownership and control (Jensen & Meckling, 1976). Managerial ownership is considered capable of overcoming agency problems. It is possible because by owning company shares, managers are expected to feel the immediate benefits of each decision taken. Eng and Mak (2003) stated that based on agency theory there is a negative relationship between managerial ownership and financial reporting of fraud. This is because, when managerial ownership is high, management will act opportunistically for its interests, and tends to practice earnings management that can distort information encapsulated in quality financial reports. Research conducted by Prasetyo (2014) yields the conclusion that managerial ownership affects financial report fraud.

H₂: Managerial ownership influences financial reporting fraud

Effect of Company Size on Financial Reporting Fraud

Positive accounting theory explains that the size of the company is proxied by the size of its political costs. The greater the political costs endured by the company, the more managers tend to choose accounting procedures that minimise the current period earnings for future earnings, because high profitability can lead to an increase in political temperature and create new regulations / taxes (Watts & Zimmerman, 1986). Moses (1987) found evidence that larger companies have a greater incentive to make income smoothing, compared to smaller companies, because larger companies are subject to inspection (strict oversight from the government and the general public). Big companies are trying to shrink their profits so that there are no new regulations or taxes set for them. In addition, the larger the size of the company, the greater the monitoring costs (agency costs) incurred to supervise the agent.

Large companies generally have more complex transactions compared to small companies. When company transactions are increasingly complex, the possibility of fraudulent financial



reporting will also increase (Prasetyo, 2014). In addition, the high assets owned by the company are the main attraction for investors. This can increase the likelihood of financial statement manipulation; manipulated financial statements can indicate the occurrence of fraud in financial reporting.

Owens-Jackson et al (2009) find empirical evidence that firm size has a significant positive effect on fraud. That is, when a company is in its growth stage, the likelihood of fraud is higher. But research by Beasley et al. (1999) on US public companies found evidence that fraud was generally carried out by small companies. That is because small companies were unable to implement effective internal controls, especially segregation of duty, thus creating opportunities for senior management to override existing controls. In addition, small companies may not be able to hire someone who has expertise in financial reporting processes and legal requirements.

H₃: Company size influences financial reporting fraud

Effect of Leverage on Financial Reporting Fraud

According to Fakhruddin (2008:109), *leverage* represents the amount of debt used to finance / buy company assets. The higher the leverage, the higher the credit risk withstood by the company, because it must pay the principal and interest on large amounts of debt. This causes the company to tend to report high profitability. The board of directors will choose an accounting method that can reduce the company's leverage ratio, to keep the creditor still lending to the company and not restrict the company in giving dividends to shareholders (Prasetyo, 2014).

Research conducted by Wang, Chen, Chin, and Zang (2017) concluded that leverage has a significant positive effect on fraud. That is, companies tend to cheat financial reporting when the leverage ratio is high. This is in line with the research of Dalnial, Kamaluddin, Sanusi, & Khairuddin (2014) which concluded that companies which commit fraud have a high leverage ratio. High leverage indicates an increased desire to violate loan agreements, and reduce the ability to obtain capital through loans. In addition, Hawariah Dalnial also stated that leverage is a significant predictor in detecting fraud.

H₄: Leverage affects financial reporting fraud



Methods

A causal study with a quantitative approach was used. The population is the set of manufacturing companies listed on the Indonesia Stock Exchange in 2014-2016. The sample was selected using purposive sampling technique which produced 51 sample companies. The data comes from both the company's financial report and annual report.

The dependent variable (Y) in this study is fraudulent financial reporting. Companies identified as having committed fraud on financial reporting will be given a score of 1. Companies that are not indicated as committing financial reporting fraud will be given a score of 0. The lack of financial reporting is measured using the Beneish M-Score model. Companies that have $M\text{-Score} > -2.22$ are indicated as having a fraudulent financial report, while companies that have the $M\text{-Score} \leq -2.22$ are not indicated as having a fraudulent financial report.

Beneish M-Score Formula:

$$M = -4.840 + 0.920*DSRI + 0.528*GMI + 0.404*AQI + 0.892*SGI + 0.115*DEPI - 0.172*SGAI + 4.679*TATA - 0.327*LVGI$$

Where :

DSRI= Days Sales Receivable Index

GMI= Gross margin Index, AQI= Asset Quality Index, SGI =Sales Growth Index, DEPI = Depreciation Index. SGAI= Sales and General administration expenses index, LVGI = Leverage Index. TATA = Total Accrual to Total Asset

This variable is measured by the percentage of audit committee members who have an educational background, and experience in the accounting and financial fields of the total number of audit committee members.

$$KKA = \frac{\sum \text{KA with accounting and financial background}}{\sum \text{total member of audit committee}} \times 100\%$$

Managerial ownership is calculated by adding up the shares owned by the directors and commissioners of the company, divided by the total shares outstanding.

$$KM = \frac{\sum \text{shares owned by directors and commisioners}}{\sum \text{total share issued}} \times 100\%$$

In this study, the size of the company is proxied by (natural logarithm of total corporate assets).

$$Size = LN (Total Assets)$$



According to Fakhruddin (2008: 109), leverage is the amount of debt used to finance / buy company assets. In this study leverage is measured by the total assets.

$$Lev = \frac{\text{Total Debt}}{\text{Total Asset}}$$

Data analysis methods used in this study are descriptive statistics and logistic regression analysis including overall model fit test, goodness of fit, Nagelkerke R Square test, Wald test, and classification matrix test.

Logistic regression analysis was chosen because the data used in this study are non-metric on the dependent variable, while the independent variable consists of metric and non-metric data. Logistic regression analysis technique does not require normality testing and classical assumption on each independent variable (Ghozali, 2013). A logistic regression model was used to test hypotheses, as follows:

$$\text{Ln} \frac{\text{FFR}}{1 - \text{FFR}} = \beta_0 + \beta_1 \text{KOM} + \beta_2 \text{KM} + \beta_3 \text{SIZE} + \beta_4 \text{LEV} + \varepsilon$$

Information:

$\text{Ln} \frac{\text{FFR}}{1 - \text{FFR}}$ = Dummy with a value of 1 for companies that commit fraud, and 0 for companies that do not commit financial reporting fraud (Fraudulent Financial Reporting)

β_0 = Constant

β_i = Regression coefficient (i = 1,2,3...)

KOM = Audit Committee Competence

KM = Managerial Ownership

SIZE = Firm Size

LEV = Leverage

Results and Discussion

Table 1
Logistic Regression Test Results

		B	S.E.	Wald	df	Sig.	Exp(B)
Step	KKA	-1,962	,879	4,983	1	,026	,141
1 ^a	KM	-,175	1,623	,012	1	,914	,839
	Size	-,168	,129	1,701	1	,192	,845
	Lev	2,101	,989	4,517	1	,034	8,178
	Constant	4,285	3,725	1,324	1	,250	72,632

The logistic regression analysis equation used is:



$$\text{Ln} \frac{\text{FFR}}{1-\text{FFR}} = 4,285 - 1,962 \text{ KKA} - 0,175 \text{ KM} - 0,168 \text{ Size} + 2,101 \text{ Lev}$$

The interpretation of table 1 is as follows:

- a. The competence of the Audit Committee (KKA) has a logistic regression coefficient of -1,962 with a significance level of 0.026. The significance value is smaller than 0.05. Therefore, it can be concluded that audit committee competence has a negative and significant effect on financial reporting fraud.
- b. Managerial ownership (KM) has a logistic regression coefficient of -0.175 with a significance level of 0.914. The significance value is greater than 0.05. Therefore, it can be concluded that managerial ownership has a negative but not significant effect on financial reporting of fraud.
- c. Company size (Size) has a logistic regression coefficient of -0.168 with a significance level of 0.192. The significance value is greater than 0.05. Therefore, it can be concluded that the size of the company has a negative but not significant effect on financial reporting fraud.
- d. Leverage has a logistic regression coefficient of 2.101 with a significance level of 0.034. The significance value is smaller than 0.05. Therefore, it can be concluded that leverage has a negative and significant effect on financial reporting fraud.

The Audit Committee Competency variable produces a logistic regression coefficient of 1,962 which is negative. This shows that the higher the competence of the Audit Committee, the smaller the occurrence of fraudulent financial reporting. In addition, the Audit Committee Competency variable produces a significance value of 0.026. This significance value is less than 0.05. Therefore, it can be concluded that H_0 is rejected and H_a is accepted. This implies that the Audit Committee Competence has a negative and significant effect on fraudulent financial reporting.

The competence of the Audit Committee (KKA) is hypothesised to have a significant effect on fraudulent financial reporting. That is because the existence of an audit committee can be considered as an indication of improved monitoring quality, and has a significant effect on reducing the likelihood that fraudulent financial statements will occur (Beasley, 1996). This is in line with the research by Kusumaningtyas and Farida (2015). It concluded that audit committee competence has a significant negative effect on earnings management. The audit committee is an expert in the field of accounting or finance. It can improve the supervisory function of company owners (principals) against the management (agent).

The results showed that the audit committee had a negative and significant effect on fraudulent financial reporting, and confirmed previous research conducted by Beasley (1996), Kusumaningtyas and Farida (2015). This is because the audit committee with education and experience in the field of accounting and finance has a better understanding of the financial statements and the financial reporting procedures themselves, as well as experience in



evaluating financial statements, to improve the quality of financial statements that indirectly reduce the possibility of fraudulency on finance reports. This confirms the Regulation of the Financial Services Authority Number 55 / POJK.04 / 2015. It requires the audit committee to have an understanding of financial statements, to create a good quality financial statement for companies. Dewayanto et al. (2017) revealed that the financial expertise of audit committees has a significant influence in relation to the complexity of financial statements, to reduce the re-presentation of financial statements. This accords with research conducted by Huang and Thiruvadi (2010) which concluded that financial expertise is significantly related to fraud prevention. In addition, Carcello, et al. (2006) found evidence that the presence of accounting financial experts into audit committee membership would reduce earnings management, because experts are able to monitor the financial reporting process effectively.

The Managerial Ownership variable produces a logistic regression coefficient of 0.175 which is negative. This shows that the greater the value of Managerial Ownership, the smaller the occurrence of fraudulent financial reporting. In addition, the Managerial Ownership variable produces a significance value of 0.914. This significance value is greater than 0.05, so it can be concluded that H_0 is accepted and H_a is rejected. This implies that Managerial Ownership, partially, has no significant effect on financial reporting fraud.

Manpower ownership (KM) is hypothesised to have a significant effect on fraudulent financial reporting, because share ownership is considered to be able to confirm the objectives between the agent and the principal, so that the agent acts in accordance with company interests. Research conducted by Owens-Jackson et al. (2009), concluded that managerial ownership has a negative effect on financial report fraud.

The results of the study show that managerial ownership affects financial reporting fraud, meaning that share ownership by corporate managers such as the board of directors and commissioners cannot reduce the occurrence of fraudulent financial reporting. This is in line with Prasetyo's research (2014) which states that managerial ownership has no effect on financial reporting fraud. Regardless of the percentage of share ownership held by management, both large and small, they will still commit fraud through financial reporting. This is due to pressure from outside parties that makes management feel they have to meet the company's targets, so they tend to continue to commit fraud on financial reporting to achieve these targets (Widarti, 2015). The management will try to present financial statements as reflecting good performance, even though in reality the company is experiencing difficulties.

The Company Size variable produces a logistic regression coefficient of 0.168 which is negative. This shows that the greater the value of the Company Size, the smaller the occurrence of fraudulent financial reporting. In addition, the Company Size variable produces a significance value of 0.192. This significance value is greater than 0.05, so it can be



concluded that H_0 is accepted and H_a is rejected. This implies that Company Size partially does not have a significant effect on financial reporting fraud.

Company Size (Size) is hypothesised to have a significant effect on financial reporting fraud. The results showed that the size of the company had no effect on financial reporting fraud, because both large and small companies made it possible to commit financial reporting fraud. This confirms research conducted by Beasley et al. (1996) and Dalnial et al. (2014). Firm size between companies involved in fraudulent financial reporting, and those not involved in fraudulent financial reporting, is relatively the same. Large companies generally avoid high tax charges, so they move earnings to the next period. Small companies, however, generally do not have effective internal controls, either in the implementation of the company's business processes or in the process of presenting financial statements, especially because of a lack of segregation of duty. This creates opportunities for senior management to ignore existing controls. In addition, small companies may not be able to employ someone who has expertise in financial reporting, which will cause errors in financial statements.

Leverage variables produce a logistic regression coefficient of 2.101 which is negative. This shows that the greater the value of Leverage the greater the occurrence of fraudulent financial reporting. In addition, the Leverage variable produces a significance value of 0.034. This significance value is smaller than 0.05, so it can be concluded that H_0 is rejected and H_a is accepted. That is, leverage partially has a negative and significant effect on fraudulent financial reporting.

Leverage is hypothesised to have a significant effect on fraudulent financial reporting. That is because leverage represents the amount of debt used to finance/buy company assets, and shows the level of risk owned by the company. Thus, companies that have high leverage also have a high credit risk.

The results show that leverage has a negative and significant effect on financial reporting fraud. This contrasts with research by Dalnial, et al. (2014), Prasetyo (2014) and Owens-Jackson, et al. (2009) which states that leverage has no significant effect on the possibility of fraud. The reasoning behind the view that leverage has a positive and significant effect on financial reporting fraud, is that the higher the leverage, the higher the credit risk endured by the company, because the company must pay the principal and interest on large amounts of debt. In general, creditors provide certain conditions to debtors in lending money, including the debtor's obligation to maintain certain ratios in the financial statements. This has resulted in directors choosing an accounting method that can reduce the company's leverage ratio to keep creditors on their side, which means still lending to companies and not restricting companies from giving dividends to shareholders.



Conclusions

Based on the results of data analysis and discussion in the previous chapter, conclusions can be drawn as follows:

1. Audit committee competence negatively affects financial reporting fraud. The higher the competence of an audit committee, means an audit committee with an accounting education, the lower the occurrence of fraudulent practices on financial reporting.
2. Managerial ownership does not affect fraud as to financial reporting. It happens due to the absence of a high agency conflict; the ability to synchronise the interests of agents and principals. Therefore, it does not show any indication of fraud in financial reporting.
3. Company size does not affect financial reporting fraud. This shows that fraud is not only carried out by large companies, but even small companies have tendencies to fraudulent practices in the presentation and financial reporting process. It occurs through the estimation of certain post items, and the selection of accounting methods according to management judgment, to enable the financial report to show a good performance with a low net score which shows no fraud in its financial reporting.
4. Leverage has a positive and significant effect on financial reporting fraud. Nearly 43% of the companies surveyed showed a high degree of leverage. This means that 43% of 53 sample companies tested were financing their assets with debt. This influenced their quality financial reporting efforts by practising creative accounting. Theoretically creative accounting is one form of fraudulent practices in financial reporting.
5. Audit committee competence, managerial ownership, company size, and leverage simultaneously affect financial reporting fraud.

Research Limitations

1. This research was conducted only on manufacturing sector companies listed on the Indonesia Stock Exchange (IDX) with a 3-year observation period, namely 2014 - 2016.
2. Independent variables regarding corporate governance used in this study are limited to the competence of the audit committee.
3. The only indicator used to measure financial reporting fraud in this research is the Beneish M-Score Model which is a probabilistic model. Therefore the estimations are not 100% accurate, and are less precise if used in other companies such as service / financial companies.

Recommendations

1. For investors, this research can be used as a reference in making investment decisions. Investors can evaluate the company's performance through financial statements, to



find out which company produces the most profitable investment. This is also done to reduce investment risks, especially for long-term investments.

2. Future researchers are advised to add research samples from other sectors, such as the service and financial sectors, so that the results obtained can be broader and increase the time span of the study to obtain better results.
3. Future researchers are advised to add other independent variables related to financial reporting fraud, such as the effectiveness of the audit committee, the effectiveness of the board of directors and commissioners. In this study, the only independent variables related to corporate governance was audit committee competence.



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