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Corporate Governance Mechanisms and Possible Financial Statements Containing Fraud

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Abstract

The aim of this study is to ascertain effect of Corporate Governance mechanisms on the possibility of financial statements containing fraud. This study examines the size of the board of commissioners as determined by the total number of board members in a company, the proportion of independent board members as determined by the proportion of an organization's board of directors that are independent as a percentage of the total number of board members, and board members with international experience. The audit committee's and worldwide audit's efficacy is evaluated by assigning a code one if all necessary information is released, a code two if Indonesia is informed but does not comply with the Code of Good Corporate Governance, and a code three if no information is provided. The Beneish M-Score measures financial statement fraud. The company indicated manipulator would be given code one if not indicated code 0. The company's size is quantified by the logarithm of the company's total assets in year t, leverage is measured by dividing total debt by total equity, and the company's age is estimated based on the number of years since the corporation was incorporated. On the Stock Exchange. A sample in this study of 100 non-financial companies listed on the Indonesia Stock Exchange in 2019. The statistical method used is binary logistics analysis. The findings of this study indicate that board size does not affect the likelihood of financial statements containing fraud; the proportion of independent board members does not affect the possibility of financial statements preventing fraud; board members with international experience do not affect the likelihood of financial statements preventing fraud.

Keywords
financial statement Fraud; corporate governance; financial statements

I. Introduction

Fraud in financial statements has attracted the public, press, investors, economic community, and regulators due to the many scams encountered, such as Lucent, Xerox, Cendant, Enron, WorldCom, Adelphia, and Tyco. Some of these financial scandals show a significant comparison between the accounting information disclosed by managers and the company's economic reality (Ines, 2017). Encouragement or motivation from various parties to always appear suitable frequently requires the company to manipulate somehow. The company provides incorrect data that is dangerous in a variety of ways. Accounting fraud is commonly used to refer to the attempt by the company to commit fraud, such as manipulating its financial statements (Pamungkas et al., 2018). Weak corporate governance and lack of transparency are considered one of the causes of corporate destruction and accounting fraud (Mohamad and Sulong, 2010). Good Corporate Governance can regulate and control companies that create added value for all stakeholders (Wahyudi et al., 2019). So that the

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need for Good Corporate Governance as a mechanism used to minimize the performance of inefficient company management due to moral hazard and wrong decision making to achieve the company's goals.

In the corporate governance mechanism, there is a board of commissioners tasked with monitoring the quality of information contained in financial statements. Abbott et al. (2000) found a significant association between board size and the quality of financial reporting monitoring. Alfraih (2016) states that the experience, expertise, and qualifications possessed by the board of commissioners can improve monitoring and improve the quality of financial reporting.

Generally, independent commissioners are part of the membership of the board of commissioners, including individuals outside the organization, and the number of independent commissioners is at least 30 percent of the membership of the board of commissioners. Uzun et al. (2004) prove the level of independence of the company is high, then fraud in a company will be small. According to Razali and Arshad (2014) an independent board of commissioners can be an effective corporate governance mechanism to improve the quality of financial reporting.

In addition to the board of commissioners who play a role in the corporate governance mechanism, the board of directors also plays a role in it. It is expected that with the presence of board members and directors with international experience, able to prevent fraud in financial statements. Carpenter and Feroz (2001) argue that with global expertise different from local expertise, it is believed that such board members can assist in informing and avoiding mechanisms for-profit management more actively in the organization.

The board of commissioners will have the support of the audit committee in the implementation of its duties. The audit committee assists the commissioner primarily in the task of overseeing financial statements. Razali and Arshad (2014) proved that the audit committee's effectiveness could reduce the likelihood of fraud in financial statements.

In its implementation, the audit committee can coordinate with the internal audit department to review and discuss its performance to encourage good monitoring. Monisola et al. (2013) found that an internal audit department within a company's organization could strengthen the company's control over errors, irregularities, and fraud. Drogalas et al. (2017) demonstrates that the effectiveness of internal audits can detect fraud.

The company's size and leverage age of the company can affect the occurrence of fraud in financial statements. Therefore, these three factors will be used as control variables in this study. The existence of the company can grow and be sustainable and the company gets a positive image from the wider community (Saleh, 2019). Company growth can be calculated by Asset Growth, which is proxied by the growth in net assets (Mauris, 2021).

Previous research provides evidence of the advantages of using two cheating measuring instruments, the Altman-Score and Beneish M-Score models, which have high predictive power in detecting fraud(e.g., Mavengere, 2015; Maccarthy, 2017; Akra and Chaya, 2020). However, Ofori (2016) said that both models have shortcomings, namely the influence of the definition of metrics used in conducting financial analysis to result in predictions of company default risk and manipulation of profits that are different.

Based on the above explanation, the purpose of the study is to test the size of the board of commissioners, the Proportion of independent board of commissioners, board members with international experience, the effectiveness of the audit committee, and the effectiveness of internal audits against possible financial statements containing fraud. So that buying this testing will provide benefits for the relevant parties. In the current economic development, manufacturing companies are required to be able to compete in the industrial world (Angelia, 2020).

II. Review of Literatures

2.1 Agency Theory

Jensen and Meckling (1976) showed the agency's contractual relationship between the principal and the agent. This agency theory explains the general interests of shareholders as principals to managers as agents. Compared to principals, managers as agents have superior information about a company's operations, and selfish managers may engage in illegal or fraudulent activities to increase personal wealth (Ali, 2020).

2.2 Fraud Triangle Theory

Fraud can occur due to various causes and opportunities that can be used as a basis for cheating in accounting (Putri and Irwandi, 2016). Cressey (1953) came up with a fraud triangle theory that discusses the factors that cause fraud. The fraud triangle theory discusses three elements of fraud in financial reporting, namely pressure to achieve goals, opportunities to commit fraud, and rationalization of fraudsters.

2.3 Corporate Governance

Ehsan et al. (2018) emphasizes the role of corporate governance in encouraging managers to engage in socially responsible activities and point out that there is statistically recognized evidence that government can promote the fulfillment of managers' social responsibilities by instilling applicable management practices. Ehsan et al. (2018) also agreed that suitable corporate governance mechanisms could help companies more effectively limit directors in using organizational resources for personal gain through oversight and management committees because corporate governance comes from the supervisory system. In this study, corporate governance can be expressed in the size of the board of commissioners, the Proportion of independent board of commissioners, board members with international experience, the effectiveness of audit committees, and internal audits.

2.4 Size of the Board of Commissioners

To guarantee an organization's success, Alzoubi and Selamat (2012) believe that the board of commissioners is obliged to set the goals and strategies of the organization and balance them with the interests of shareholders. In terms of financial statements, they are responsible for the transparency and credibility of financial statements. The Council on Foundations (2010) argued that expanding the size of the board would provide better opportunities for the development of diversified companies and have a wide range of views and ideas, which would help resolve issues affecting the company.

2.5 The proportion of Independent Board of Commissioners

The National Committee on Governance Policy (KNKG) (2006) stated that independent commissioners are commissioners of unrelated parties, namely parties who have no business or kinship with controlling shareholders, directors, and other board of commissioners company itself. Instead of different backgrounds and independence, these independent commissioners can also discuss and debate reasonably with the executive director in board meetings. They will then establish an effective board to help the organization reduce and prevent fraud (Razali and Arshad, 2014).

2.6 Board Member with International Experience

Carpenter and Feroz (2001) believe that board members with international experience have unique characteristics and can be used for participation in the company's competitive advantage. Board members may get international experience. from assignments, as well as experience in foreign companies. These people are displayed in the makeup of financial data and financial statements or shown in organizational management and are also displayed in corporate monitoring activities by foreign companies. These businesses' methods may be affected by culture, legislation, and other factors. The laws or regulations of the country/region in which the company operates. This experience can help board members manage the complexities tied to the implementation of profit management. Through the international experience that differs from local expertise, it is also believed that such board members can help to inform and avoid mechanisms for-profit management more actively in the organization.

2.7 Effectiveness of the Audit Committee

The audit committee's function is to provide opinions on issues related to fiscal policy, accounting, and internal control. Establish an audit committee to ensure that published financial statements will not mislead their users and comply with generally accepted accounting practices (Wahyudi et al., 2019). The Financial Services Authority of the Republic of Indonesia (2015) requires at least three audit committee members, which comes from independent commissioners and groups outside issuers or public companies, with independent commissioners as to their chairman.

2.8 Effectiveness of Internal Audits

Based with the American Institute of Certified Public Accountants (AICPA), internal auditing includes the efforts, methods, and actions taken by an organization to protect its assets, control the accuracy and reliability of its accounting data, improve its operational efficiency, promote its development and maintain its standard business strategy. Therefore, the responsibility of the internal audit department is to review the internal control system periodically and ensure effective and efficient operations. The function of internal auditing can prevent fraudulent financial reporting within the organization through inspection and evaluation (Harden, 2010).

2.9 Size of the Company

The size of a company can be seen in total assets, sales, and market value. The greater the total assets, sales, and market value, the larger the company's scale. The larger the size of a company, the incentive to disclose information and reduce political costs will also be significant because larger companies can treat their size as variables to encourage public attention or oversight of their operations so that the company can have more information in their reports, and can provide relevant information to different users in its reports (Madhani, 2016).

2.10 Leverage

Companies with high leverage threatened to be unable to meet their debt obligations in time (Wahyudi et al., 2019). Leverage describes the source of the company's operational funds and shows the risks facing the company (Indracahya and Faisol, 2017).

2.11 Age of the Company

The company's age can be measured from the entire year since the establishment of the company to date, and it can also be estimated from the number of years since the company was listed on the stock exchange (Memon et al., 2019). Older companies are less likely to do profit management because old companies or established companies already have a fixed source of funds, so the company's interests are more focused on retaining investors and continuously improving the company's performance, which can result in investor expectations with good performance (Indracahya and Faisol, 2017).

2.12 Financial Statement Fraud

The Association of Certified Fraud Examiners (ACFE, 2014) describes fraud in the form of fraud trees that include corruption, asset irregularities, and fraud in financial statements. ACFE (2014) argues that financial statements containing fraud refer to fraudulent management behavior in the form of incorrect presentation of financial statements that can harm relevant parties such as investors and creditors. This scam is either a financial fraud or a non-financial scam.

2.13 Relationships between Variables

a. Relationship of Board of Commissioners Size and Possible Financial Statements Containing Fraud

The Council on Foundations (2010) argued that expanding the size of the board would provide better opportunities for the development of diversified companies as well as having a wide range of views and ideas, which would help in resolving issues affecting the company.

Abbott et al. (2000) found a significant association between board size and the quality of financial reporting monitoring. Alfraih (2016) states that the experience, expertise, and qualifications possessed by the board of commissioners can improve monitoring and improve the quality of financial reporting.

Based on the description above, the following hypothesis is proposed:

H1 = The size of the board of commissioners negatively affects the possibility of financial statements containing fraud.

b. Relationship proportion of Independent Board of Commissioners to Possible Financial Statements Containing Fraud

Due to different backgrounds and independence, these independent commissioners can also discuss and debate reasonably with the executive director in board meetings and will then establish an effective board to help organizations reduce and prevent fraud (Razali and Arshad, 2014).

Uzun et al. (2004) proves if the level of independence of the company is high, then fraud in a company will be small. According to Razali and Arshad (2014) an independent board of commissioners can be an effective corporate governance mechanism to improve the quality of financial reporting.

Based on the description above, the following hypothesis is proposed:

H2 = Proportion of independent board of commissioners negatively influential with possible financial statements containing fraud

c. Board Members' Relationship with International Experience with Possible Financial Statements Containing Fraud

Board members with international experience have unique characteristics and can be used for participation in the company's competitive advantage (Carpenter &Feroz, 2001).

Carpenter and Feroz (2001) argue that with international experience different from local expertise, it is believed that such board members can assist in informing as well as avoiding mechanisms for profit management more actively in the organization.

Based on the description above, the following hypothesis is proposed:

H3 = Board members with negative international experience with possible financial statements containing fraud.

d. Audit Committee's Effectiveness Relationship to Possible Financial Statements Containing Fraud

The establishment of an audit committee to ensure that published financial statements will not mislead their users and comply with generally accepted accounting practices (Wahyudi etal., 2019).

Razali and Arshad (2014) proved that the audit committee's effectiveness can reduce the likelihood of fraud in financial statements.

Based on the description above, the following hypothesis is proposed:

H4 = The effectiveness of the audit committee negatively affects the possibility of financial statements containing fraud.

e. Relationship to Effectiveness of Internal Audits against Possible Financial Statements Containing Fraud

The responsibility of the internal audit department is to review the internal control system periodically and ensure effective and efficient operations. The function of internal auditing can prevent fraudulent financial reporting within the organization through inspection and evaluation (Harden, 2010).

Monisola et al. (2013) found that an internal audit department within a company's organization could strengthen the company's control over errors, irregularities and fraud. Drogalas et al. (2017) demonstrates that the effectiveness of internal audits can detect fraud.

Based on the description above, the following hypothesis is proposed:

H5 = The effectiveness of internal audits negatively affects the likelihood of financial statements containing fraud.

f. Research Model

The research model will explain the relationships between the variables to be studied, and aims to facilitate understanding the direction of the research. Based on the above review, the research model is shown in figure 1, as follows:

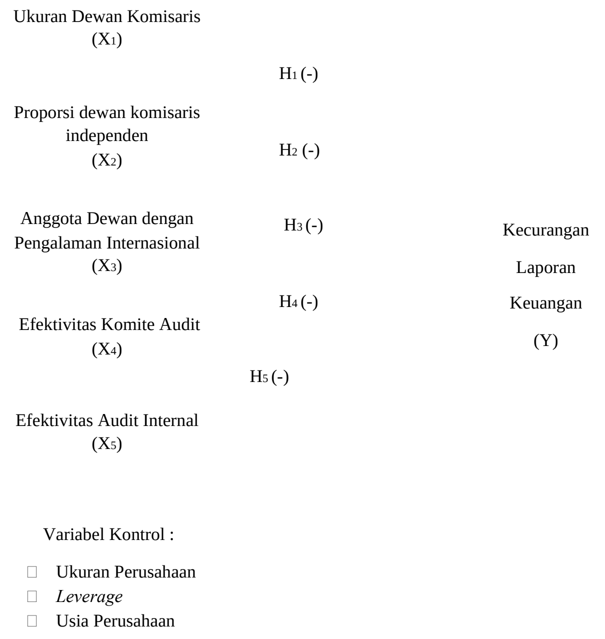

Figure 1. *Research Model*

III. Research Methods

Financial reporting fraud is measured using the Beneish M-*score* scoring model (1999). If the company indicated *fraud* will be given code 1, if not stated *fraud* is regulation 0 (Razali and Arshad, 2014). Corporate *governance mechanisms* include the size of the board of commissioners, the Proportion of independent board of commissioners, board members with international experience, audit committees' effectiveness, and internal audits' effectiveness. The smallness of the board of commissioners is measured by the company's board of commissioners (Suyono, 2016). The Proportion of the independent board of commissioners is measured by the percentage of the number of independent commissioners of the company against the total commission of commissioners (Suyono, 2016). Board members with international experience are measured based on the percentage of board members who have international understanding of the total number of board members (Razali and Arshad, 2014). The effectiveness of the audit committee and the effectiveness of the internal audit are measured by the following methods: code "1", and all relevant items are disclosed, and if those disclosed do not conform to Indonesia's *good corporate governance* code, the code is "2", if not told, it is code "3" (Razali and Sunday, 2014).

The research utilized business size, leverage, and age as control factors. The company's size is calculated using logarithms of total assets in year t.(Ines, 2017) while *the leverage* ratio is calculated by dividing total debt to total equity (Ines, 2017),and the age of the company is estimated based on the company's already several years since it was listed on the stock exchange (Memon etal., 2019). The design is quant nature and relies on secondary data. Furthermore, the population for this research is a non-financial business that was the Indonesian Stock Exchange in 2019. Purposive sampling is a sampling method that employs particular factors. Samples were taken by as many as 100 companies in the non-*financial* sector listed on the stock exchange in Indonesia.

Binary logistic regression is used as an analysis method in this study. The bound variables included in the binary logistic regression analysis method are binary or have 2 categories (Maroof, 2012). The following logistic regression models were established:

$$FRAUD = \beta0 + B1COM + \beta2COMINDEP + \beta3INEX + \beta4AC + \beta5IA + \beta6SIZE + B7LEV + B8AGE + \varepsilon$$

Information:

FRAUD: *Dummy* variable is code one for Fraud Company and zero code in Non-fraud Company

β0 = Constant
β1,2,3,4,5,6,7= Regression coefficient of each proxy
COM= Size of the board of commissioners
COMINDEP= Proportion of independent board of commissioners
INEX = Board member with International experience
AC = Effectiveness of the audit committee
IA = Effectiveness of internal audit
AUDSIZE= KAP size
SIZE= Size of the company
LEV = *Leverage*
AGE= Age of the Company
ε = Error

IV. Results and Discussion

4.1 Results

Descriptive statistical analysis can provide an overview of the data consisting of minimum, maximum, average *(mean)*, and standard deviation. Descriptive statistics of all the variables used in this study can be explained as follows:

The amount of data (N) included in this study was obtained from a sample of 100 *non-financial* sector companies *listed* on the Indonesia Stock Exchange, which was taken using *purposive sampling*methods. Dummy variables are used to measure fraud, *non-fraud* indications will be given code 0, and if fraud indications will be given code 1. Therefore, the minimum fraud value is 0, maximum 1, average 0.1300 and standard deviation value of 0.33800. The minimum size of the board of commissioners (COM) is 2, the maximum is 9, the average is 4.3700 and the standard deviation is 1.76758. The minimum Proportion of independent board of commissioners (COMINDEP) is 0.25, the maximum is 0.66, the average is 0.4097 and the standard deviation is 0.08717. Board members with international experience (INEX) have a score of 0, a maximum score of 0.69, an average score of 0.1526 and a standard deviation score of 0.19470. The effectiveness value of the audit committee (AC) is minimum 1, the maximum value is 2, the average is 1.3800 and the standard deviation value is 0.48783. Internal audit effectivity (IA) has a minimum value of 1, a maximum weight of 2, and an average of 1.4000 and a standard deviation value of 0.49237. The minimum value of the company size (SIZE) is 8.27, the maximum value is 18.42, the average is 14.8916 and the standard deviation value is 1.73570. Leverage's minimum value is 0.08, maximum weight is 17.21, average is 1.3257 and normal deviation value is 1.95732. The minimum age of the company (AGE) is 3 years, the ultimate value is 39 years, the average is 19.2500, and the standard deviation is 9.18758.

The feasibility results of the regression model in this study were evaluated through the *Hosmer and Lemeshow Test, Goodness of Fit* obtained 0.285 and probability sig. 1,000 where 1,000 > 0.05. Therefore, it shows that the regression model used is acceptable because it can predict the observed value or the model corresponds to the observed data.

The *Omnibus Test of Model Coefficients* shows *Chi-Square's result* of 22.128 and signification of 0.005 < 0.05, which shows all free variables can affect bound variables. In other words, the model is declared suitable.

The determination coefficient test obtained *a Cox and Snell R Square* value of 0.285 (28.5%). *Nagelkerte R Square* value of 0.624 (62.4%). These results suggest that the 5 independent variables used in the study may explain 62.4% of dependent variables and the remaining 37.6% are clarified by variables outside the study.

Based on the results of the binary logistic regression test above, the equation can be derived as follows:

$$\text{FRAUD} = -13{,}053 - 0.232\text{COM} + 37{,}458\text{COMINDEP} - 25{,}643\text{INEX} - 3{,}860\text{AC} + 2.871\text{IA} - 0.341\text{SIZE} + 0.505\text{LEV} - 0.048\text{AGE} + \varepsilon$$

Where:

The constant value of -13,053 in this study can be interpreted as follows: if the board of commissioners' size, the proportion of independent commissioners, board members with international experience, the audit committee's effectiveness, and the effectiveness of internal audits are constant or zero, financial statement fraud decreases by 13,053. The coefficient of the size of the board of commissioners of - 0.232 with a significance value of 0.800 > 0.05 indicates that the size of the board of commissioners does not affect the possibility of financial statements containing fraud. The Proportion coefficient of an independent board of commissioners of 37.458 with a significance value of 0.144 > 0.05 indicates that the Proportion of separate boards of commissioners does not affect the likelihood of financial statements containing fraud. The coefficient of board members with international experience of -25,643 with a significance value of 0.262 > 0.05 indicates that board members with international experience do not affect the likelihood of financial statements containing fraud. The audit committee's effectiveness coefficient of -3,860 with a significance value of 0.041 < 0.05 indicates that the audit committee's effectiveness negatively affects the likelihood of financial statements containing fraud. The coefficient of internal audit effectiveness of 2.871 with a significance value of 0.147 > 0.05 indicates that if the effectiveness of the internal audit does not affect the likelihood of financial statements containing fraud. The *size* coefficient is -0.341, leverage is 0.505 and the company's lifespan is -0.048.

Table 1. Hypothesis

Hypothesis	Significance Value	Information
The size of the board of commissioners relates negatively to the possibility of financial statements containing fraud.	0,800	Rejected
Proportion of independent board of commissioners negatively relates to possible financial statements containing fraud	0,144	Rejected
Board members with international experience relate negatively to possible financial statements containing fraud	0,262	Rejected
The effectiveness of the audit committee relates negatively to the possibility of financial statements containing fraud.	0,041	Accepted
The effectiveness of internal audits relates negatively to the possibility of financial statements containing fraud.	0,147	Rejected

4.2 Discussion

The result of the first hypothetical logistic regression analysis is that the size of the board of commissioners does not influence with the possibility of financial statements containing fraud. So H_1 was rejected, this result is in line with Salleh and Othman (2016) who proved that the size of the board did not prevent fraud. This shows that a small number of board members in the company have not contained fraud in financial reporting.

On the second hypothesis the result of a logistic regression in which the Proportion of and the existence of an independent board of commissioners has no bearing on possibility of financial statements containing fraud. So$_{H2}$ was rejected, so that independent board members have not been able to prevent fraud. Al-Rassas and Kamardin (2015) explained that independent board members could have delegated financial monitoring responsibilities to the audit committee, responsible for reporting the company's financial status.

Next, for the third hypothesis shows the results of a logistic regression analysis of board member variables with international experience does not affect the possibility of financial statements containing fraud. As a result$_{H3}$ was rejected, the results of this study are in line with Razali and Arshad (2014) which showed board members with international experience have not been able to increase their role and responsibility in improving the effectiveness of overall corporate governance.

Subsequent hypothesis testing proves that the fourth hypothesis is the effectiveness of the audit committee negatively influential with the possibility of financial statements containing fraud. So H_4 was received, this result is in line with Razali and Arshad (2014) which proved that the effectiveness of the audit committee can reduce the possibility of fraud in financial statements.

Furthermore, the fifth hypothesis indicates that a logistic regression analysis of internal audit effectiveness variables has does not affect possibility of financial statements containing fraud. As a result$_{H5}$ is rejected, this is possible because the internal audit task is essentially an assessment, leading to delays in detecting fraud within the company. In his study Wahyudi *et al.* (2019) indicates that an internal audit is insignificant to the possibility of fraud in financial statements. This can happen due to a conflict of interest in the inner that can affect the quality of internal audit activities.

V. Conclusion

Research data as 100 companies with non-financial sector corporate objects listed on the Indonesia Stock Exchange in 2019. This study has the results of logistic regression that shows the audit committee's effectiveness negatively affects the fraud of financial statements. The audit committee's effectiveness conducted by the company is not the only factor to prevent fraud in the company's financial statements.

The board's size variable does not affect the possibility of financial statements containing fraud it provides evidence that how many board members in the company have not been able to prevent fraud in financial statements. Proportion of independent board of commissioners has no influence with fraud prevention in financial statements, an independent board of commissioners could have given financial monitoring responsibilities to the audit committee. Board members with international experience do not affect the possibility of fraudulent financial statements, suggesting that international experience has not increased their roles and responsibilities. The effectiveness of internal audits does not have a significant effect on the prevention of fraud in financial statements this can occur due to conflicts of interest within the company that can affect the quality of internal audit activities.

There are limitations in this study, namely on the number of samples of companies used 100 data in a period of 1 year, so it is not possible to describe the condition of financial statement fraud on the company. Future research is expected to add a sample of companies with a more extended research year and add variables in the number of audit committee meetings, managerial ownership, and other variables.

The managerial implications of this research are expected to influence the company's management to elect an internationally experienced independent board of commissioners and commissioners, where international experience can assist the company in actively identifying and avoiding fraud mechanisms in financial statements, and to be more cautious in selecting competent and qualified internal auditors. As for investors and prospective investors to be more careful to make investment decisions in the company by assessing the level of fraud in the presentation of financial statements.

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