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# THE INFLUENCE OF AUDIT COMMITTEE QUALITY AND INTERNAL AUDITOR OBJECTIVITY TOWARD THE PREVENTION OF FRAUDULENT FINANCIAL REPORTING (A Survey in State Owned Enterprises of Indonesia)

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## ABSTRACT

Some cases both nationally and internationally indicate the occurrence of irregularities in financial reporting due to the weakness of the company's internal control system, and the audit committee that has not functioned optimally, so that the resulting of the financial reporting is in low quality. This study used explanatory method. The data were collected through survey by distributing questionnaires to State Owned Enterprises (SOEs) in Indonesia. The respondents involve audit committee, internal auditors and financial directors. The data have been analyzed by using partial least square analysis modeling to test the hypotheses. The results concluded that, the quality of the audit committee and objectivity of internal auditor has an affect on the prevention of fraudulent financial reporting.

*Keywords*: Audit committee quality, internal auditor objectivity, and fraudulent financial reporting

## 1. INTRODUCTION

Fraudulent Financial Reporting is an intentional deceiving act set by top management in order to show a better report than the actual report (Albrecth 2003). The cause of the fraud and financial scandal, which recently have been revealed are regarding with the weak corporate governance (Cohen et al. 2004). This fraudulent financial reporting misguides the investors. This report, which usually functions as guidance sometimes, misguides the investors in their decision (Verdi, 2006). Fraudulent financial report can give bias and misguiding information (Belkaoui, 2004).

These fraudulent cases have recently happened because the internal audit function is still not effective yet (Nasution, 2009). It is also supported by the research of *Bapepam* which reveals that: 1) the financial report audit for external and internal is still not effective, 2) the function of internal audit or the risk assessment function is not effective while in fact this function is really needed by companies in order that the internal audit can run smoothly. The modus of financial crime is not only about fraud but also about the weak system of audit (Luhukay, 2011).

Research by COSO (2007) explains that there is income claim by managements using fraudulent technique such as: fraudulent financial reporting and asset misappropriation. Bahr, et al (2010) also proves that the involvement of chief executive officer and chief financial officer which triggers the fraud from 1997-2007 increases for about 6% or from 294 cases up to 347 cases and the most common fraud is about income claim. Other research by ACFE (2010) reveals that American companies suffer from 6% lost which is caused by fraud, this lost has not changed yet since 1996, the most common fraud that has happened is asset misappropriation (85%), corruption (13%), and fraudulent financial report which is only (5%), but it gives the most significant lost for about $ 4.25 million.

Audit by Financial Controller in Indonesia (BPK) from 2005 to 2011 explains that there are 24 suspected corruptions of SOEs, these frauds happen because of some factors, and the most factors is the weak system in internal control and accountant control. Choliq (2011), found an excess of report of 4

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billion Rupiahs, which is made by previous director in doing fraudulent financial report during 2004-2008 by claiming the next prospective income as a certain period income. Moreover, an investigation by BPK towards Bank Century also reveals some important things such as: 1) $ 18 billion corruption of finance foreign exchange and 247 negotiable certificate of deposits with respective of 2 million rupiah; 2) there are some frauds done by bank officers, wealth holders and other related people which suffers Bank Century (Purnomo, 2011). The reveals of some cases in India also show the fraudulent financial reporting, like Satyam Computer Services, Ltd., which reported the finance of about Rs. 50.4 billion or $1.04, which is actually a fictive report. While the Lehman Brothers in USA 2008 was caused by materially misleading accounting gimmick or window dressing, that is an effort which is done in order to camouflage the real ugly truth.

KPMG (Klynveld Peat Marwick Goerdeler) in 2010 did a survey about fraud in any industrial segment in India with the managing director/Chairman, CFO, Head of Internal Audit and Compliance, Fraud Risk Manager and Senior management as respondent, and it was known that some factors initiating the fraud are: weak internal control (63%) the decrease of etiquite value (48%) and the fault in any action (40%). The reason of doing fraud is for management overrides control (66%), reaching market expectation (63%) and for remuneration based on work ethic (61%). Fraud detection is mostly done by internal auditor (47%). Detected fraud from mobile cellular is (38%) and from wistle blower is (26%).

Based on the data of fraud action by Certified Fraud Examiners (CFEs), the fraud done by top management and superiors contributes the biggest lost. The fraud prevention and detection are done by accounting standard board (FASB, 2008) and American Institute of Certified Public Accountants (AICPA, 2005). They are done by issuing standards and rules, which may prevent the fraud action.

The governor deputy of Bank Indonesia in Banking Efficiency Award discussion 2011 stated that the happening of many fraud cases caused by the control toward top managements is not sustainable. The unoptimal internal control, the weakness in the policy and procedural implementation, and Human resource department do not really know their employee (Alamsyah, 2011).

The preventive action of fraud has been done by the regulators (Bank Indonesia and Bapepam LK) through regulation of Bank Indonesia No: 5/8/PBI/2003 which explains that Fraud Risk Management must have the active control of Board of Commissioners and directors, sufficient policy, procedure and sufficient identification, measurement, controlling and risk control, also management information system and thoroughly internal control by introducing risk prevention with “No fraud Tolerance” through optimalization of Principle based-regulation through optimalization function of complience director, internal audit, and risk management which operates independently (KNKG, 2006).

Bapepam notification letter No. SE-03/PM/2000 is stated that audit committee helps commissioners for: 1) improving the quality of financial reporting, 2) setting up the dicipline and control environment which can prevent the fraud action in company management, 3) increasing the activity of internal and external audit, and 4) identifying things which needed an attention of board of commissioners concern. Some colleagues also stated that the cause of fraud action is also mainly about the decreasing of internal committee audit quality like in case of Enro and Tyco (O’ Keefe, 2003). This thing can help in rethinking that the improvement of audit committee quality must be done for preventing fraudulent reporting (Beasley et al. 2000; and Chtourou et al. 2001).

The audit committee is responsible in controlling things which have potential in the internal control system and monitoring the control process which is done by internal auditor (FCGI, 2006). Standards for the Profesional Practice of Internal Auditing (SPPIA) also stated that the internal auditors must be able to use their post in doing internal control carefully, pay an attention to any possibility of fraud, errors, manipulation, in-efficiency, non-effectiveness a conflict of interest and condition and activities which might cause irregularity (IIA, 2003).

Internal auditor also helps management in designing and sustaining the internal control sufficiency. It is also responsible to control the sufficiency and effectiveness of respective control system (Hermanson et al. 2008). According to Rezaee and Riley (2010), internal Auditor also has important roles in preventing and detecting the existence of fraudulent financial reporting, also in evaluating the implementation of corporate governance.

The aim of this study is to find the clearity and empirical evidence about “the influence of audit committee quality and internal auditor objectivity toward the prevention of Fraudulent Financial

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reporting" in SOEs in Indonesia. The objective of this study is to analyze 1) the influence of audit committee quality toward the prevention of fraudulent financial reporting; and 2) the influence of internal auditor objectivity toward the prevention of fraudulent financial reporting.

## 2. THEORITICAL REVIEW

### 2.1. Audit Committee Quality

The audit committee is established by the board of directors to assist and strengthen the task of the board of commissioners in performing supervisory functions (Oversight) on a framework of accountability in the process of financial reporting, risk management, internal and external audit (AICPA, 2005; IAI 2009; Braiotta et al. 2010). The audit committee is responsible for monitoring and overseeing management in improving the financial reporting quality for the benefit of all shareholders, therefore the committee members audits should be independent of management, have the expertise and experience in accounting and finance in order to reduce the risk of material errors in the financial reporting process (fraudulent financial reporting) (Braiotta et al., 2010; Baxter, 2010).

The audit committee is responsible for ensuring that management fulfills his responsibilities in the preparation of financial statements, therefore CFO (Chief Financial Officers) as managing director is responsible for the management and decision-making company, should consult or communicate with the audit committee to consider several issues related to practices financial reporting (FCGI, 2002; Braiotta et. al. 2010). The audit committee is also assisting the commissioners in a few things: 1) improving the quality of financial reporting, 2) Creating a climate of discipline and control that can reduce fraud in the management of the company, 3) improving the effectiveness of internal and external audit functions, 4) identifying matters that require the attention of commissioners (Higson, 2003).

The audit committee quality associated with the reduction or mitigation management opportunities to commit fraud management material by willful misconduct on its financial results. Furthermore, the quality of the audit committee is determined by the control of the process of the financial reporting quality by reducing the opportunities in the fraudulent financial reporting (Beasley et al, 1999b, 2000;. Chtourou et al, 2004).

The existence of an audit committee quality is necessary, because the audit committee as the outside directors can enhance the independence and effectiveness of the external auditor and to improve the financial reporting quality (Messier et al., 2008; Moeller, 2005). The role and functions of the audit committee can be enhanced if it has independent members, understand financial statements, have enough time, and regularly hold meetings of members (Baxter, 2010). One of the keys to increasing public confidence is to establish an independent audit committee involving the board directly to the integrity of information in the financial statements (Braiotta et al. 2010). Integrity is a moral principle for someone to act according to conscience, impartial and honest, perceive and express the fact as it is, while objectivity is a principle that requires a professional to act impartially and avoid conflicts of interest in carrying out his professional duties (AICPA, 2005 ; IAI, 2009; Messier et al., 2008; Arens et al. 2012).

The audit committee quality can improve the integrity and reliability of financial reporting through oversight of the financial reporting process and supervision of the total audit process, audit and accountability committee has consequences in the financial reporting process that can reduce the effect of accounting measurement inaccuracy, inadequacy influence on accounting disclosure, and influence management irregularities and illegal acts (Tugiman, 1995).

The finance competence of the audit committee is very important because the audit committee is responsible for the monitoring function, control and financial reporting companies, so that the audit committee can critically analyze accounting policies and financial reports, identify potential problems, and solving problems occurs in an organization (Dhaliwal et al. 2006). The Sarbaness Oxley Act (2002) section 407 also stressed the need for audit committee members with financial expertise, in order to detect material misstatements, and also understand the standards and technical accounting procedures. Several studies have shown that the audit committee financial expertise is negatively related to the tendency of companies doing fraud (Abbortt et al., 2004; Bedard et al., 2004; Huang and Thiruvadi, 2010).

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## 2.2. Internal Auditor Objectivity

The internal auditors objectivity according to the Rule of Professional Conduct International Practices Framework (IPPF) - The Institute of Internal Auditors Research Foundation (IIARF, 2009) are as follows:

1. The internal auditor did not participate in activities or relationships that may disrupt or interfere with their judgment considered. This participation includes those activities or relationships that conflict with the interests of the organization.
2. The internal auditor does not accept anything that may disrupt or interfere considering his professional assessment.
3. The internal auditors disclose all material facts known, if not disclosed, they may distort the reporting of activities that were examined.

The International Standards for the Professional Practice of Internal Auditing issued by The Institute of Internal Auditors (IIA, 2010) and The Professional Standards of Internal Auditors (PSIA, 2004) also described in terms of the standard attributes that individual objectivity, internal auditors must have an impartial attitude, unbiased/objective, and to avoid conflicts of interest. Braiotta et al. (2010) also explains that, the internal auditor should have sufficient knowledge and experience to perform the identification, analysis and evaluation of all the independent evidence, including identifying indicators of irregularities (fraud) and record all information to achieve organizational goals.

According to Sawyer (2005) the internal auditors conduct the systematic and the objective assessment of the operational and control to assist the organization in carrying out its responsibilities effectively to determine whether (1) the financial information and operating companies have been accurate and reliable, (2) the risk facing the company has been identified and minimized, (3) the external regulations and internal policies and procedures are acceptable to be followed, (4) the operational criteria have been met, (5) the resources have been used efficiently and economically, and (6) the purpose organization has been achieved effectively.

Moeller (2005) also explains that the internal auditors carry out the professional work based on the principles of integrity, objectivity, confidentiality and competence which are the norms of ethical conduct of the internal auditors, the mental attitude that its objective can be measured from the level of honesty, accuracy, ethics profession, do not accept bribes and rewards, uphold the integrity and loyalty to the organization. Internal auditors should also avoid any conflict of interest in all activities of the organization, adhere to professional standards, policies and rules of the organization, and does not have a stake in the organization. Conflicts of interest can make it difficult to meet the internal auditor duties and responsibilities objectively professional that can undermine confidence in the internal auditor (IIARF, 2009).

The activities of the internal audit according to Rezaee and Riley (2010) are: (1) to assess the effectiveness and efficiency of operations, (2) to ensure the adequacy and effectiveness of the internal control system in achieving its objectives, (3) to review the financial reporting process, to ensure the quality and integrity, to produce reliable financial information, relevant, transparent and useful for decision-making, (4) to ensure the implementation of corporate governance, and (5) to prevent and detect fraud in the organization, especially in the fraudulent financial reporting. The internal control system is essential for the prevention of losses caused by the fraudulent financial reporting and internal auditors play an active role in carrying out investigations on the deviation (Moeller, 2005).

### 2.2. Fraudulent Financial Reporting

Belkaoui (2004) explains that fraud consists of four types: corporate fraud, fraudulent financial reporting, white-collar crime, and audit failure. The fraudulent financial reporting is a misstatement or omission committed by the management of the amount of material value or disclosures that aims to trick users of financial statements, among others, with reported earnings or other assets is higher than the actual (Weirich et al ., 2010; Arens et al., 2012).

The fraudulent financial reporting is the intentional behavior either by the act or by the omission that results in the misleading financial statements by using certain techniques, such as: 1) Recognition of income that is not true, 2) Recording fictitious revenues, 3) Recording premature revenue, 4)

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Exceeding the existing assets 5) Recording fictitious assets, and 6) Minimizing the amount of charge (Albrecht, 2003). Meanwhile, according to Belkaoui (2004), irregularities in the financial reporting is a deliberate act or omission that resulted in material errors in the financial statements that can reduce harm the integrity of financial information and related parties such as shareholders, creditors, employees, auditors and competitors. Types of the fraudulent financial reporting, namely: 1) manipulation, falsification or alteration of records or documents; 2) suppression or elimination of the effects of transactions that have been completed; 3) the recording of transactions that no substance; 4) errors in the application of accounting policies; 5) the failure of a significant disclosure.

The fraudulent financial reporting may occur for several reasons, namely: a) the lack of corporate governance that is responsible, b) the Board of Directors that is not effective, c) ineffective audit committee, d) the existence of the management team dominant and lack of accountability e) there is a review of top executives activities and there is no requirement for disclosure of executive, f) the existence of related parties transactions are material, g) the inadequate and ineffective internal audit function (Rezaee and Riley, 2010).

While the symptoms of the fraudulent financial reporting, which is due to 1) Decrease in earnings quality as evidenced by a decline in sales volume 2) Lack of adequate working capital 3) tight credit, high interest rates, and the ability to getting credit is reduced, 4) difficulty in collecting accounts receivable, 5) requirement of additional collateral to meet the requirements of the debt, 6) a significant decline in income or a substantial increase in costs (Rezaee and Riley, 2010) .

The National Commission on Fraudulent Financial Reporting by The Treadway Commission (2010) recommends four (4) measures to reduce the possibility of the fraudulent financial reporting, namely: (1) Establish an organizational environment that contributes to the integrity of financial reporting (financial reporting); (2) Identify and understand the factors that lead to fraudulent financial reporting; (3) Assess the risk of fraudulent financial reporting within the company; and (4) Design and implement adequate internal controls for financial reporting.

The early prevention of fraudulent financial reporting should be started at the time of preparation of the financial report, various independent board that examines the corporate governance practices such as the Joint Committee on Corporate Governance (2001); US Securities and Exchange Commission (SEC) in 2000 and the UK Cadbury Committee and the Blue Ribbon Committee, concluded that the corporate governance practices not only in reducing the likelihood in the fraudulent financial reporting, but also in reducing the possibility of earnings management. The implementation of the prevention of fraudulent financial reporting should also consider measures related to the detection and repair, because the prevention is an integral part of the three parts of the defense in the internal control process which consists of prevention, detection, and corrective (Hopwood et al. 2012).

## 3. METHOD

The objects of this study are audit committee quality, objectivity of internal auditor, and the prevention of fraudulent financial reporting in SOEs in Indonesia. The method used in this study is explanatory method, which explains the cause-effect relationship among variables (Cooper and Schindler, 2006). There are two variables in this research: Independent variable (eksogen), which consists of audit committee quality variable (X1) and internal auditor objectivity variable (X2). The Dependent variable (endogenous), which consists of the prevention of fraudulent financial reporting (Y).

The population of this study consists of 141 SOEs in Indonesia. The sampling technique used is proportioned stratified random sampling because the population has heterogenous members and in proportional level (Sugiyono, 2009). The minimum number of sample in this research is 58 BUMN in Indonesia. The variable is measured by using likert scale. The method for analysis the data is Structural Equation Modelling (SEM) which is based on component or variance which is also known as partial least square (PLS), due to the limitation which is caused by number of sample, the multivariate normality of data, indicators must be reflective, the model must be based on theory and indeterminacy (Sekaran, 2010).

The measurement model in this research will be convergent validity and discriminant validity. Inner model will be evaluated by looking at the three quantities: R-square for dependent construct, Stone-

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Geisser Q-square test, t value and significance from structural parameter coefficient (Ghozali, 2008). The hypotheses in this study are as follows:
1. There is an infuence of audit committee quality (ACQ) toward the prevention of fraudulent financial reporting (PFFR).
2. There is an influence of internal auditor objectivity (IAO) toward the fraudulent financial reporting (PFFR).

## 4. RESULT AND DISCUSSION

### 2.1. The first hypothesis test: There is an influence of audit committee quality toward the prevention of fraudulent financial reporting

Through the estimation of coefficient, the exogen variable influence can be measured (audit committee quality) toward the prevention of fraudulent financial reporting and the result is:

Tabel 1. The Influence of Audit Committee Quality (ACQ) Toward The Prevention of Fraudulent Financial Reporting (PFFR)

| Variable | Coefficient | Direct Influence | Indirect Influence | | Total |
|---|---|---|---|---|---|
| | | | ACQ | IAO | |
| ACQ | 0.468 | 21.8% | | 12.0% | 33.8% |
| Total | | | | | 33.8% |

The analysis result for variable ACQ the t-value = 2.586 and the p-value < 0.05 it can be concluded that ACQ has positive influence and significance towards PFFR and SOEs in Indonesia. Automatically, audit committee quality contributes influence of 21.8% toward the prevention of fraudulent financial reporting. Unintentionally, because the correlation with audit committee quality is 12.0% so the total influence of audit committee quality toward the prevention of fraudulent financial reporting in SOEs Indonesia is 33.8%.

### 2.2. The second hypothesis test: There is an influence of internal auditor objectivity toward the prevention of fraudulent financial reporting

Through coefficient value it can be mesured that the influence of respective independent variables is internal auditor objectivity (IAO) toward the prevention of fraudulent financial reporting (PFFR).

Table 2. The Influence of Internal Auditor Objectivity (IAO) Toward The Prevention of Fraudulent Financial Reporting (PFFR)

| Variable | Coefficient | Direct Influence | Indirect Influence | | Total |
|---|---|---|---|---|---|
| | | | ACQ | IAO | |
| IAO | 0.325 | 10.6% | 12.0% | | 22.6% |
| Total | | | | | 22.6% |

Based on the above measurement it can be seen that t-value of variable IAO = 2.738 is higher than t- critical = 1.96, based on the significant level of 5% it can be concluded that IAO has positive and significant influence toward PFFR in SOEs Indonesia. Directly, IAO gives contribution 10.6% toward PFFR, indirectly because of its correlation with ACQ is 12.0% so the total influence towad PFFR in SOEs Indonesia is 22.6%.

## 5. CONCLUSIONS

1. There is an influence of audit committe quality toward the prevention of fraudulent financial reporting. The function of audit committe in preventing the fraudulent financial reporting is not optimal and is caused by the weak control function and internal controll by audit committee it is because of the lack of knowledge and experience audit committee in financial accuntancy; lack training and coaching in accuntancy, finance, and auditing which is held by profesional organization; and the decreasing of etiquite value.

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2. There is internal auditor objectivity influence toward the prevention of fraudulent inancial reporting. The internal controll and the controlling function are not yet optimal because of not all the internal auditors have sufficient ability in detecting the existence of symptomp and red flags; to identify the possibility of fraud which is done by management; the finding which is still influenced by independency; lack of commitment by top management and doing the controll function and internal controlling to prevent the fraudulent financial reporting.

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