Study on Early Detection of Potential Financial Statement Fraud: External Auditors' Judgement Perspective

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Abstract. Financial statement fraud has occurred frequently, and external auditors are often unable to make early detection of such fraud. External auditors are auditors who are assigned to check the fairness of the financial statements of business entities. To be able to learn from the experience of fraud cases that have occurred, auditors can take advantage of the Electronic Knowledge Repository (EKR). This study aims to provide empirical evidence that auditors' independence, utilization of EKR and mastery of good governance principles can affect auditors' judgment in early detection of potential fraudulent in financial statements. The research population is auditors at the Public Accounting Firms (PAFs) in Jakarta. The sample was selected based on cluster-random sampling, namely clusters of PAFs affiliated with foreign PAFs and non-affiliated PAFs. Each cluster is selected randomly. The number of respondents who participated were 105 auditors, consisted of 53 foreign affiliated PAF auditors and 52 non-affiliated PAF auditors. The research instrument used were a closed questionnaire and an open questionnaire. An open questionnaire was used to measure the auditors' judgment in assessing the potential for fraud. The research design is causal, and the data was analysed using Partial Least Square. The results of the study conclude that auditors' independence, EKR, and corporate governance have a positive and significant effect on auditors' judgment in detecting fraudulent in financial statements. The results of the research can be used by the Financial Services Authority and PAFs in order to improve the service quality of Public Accountants.

Keywords: fraud · independency · governance · auditor · repository

1 Introduction

The financial statements are not only used by the owners of the company's capital but also by stakeholders such as the government, creditors, suppliers and company employees. To be able to meet the expectations of these stakeholders, it is essential to have a reliable and trustworthy financial report. Under some circumstances, the company's management will require the services of a third party to perform a task in which the financial accountability presented to outside parties is reliable. On the other hand, stakeholders need the services of a third party to gain confidence that the financial statements presented by

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the company's management have credential basis for their decision making. An auditor is required to be able to carry out a professional role properly. However, this role still cannot be optimally assigned due to the fact that fraud on financial statements still occurs without being detected by the auditor. [1] and [2] conducted research on audit quality, concluding that the competence and independence of auditors have a significant effect on audit quality. In addition, [3] also conclude that competence, experience, independence and due professional care affect audit quality. [4] examines the effect of client business understanding, audit experience and auditor competence on fraud detection strategies and concludes that these aspects have positive effects on fraud detection strategies. The research that the author does has a novelty, namely by adding a new variable about Electronic Knowledge Repository (EKR). EKR is an electronic repository of content related to all case subjects or knowledge for which the organization retains knowledge. EKR as a reflection of the use of information technology to help accountants learn or acquire knowledge that can be used to make audit judgments.

Corporate governance is an organizational culture that establishes a code of ethics for employees and motivates them to place high ethical values. If senior managers do not organize and take appropriate action, it is likely that fraud will occur in a company. Inefficient corporate governance will lead to an increase in financial statement fraud [5]. In addition, the Audit Committee must be aware of the risk of fraud and must take appropriate action against the occurrence of fraud. This research concludes that internal control has a positive effect on GCG and GCG has a positive effect on fraud detection. The purpose of this research is to provide empirical evidence about the effect of auditor independence, EKR and GCG on the detection of potential fraud in auditing financial statements.

2 Theoretical Framework and Hypothesis Development

2.1 Agency Theory and Signalling Theory

This agency theory can help an auditor to understand the problems that occur between the agent and the principal. In the agency context, the role of a third party serves to monitor the behaviour of management as an agent and ensure that the agent acts in accordance with the will of the principal. Auditors are considered as parties who are able to bridge the principal and agent as a form of accountability from the agent to the principal. The task of the auditor is to provide an opinion on the fairness of the results of the financial statements presented by agents whose problems can be seen from the quality of the audit produced by the auditor. Signal theory introduced by [6] argues that the sign gives a signal, the owner of the information tries to provide relevant information that can be utilized by the recipient. Signalling theory suggests how a company should give signals to the users of financial statements. This signal is in the form of information about what management has done to realize the owner's expectation which audited financial statements.

2.2 Fraud in Financial Statements

According to [7], fraud is an intentional error which is grouped into two types, namely: (1) fraudulent financial reporting, which includes: manipulation, falsification, or alteration of accounting records or supporting documents and financial statements that are prepared, do not present in or intentionally omitting important events, transactions, and important information and financial statements, and intentionally applying wrong accounting principles, (2) misappropriation of assets, which includes embezzlement of cash receipts, theft of assets, and things that cause an entity to pay for goods or services not received. Cases of fraudulent financial statements that occurred in Indonesia are part of the audit failure that was also carried out by PFAs in several other countries. International Standards on Auditing (ISA) explains the illustration of fraud factors, namely ISA No. 240 and SAS No. 99 [8] which is based on the fraud triangle theory. Presence of even a single red flag increases auditors' sensitivity towards fraud presence and helps in understanding the root cause of fraud [9].

Inadequate Internal Control System includes variables related to poor internal control that contribute to asset misappropriation in a company. Several research studies have revealed that an inadequate Internal Control System incorporates variables related to poor internal control that contribute to asset misappropriation in an organization. Research has revealed that poor internal control is one of the most important factors in cases of fraud [10]. An organization's internal control system is an important tool to diminish the occurrence of fraud [11]. Management plays an important role in setting up an efficient internal control system. Studies, furthermore, show that auditors will not focus on red flags in cases of internal control. However, weak internal controls act as a red flag. Inadequate management review contributes to inefficient controls [12]. Based on the study conducted by [13], it mentioned that research in the field of corporate fraud has been getting a boost as fraud continues to increase. Red flags are events, conditions, situational pressures, opportunities or personal characteristics that may cause management to commit fraud on behalf of the company or for personal gain [14]. Therefore, the red flag is a useful signal for the auditor in detecting the possibility of fraud in the financial statements at an early stage.

2.3 Judgement Auditor

To achieve the expected results, the auditor must also use the skills possessed for judgment and use his scepticism appropriately to obtain and evaluate sufficient evidence to provide a fair and impartial audit opinion in detecting fraud. Audit judgments belong to the auditor's judgment or perspective in responding to information that may affect the documentation of evidence and audit decisions [15]. In determining audit judgments, the auditor must comply with applicable auditing and ethical standards. In addition, auditors are also required to exercise their professional judgment as stated in the Auditing Standards. As part of the planning phase of the audit, the auditor is required to: make a preliminary fraud risk assessment based on the risk factors (red flags) found in the so-called fraud triangle (Statement on Auditing Standards No. 99 [16] and International Standards on Auditing 240 [17]): management attitudes, opportunities, and incentives.

Fraud assessment is a very sensitive area and has been subject to much professional attention in the wake of past accounting and auditing scandals.

[18] shows a dilution effect in the auditor's judgment. The presence of irrelevant information (also called non-diagnostic evidence) mixed with relevant information (diagnostic evidence or red flags in fraud detection) will result in the auditor's assessment of fraud risk being less extreme. This insensitive risk assessment will have serious repercussions for the fraud detection task. Because fraud is a relatively rare event, fraud schemes are generally complex, and few guidelines exist to aid the auditor's assessment.

2.4 The Relationship Between Auditor's Independence and Fraud Detection

Independence is an impartial attitude and is not under the influence of pressure from certain parties in taking actions and decisions [19]. According to Jalil [20], revealed a positive and significant relationship between audit firm size, auditor rotation, auditor industry specialization, focus on audit markets, auditors' financial independence, audit report delays and financial statement updates by detecting fraud in financial statements. The ability of auditors to detect fraud and to prevent financial reporting depends on their qualifications and financial independence.

Auditors who have an independent attitude will always think objectively, honestly, and always act fairly so that they can detect fraud [21]. In addition, several studies related to independence and fraud, [22] found a significant and positive effect between fraud and independence. According to [23], independence can be classified into two aspects, namely independence in fact and independence in appearance. Independent in fact is independent in the auditor, namely the ability of the auditor to be free, honest, and objective in carrying out audit assignments. Independent in appearance is independent as seen from the parties with an interest in the company being audited who know the relationship between the auditor and his client. In addition, according to [24], accounting professional education has an important role in increasing the professionalism of auditors. Hypothesis 1: auditor independence has a positive effect on the auditor's ability to detect potential fraud.

2.5 The Relationship Between EKR and Fraud Detection

According to [25], EKR is an electronic repository of content related to all case subjects or knowledge in which the organization retains knowledge. [26] defines EKR as a kind of knowledge management system that allows individuals to contribute their knowledge and reuse previous knowledge in the future. EKR has become an increasingly popular tool to enable employees to utilize and reuse existing knowledge, share knowledge with others, and stimulate the development of new knowledge and ideas [27]. Auditors use EKR to find template worksheets, quickly search for appropriate literature, conduct research, and resolve client issues. EKR is a place to store documents such as presentation materials and working papers, employees may be free to upload documentation for people to find and reuse. Some of the well-known and successful EKRs implemented in PAFs vary in size and knowledge domain. According to [28], investment in the Intellectual Capital (IC) can improve company performance in several ways, which can decrease the motivation of managers and owners to engage with fraud reporting. Hypothesis 2: EKR has a positive effect on the auditor's ability to detect potential fraud.

2.6 The Relationship Between GCG and Fraud Detection

The role of GCG to detect fraud is closely related where GCG combines variables related to poor internal control that contribute to fraud in an organization. Based on previous research, among the reasons for fraud in financial statements, we can refer to weak management (e.g. lack of managers with financial expertise) [29], absence of independent members on the Board of Commissioners [30], lack of members sufficient board [31], as well as the amount of manager's salary payment. GCG is a corporate governance that focuses on a balance between economic and social goals between personal and group goals. According to research results [32], it is stated that internal control has a positive and significant effect on early warning fraud. In addition, according to [33], companies that have strong independent commissioners, business education background, business experience, fixed meeting schedule, investors, perception of high meeting attendance have high quality and transparent financial reports.

Referring to FSA Regulation (POJK) No. 21/POJK.04/2015 and FSA Circular Letter (SEOJK) No. 32/SEOJK.04/2015, the following five aspects and recommendations submitted by FSA are as follows: public company relationship with shareholders by guaranteeing rights shareholders, the functions and roles of the Board of Commissioners, the functions and roles of the Board of Directors, stakeholder participation and information disclosure. GCG is a process and structure used to improve business success and corporate accountability that aims to increase the value of the company in the long term by taking into account the interests of stakeholders and based on laws and regulations, morals and ethical values. The quality of PAFs performance is largely determined by an auditor's understanding of the basic principles of GCG knowledge. With a good understanding, the auditor is expected to be able to detect fraud that occurs in the company. Hypothesis 3: the auditor's understanding of GCG has a positive effect on the auditor's ability to detect potential fraud.

3 Research Methodology

Based on the research objectives, this type of research is causality research which aims to test hypotheses about the effect of auditor independence, EKR and GCG on auditor judgment in detecting potential fraudulent financial statements. The research population is auditors who work in PAFs listed on the Indonesian stock exchange The target population or research respondents are auditors who have the position of supervisors or managers or partners. The sample was selected based on cluster-random sampling. PAF's auditors are divided into clusters of PAFs affiliated with foreign PAFs and PAFs that are not affiliated. Each cluster is then selected randomly. The research instrument used a closed questionnaire and an open questionnaire for the analysis of potential fraud cases. analysis. The type of closed questionnaire, which is a questionnaire that has been given questions and answered by selecting the available answers, is used to collect primary data related to the independent variables, EKR and GCG. An open questionnaire was

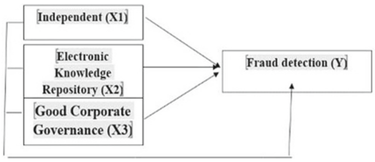

Fig. 1. Research Framework

used to assess the auditor's judgment in detecting potential fraud. An open questionnaire was used to present external audit case scenarios, and respondents were asked to assess the potential fraud to occur. The analysis method used quantitative methods with Partial Least Square (PLS). The framework of this research can be described as shown in Fig. 1.

4 Results and Discussion

4.1 Description of Respondent Profile

The research population is auditors who work in PAFs listed on the Indonesian stock exchange, who have obtained permission to audit the financial statements of issuers. Collecting data using google forms and communicating directly with PAF's auditors to get a fast response. Data collection for two months and obtained the number of auditors who participated as many as 105 people. Description of the characteristics of the respondents was conducted to obtain an overview of the distribution of positions, PAF affiliation, length of service, education, gender, and age of the respondent are as follows:

a. Characteristics of respondents based on position/position obtained 39.0% are supervisors, 35.2% are managers, and 25.7 percent are partners/colleagues. The majority of respondents are supervisors and managers with a total of 74.2%.
b. Characteristics of respondents based on PAF obtained 50.5% came from PAF with foreign affiliation and 49.5% came from PAF not foreign affiliation. The number of the two groups is relatively the same so that it provides a representative picture for each group.
c. Characteristics of respondents based on length of work obtained 22.9% worked less than 5 years, 45.7% worked for 5–10 years, 16.2% worked for 10–15 years, and 15.2% worked for more than 15 years. The number of respondents who have experience of more than 5 years is 77.1%, indicating that the majority of respondents are classified as having sufficient experience in carrying out external audits.
d. Characteristics of respondents based on education obtained 82.9% have a bachelor's education, 16.2% have a master's education and 1.0 percent have a Doctoral education.
e. The majority of the participating respondents are undergraduates and the characteristics of respondents based on gender obtained 62.9% are male and 37.1% female. Men work more as auditors in PAF compared to women. Characteristics of respondents based on age 15.2% aged 25–30 years, 58.1% aged 30–39 years, and aged 40–49 years 21.0%, 5.7% aged over 50 years. Based on the characteristics of the

Table 1. Description of Independence

No.	Description	Mean	SD
1	Independence in fact	3.353	0.948
2	Independence in appearance	3.745	0.857

Source: Processed Research Data (2022)

Table 2. Description of EKR

No.	Description	Mean	SD
1	Knowledge Creation Dimension	4.207	0.714
2	Knowledge Storage Dimension	4.393	0.617
3	Knowledge Sharing Dimension	4.115	0.749
4	Dimensions of knowledge use	4.290	0.631

Source: Processed Research Data (2022)

Table 3. Description of Corporate Governance

No.	Description	Mean	SD
1	Relationship between Public Company with Shareholders by guaranteeing shareholders' rights	3.306	1.066
2	Functions and roles of the Board of Commissioners	3.230	0.953
3	Stakeholders participation	3.555	0.900
4	Information disclosure	3.540	0.912

Source: Processed Research Data (2022)

respondents, it can be seen that the majority have supervisor and manager positions, undergraduate education, male gender, respondent's age is above 30 years with work experience above 5 years.

4.2 Variable Description

The description of the research variables was carried out using a descriptive test based on the mean and standard deviation (SD) of indicators (Table 1).

The description of the independence variable based on the Likert scale with a score of 1 is strongly disagree, up to a score of 5 is strongly agree. Referring to the average score, it is obtained a picture of the tendency that respondents agree that the reassignment of auditors who have had a long relationship with clients, use of client facilities, determination of audit procedures and audit fees do not affect auditor independence (score 3.9–4) (Table 2).

Description of the EKR variable obtained the highest score on indicators number 1, 2, 3 and 4 (mean score 4.0). This illustrates that respondents tend to strongly agree regarding the benefits of EKR to improve the auditor's ability to analyze fraud, improve audit quality and work more efficiently (Table 3).

Table 4. Description of Potential Fraud Detection Judgment

No.	Description	Mean	SD
1	Audit Case Asset misappriation	5.730	3.099
2	Audit Case investment valuation	4.930	2.890

Source: Processed Research Data (2022)

The corporate governance variable is used to measure respondents' knowledge of good governance, the assessment used is a score of 1 not good to 5 very good. Based on the opinion of respondents, it is known that governance is considered good (mean score 4) if there is a participation from stakeholders to involve in the internal control implementation such the appointment of directors and commissioners with the educational background and experienced in their fields more than 5 years and the company has information disclosure policy such as an anti-corruption, anti-fraud policy and has a whistle-blowing system policy (Table 4).

The potential fraud detection variable is a variable used to measure the auditor's ability to detect fraud based on judgment. To measure the potential fraud judgment, respondents were asked to provide an assessment of the case that had been designed by the researcher. There are two cases, namely cases related to assets that have a probability of misstatement and cases related to the valuation of investments in unicorn companies. The auditor must have scepticism over the case so that he can answer exactly what audit evidence is needed to identify whether or not there is potential fraud. Case ratings are scored from one to ten. The results of the assessment showed a relatively low mean score of 5.7 for case 1 and 4.93 for case 2, as well as a high standard deviation. This is presumably because the respondents were less careful in understanding the case. Respondents with partner and senior manager positions received high scores, while respondents with supervisory positions received relatively low scores. The majority of respondents' profiles based on position are supervisors and young managers.

4.3 PLS Testing - Outer Model Test Results

Outer model analysis is carried out to ensure that the measurement used is feasible to be used as a measurement (valid and reliable). In the analysis of this model, it specifies the relationship between latent variables and their indicators. Outer model test results include convergent validity, discriminant validity, and construct reliability. The results of the discriminant validity test using the cross-loading value obtained that the loading factor in the column of each variable (bold print) is the highest value compared to the cross-loading value of other variables so that the indicators of each independent variable (X1), EKR (X2), GCG (X3), and fraud detection (Y) have met discriminant validity (Table 5).

The results of the discriminant validity test using the AVE root value obtained that the AVE root value (bold print) is greater than the correlation value between latent variables, so that the independence variable (X1), EKR (X2), GCG (X3), and detection fraud (Y) have met discriminant validity. Composite reliability is an indicator to measure a construct that can be seen in the view of latent variable coefficients. To evaluate composite reliability, there are two measuring tools, namely internal consistency and

Table 5. Discriminant Validity Test Results Using Fornell- Larcker Criterion

No.	Variabel	X1	X2	X3	Y	Ket.
1	Independent (X1)	0.789	0.358	0.558	0.406	Fulfilled
2	EKR (X2)	0.358	0.746	0.349	0.366	Fulfilled
3	GCG (X3)	0.558	0.349	0.735	0.440	Fulfilled
4	Fraud detection (Y)	0.406	0.366	0.440	1.000	Fulfilled

Source: Processed Research Data (2022)

Table 6. Construct Reliability Test Results

No.	Variabel	Cronbach's Alpha	Composite Reliability	Remark
1	Independent (X1)	0.738	0.760	Reliable
2	EKR (X2)	0.736	0.833	Reliable
3	GCG (X3)	0.716	0.824	Reliable
4	Fraud detection (Y)	1.000	1.000	Reliable

Source: Processed Research Data (2022)

Table 7. Coefficient of Determination Test Results

No.	Free Variable	Variabel terikat	R Square	R Square Adjusted
1	Independent (X1)	Fraud detection (Y)	0.267	0.246
2	EKR (X2)			
3	GCG (X3)			

Source: Processed Research Data (2022)

Cronbach's alpha. In this measurement, if the value achieved is > 0.70, it can be said that the construct has high reliability (Table 6).

The results of the reliability test using the Composite Reliability value and the Cronbachs Alpha value obtained that the test results meet the test criteria of more than 0.70 so that each independent variable (X1), EKR (X2), corporate governance (X3), and fraud detection (Y) has met the reliability of the construct.

4.4 PLS Testing - Inner Model Test Results

The inner model analysis can be evaluated by using R-square for the dependent construct. In evaluating the inner model with PLS (Partial Least Square) it begins by looking at the R-square for each dependent latent variable. Changes in the value of the R-square can be used to assess the effect of certain independent latent variables on the dependent latent variable whether it has a substantive effect. The results of the inner model test include the coefficient of determination (R-square) (Table 7).

The results of the coefficient of determination of the influence of independence (X1), EKR (X2), and GCG (X3) on fraud detection (Y) obtained an R square value of 0.267 which means fraud detection (Y) can be explained by 26.7 percent by independence, EKR, and corporate governance, while the rest is explained by other variables. Testing

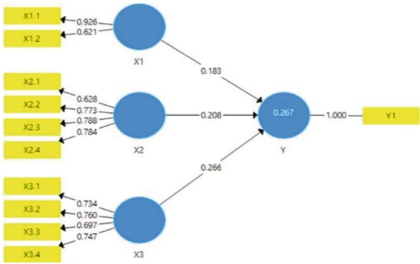

Fig. 2. Research Model Path Diagram. Source: Processed Research Data (2022)

Table 8. Hypothesis Test Results

No.	Free Variable	Koef Jalur	T Stat	P	Ket.
1	Independent (X1)	0.183	2.072	0.039	Signifikan
2	EKR (X2)	0.208	1.979	0.048	Signifikan
3	GCG (X3)	0.266	3.180	0.002	Signifikan

Source: Processed Research Data (2022)

the results of the analysis with Partial Least Square (PLS) to determine the complete effect of exogenous variables on endogenous variables can be seen in Fig. 2.

4.5 Hypothesis Testing

Table 8 describe the results of hypothesis testing based on the path coefficient value and T-Statistics/P- value.

4.5.1 The Effect of Independence on Fraud Detection

The effect of independence on fraud detection is obtained by a path coefficient of 0.183 with a t-statistic value of 2.072 and a probability value of 0.039. These results indicate that independence has a positive and significant effect on fraud detection, meaning that the better the independence, the better the auditor's ability to detect fraud. The auditor in carrying out his audit duties must be supported by an attitude of independence, both independent in fact and independent in appearance so that the audit results state the actual situation and are free from pressures from related parties. The results of this study are in line with the results of research conducted [34] which shows that the stronger the auditor maintains his independence from his clients, the better the auditor's ability to detect fraud. With independence, an auditor can carry out procedures and analyses more objectively. The same result was carried out by [35] and [36] which showed that auditor independence had an influence on the ability to detect fraud.

4.5.2 The Effect of EKR on Fraud

The effect of EKR on fraud detection obtained a path coefficient of 0.208 with a t-statistic value of 1.979 and a probability value of 0.048. These results indicate that

EKR has a positive and significant effect on fraud detection, meaning that the better the EKR, the better the auditor's ability to detect potential fraud. This study finds that the creation, storage, sharing and use of knowledge in EKR is very influential in improving audit quality and increasing the auditor's ability to detect fraud when auditing financial statements. Thus, the four EKR processes identified in PAF are the main contributors or main factors and have a significant impact on PAF performance. The findings also provide empirical evidence to highlight that knowledge is dynamic and constantly changing which may require audit staff and expertise to update their knowledge through multiple knowledge sources.

4.5.3 The Effect GCG on Fraud Detection

The effect of corporate governance on fraud detection is obtained by a path coefficient of 0.266 with a t-statistic value of 3.180 and a probability value of 0.000. These results indicate that corporate governance has a positive and significant effect on fraud detection, meaning that the higher the auditor's knowledge of corporate governance, the better the auditor's ability to detect fraud. Auditors who have good knowledge of the principles of GCG can detect the potential risk of fraud during the audit. These results are supported by another study from [37] which states that good governance is carried out by establishing an internal control system in every organizational activity and can run effectively if the internal control structure is designed to be implemented properly in the organizational environment so that GCG has a positive effect. against fraud prevention. This shows that fraud prevention can be done by eliminating the factors driving the occurrence of fraud by applying the principles of GCG.

5 Conclusion

The results of the study provide empirical evidence that: (1) the independence of internal auditors has a significant effect on fraud detection and the direction is positive. This means that the higher the independence of the external auditor, the greater the ability of the auditor to detect fraud committed by clients; (2) EKR has a significant effect on the auditor's ability to detect fraud and the direction is positive, meaning that the EKR owned by PAF and used by the auditor can increase the auditor's ability to detect potential fraud early when auditing the client's financial statements; (3) Auditors who have a strong understanding of the characteristics of good governance have a significant effect on their ability to detect fraud that occurs in the company early. The research implication is that it is very important for PAF to have an up-to-date EKR, provide continuing education for auditors in order to maintain independence and master the principles and regulations of corporate governance. Regulators make policies related to the requirement for Auditors to have competency qualifications of management knowledge and GCG regulations.

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