

The Effect of Fraud Pentagon on Fraudulent Financial Reporting

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Abstract

The goal of this study is to show and explore how the fraud pentagon influences false financial reporting. In order to conduct the inquiry, a quantitative method was used. Secondary data and a purposive sampling strategy are used in this investigation. This study used a sample of 31 Property and Real Estate Sub-Sector Service Companies that were listed on the IDX between 2017 and 2019. In this study, the statistical method used was regression analysis of panel data. The results demonstrate that the pressure and opportunity variables have a positive and significant impact on financial fraud. Meanwhile, rasionalization, competence, and arrogance all have a negative and not significant on financial reporting fraud. Pressure, opportunity, rationalization, competence, and arrogance, on the other hand, all have an impact on dishonest financial reporting, according to this study. This research can be useful to increase thoroughness and prudence in analyzing the information presented by the company.

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1. Introduction

After the accounting crisis at Enron Corporation, a known American corporation, the term "fraudulent financial reporting" has become a severe concern, and the public's trust in financial statements has dwindled (Mahama, 2015). According to the results of a poll conducted by the Association of Certified Fraud Examiners (ACFE, 2019), the media was deemed to be the most effective in identifying and uncovering fraud in Indonesia, at 38.9%. According to ACFE, fraud causes 5% of a company's revenue losses each year, and one sort of industry that is impacted by fraud is the housing industry, which accounts for 1.7 percent of all revenue losses. Especially when compared to the hotel and tourism industries. The housing business, which obtained a percentage of only 1.3 percent, had a higher proportion.

According to data from Yayasan Lembaga Konsumen Indonesia (YLKI) in 2019, the property industry has consistently ranked in the top five for consumer complaints over the last five years. With a total of 160 complaints in 2015, it was the most common complaint, and in 2019, it was the third most common, with 81 individual complaints out of 563 total cases. Consumers complained about 26.1 percent of development issues, 23.8 percent of refund issues, 9.5 percent of papers, 9.5 percent of construction specs, and 5.9 percent of transaction systems in 2019. The Meikarta project is the subject of the most consumer complaints against YLKI, accounting for 7.4% of 81 incidents and averaging consumer complaints over stopped progress. Because two indicators of fraudulent financial reporting, namely change in cash sales and change in return on assets, are illustrated in the Meikarta case, where the failure of Meikarta's development resulted in buyers requesting information, there is a need to monitor the potential for fraud that occurs in property and real estate sub-sector service companies (Budhiman, 2020).

"Fraud or fraud is not conceivable without persons who have the right ability to carry out or fraud," Wolfe and Hermanson (Tessa & Harto, 2016) contend. One indication of this ability is one's position in the organization (Kusumaningrum & Murtanto, 2016). This is in line with the findings of the ACFE study, which found that company leaders have a large enough opportunity to commit an incident; it can be seen that around 29.4 percent of fraud cases were discovered, indicating that the company's owner or board of directors is responsible for financial reporting. The ACFE data has also been proven in cases involving the property and real estate firm sub-sector in Indonesia, such as when the principal director of PT Sentul City Tbk was found to be corrupt in relation to a forest conversion case in Bogor Regency in 2014. In a similar case, the Financial Services Authority (OJK) imposed sanctions on the President Director of PT. Hanson Internasional Tbk in relation to the company's financial statements since 2016, what happened was excessive in the financial statements with a value of Rp. 613 billion due to the recognition of income us. As of December 31, 2016, Annual Report (LKT).

Many theories have been proposed by specialists to detect fraud. Donald Cressy's fraud triangle theory was the first idea created, according to Kuntadi (2017). According to Cressy in 1953, there must be three aspects to fraud: pressure, opportunity, and justification. In addition, Wolfe and Hermanson proposed the



fraud diamond hypothesis in 2004 as a companion to the fraud triangle theory, in which the fourth element, namely ability, is taken into account. In addition, Crowe (2011) developed the fraud pentagon idea as a complement to the previous theory, claiming that components of hubris and ability also influence the occurrence of fraud. As a result, Crowe's fraud pentagon hypothesis includes pressure, opportunity, rationalization, competence, and hubris as five aspects of the fraud model indicators given by Crowe.

Different proxies are still used to assess the dependent variable, which is fraudulent financial reporting. According to earlier research, such as that conducted by Tessa & Harto (2016) the restatement of financial statements is utilized as a proxy for false financial reporting, whereas the Beneish M-Score model is employed in Aprilia (2017). Not only the Beneish M-Score model, the Altman Z-Score model, and the P-Score model are utilized as proxies for dishonest financial reporting in Zaki (2017). Among various fraud models, the F-Score model has good accuracy, according to Ak et al., (2013). This is why the F-Score model was chosen as a proxy for fraudulent financial reporting in this study by the author.

The fraud pentagon variables will be utilized to find a link between variables that are directly relevant to the problem of false financial reporting. The authors are interested in performing a study named "The Effect of Pentagon Fraud on Fraudulent Financial Reporting (Empirical Study on Property and Real Estate Sub-Sector Service Companies Listed on the IDX for the 2017-2019 timeframe)" based on the context and events outlined above.

2. Literature Review

Fraud

The term fraud is familiar to auditors, according to Kuntadi (2017) in his book SIKENCUR (Fraud Control System). On a larger scale, however, the term "fraud" is still a relatively new concept. The term "corruption" or its variants, such as collusion and nepotism (abbreviated as KKN), are more well known in society.

Fraud Theory

The first theory proposed, according to Kuntadi (2017), was the Fraud Triangle theory, which was introduced by Dr. Donald Cressey (1953) in an article titled "Why do Trusted Persons Commit Fraud? A Social-Psychological Study of Defalcators," which was published in the Journal of Accountancy as well as in Patterson Smith's book *Other People's Money, A Study in the Social Psychology of Embezzlement*. An act of fraud, according to Cressey, must have three elements: pressure, opportunity, and justification. When Wolfe and Hermason indicated in 2004 that there was another component that influenced the occurrence of fraud, namely ability, the fraud triangle idea evolved into a fraud diamond (Annisya et al., 2016). Then, in 2011, Crowe Howarth proposed the latest fraud hypothesis, Crowe's fraud pentagon theory, or simply the fraud pentagon, which delves deeper into the causes of fraud (Novitasari & Chariri, 2018). Crowe claims that persons in high-ranking jobs with large egos frequently commit fraud (Rahmatika, 2020). Pressure, opportunity, rationalization, competence, and



arrogance are the five elements of this paradigm. Pressure is proxied by return on assets (ROA), opportunity is proxied by industry, rationalization is proxied by auditor change, competence is proxied by change of directors, and arrogance is proxied by frequent number of CEO's photo.

Fraudulent Financial Reporting

Misleading financial reporting is defined as a misstatement or loss of an amount, or a deliberate disclosure intended to deceive users of financial statements (Heri, 2017). Financial reporting involving fraud is typically carried out in the following manner, according to Heri (2017):

1. Manipulation, falsification, or alteration of accounting records or supporting papers that serve as the foundation for financial statement creation.
2. Intentional omission or misrepresentation of material events, transactions, or information in the financial statements.
3. Intentional errors in the application of accounting principles, especially those relating to the amount, classification, presentation or disclosure.

According to Ak et al., (2013), the f-score model is the most accurate technique of risk assessment for fraudulent financial reporting. Dechow et al. provide the following explanation for the f-score. When the f-score is greater than or equal to 1.00, according to Aghghaleh et al., (2016), the company is suggested to commit fraud or is called higher than absolute expectations (unconditional expectation), however if the f-score is less than 1.00, the company is not indicated to commit fraud.

The f-score model is the sum of two variables, namely the quality of accruals and financial performance (Skousen & Twedt, 2009).

$$***F-Score = Accrual Quality + Financial Performance***$$

The variable components in the f-score can be seen through two things, namely accrual quality and financial performance. According to (Richardson et al., 2005) accrual quality is proxied by RSST accrual, namely:

$$**RSST Accrual = \left(\frac{\Delta WC + \Delta NCO + \Delta FIN}{\text{Average Total Assets}} \right)**$$

Meanwhile, according to Skousen and Twedt (2019), the financial performance of a financial report is considered to be able to predict the occurrence of fraudulent financial reporting. Financial performance is proxied by change in receivables, change in inventories, change in cash sales, change in earnings.

$$***Financial performance = change in receivable + change in inventories + change in cash sales + change in earnings***$$



Table 1. Elements of F-Score Formula Calculation

Items	Formulas
RSST	$(\Delta WC + \Delta NCO + \Delta FIN) / \text{Average Total Assets}$ $WC = [\text{Current Assets} - \text{Cash and Short-term Investments}] - [\text{Current Liabilities} - \text{Debt in Current Liabilities}]$ $NCO = [\text{Total Assets} - \text{Current Assets} - \text{Investment and Advances}] - [\text{Total Liabilities} - \text{Current Liabilities} - \text{Long-term Debt}]$ $FIN = \text{Total investment} - \text{Total Liabilities}$
ΔREC	$\Delta \text{Accounts Receivables} / \text{Average Total Assets}$
ΔINV	$\Delta \text{Inventory} / \text{Average Total Assets}$
$\Delta CASHSALES$	$(\Delta \text{sales} / \text{Sales}_t) + (\Delta \text{receivable} / \text{receivable}_t)$
$\Delta \text{Earnings}$	$[\text{Earnings}_t / \text{Average total assets}_t] - [\text{Earnings}_{t-1} / \text{Average total assets}_{t-1}]$
ISSU	An indicator variable coded 1 if the firm issued securities during year t

Source: a combination of previous research

3. Research Methods

A quantitative technique was applied in the investigation. This study makes use of secondary data and a purposive sampling technique. The sample for this study consisted of 31 Property and Real Estate Sub-Sector Service Companies that were listed on the IDX from 2017 to 2019. Panel data regression analysis was the statistical method used in this study. The following is the panel data regression model that was used:

$$\text{F-SCORE} = \beta_0 + \beta_1 \text{ financial target} + \beta_2 \text{ nature of industry} + \beta_3 \text{ change of auditor} + \beta_4 \text{ change of directors} + \beta_5 \text{ frequent number of CEO's picture} + \varepsilon$$

Information:

- F-SCORE = Fraudulent financial reporting
- β_0 = Constant regression coefficient
- $\beta_1, 2, 3, 4, 5$ = Regression coefficient of each proxy
- ε = error

4. Results

This chapter describes and explains all research data that was gathered through secondary data and processed according to the research objectives, as well as the results. The research data was collected from 31 research samples of audited annual report documents of service companies in the real estate and property sub-sector from 2017 to 2019. In this work, the data analysis strategy was descriptive statistical analysis with linear regression equations for panel data. After putting the Chow test, Hausman test, and Lagrange multiplier (LM Test) panel data regression model to the test, the Common Effect Model (CEM) panel data regression model was chosen. As a result, this study's analysis is based on CEM.



Descriptive Analysis

Table 2. Description of Research Data Year 2017 to 2019

	Y	X ₁	X ₂	X ₃	X ₄	X ₅
Mean	- 0.051516	0.033579	0.033306	0.118280	0.096774	2.537634
Median	0.052635	0.026759	0.009262	0.000000	0.000000	2.000000
Maximum	1.884689	0.258529	0.689588	1.000000	1.000000	17.000000
Minimum	- 5.179782	- 0.066414	- 1.390929	0.000000	0.000000	0.000000
Std. Dev	0.862365	0.052731	0.218469	0.324689	0.297252	2.740831

Source: company audited annual report data (data processed, 2021)

The following is a descriptive analysis obtained from Table 2:

1. For the period 2017 to 2019, the average of fraudulent financial reporting on service businesses in the real estate and property sub-sector was -0.05151, which is less than 1.00. This means that, on average, service organizations in the real estate and property sub-sector are not flagged for misleading financial reporting from 2017 to 2019. In 2017, the company Metropolitan Land Tbk (MTLA) owned a minimum value of -5.1719, indicating that there is no evidence of dishonest financial reporting. This is in contrast to the Rista Bintang Mahkota Sejati Tbk (RBMS) corporation, which had the highest value of 1.8846 in 2017, indicating that there was evidence of dishonest financial reporting. The data for fraudulent financial reporting is dispersed heterogeneously, with a standard deviation of 0.8623, where the value is bigger than the average value.
2. The average value of the financial aim, according to the analysis, is 0.0335, which indicates the average level of the company's ability to make profits. Companies with high ROA have high false financial reporting values, according to the findings of the study. Bakrieland Development Tbk (ELTY) has the lowest ROA value of -0.0664 in 2019 and a false financial reporting value computed with an f-score of -0.5624, which is also low. Lippo Cikarang Tbk (LPCK) has the highest ROA of 0.2585 in 2018, with a false financial reporting value of 0.2682 estimated using a significantly high f-score. This condition demonstrates that the higher the ROA, the more likely a company's financial reporting is to be dishonest. This is reinforced by the fact that LPCK, the company identified as the most vulnerable to fraud, had a net income of 503 percent more in 2018 than in 2017, despite the fact that PT Lippo Cikarang Tbk's total assets decreased by 31% in 2018 compared to total assets in 2017. The financial aim variable has a standard deviation of 0.0527. This score is higher than the norm, indicating that the data on financial aims is dispersed.
3. Companies with a high nature of industry, according to the findings, have a high value of fake financial reporting. In 2017, the Metropolitan Land Tbk (MTLA) company had the lowest nature of industry value of -1.3909, as well as the lowest false financial reporting value measured with an f-score of -5.1798. Meanwhile, PP Properti Tbk (PPRO) had the highest



nature of industry value of 0.6895 in 2018, as well as a false financial reporting value of 0.4612 determined with a high f-score. The facts on the ground indicate that the PPRO company has a substantial quantity of receivables each year, indicating that businesses with a high nature of industry value can conduct fraud. MTLA enterprises with a low nature of industry value, on the other hand, have a decreasing amount of receivables each year, indicating that they are good companies with limited chance of committing fraud.

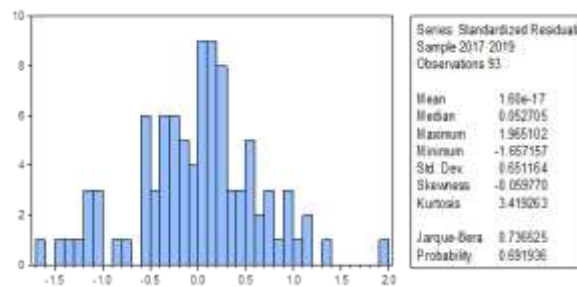
4. For the year 2017 to 2019, service companies in the real estate and property sub-sector matched the sample criteria for this study; 11.82 percent of the sample changed public accountants, while 88.18 percent did not. In 2017 and 2018, the Bukit Darma Property Tbk (BKDP) company was the one that made the most modifications on its own. According to the data, in 2017, Bumi Citra Permai TBK (BCIP), Megapolitan Developments Tbk (EMDE), PP Properti Tbk (PPRO) made the fewest changes, followed by Agung Podomoro Land TBK (APLN) and Metropolitan Land Tbk (MTLA) in 2018, and finally Bhuwanatala Indah Permai Tbk (MTLA) in 2019. (PWON). According to the facts, the Bukit Darma Property Tbk (BKDP) company that changes auditors the most frequently has a poor f-score of 0.2333 in 2017 and -0.0293 in 2018. As a result, the fact that a company's auditor changes frequently does not imply that the company is committed fraud.
5. For the year 2017 to 2019, service companies in the real estate and property sub-sector met the criteria for this research sample; 9.67 percent of all sample data in this study is known to have changed directors, while 90.33 percent did not. During the 2017 to 2019 period, the companies Forza Land Indonesia Tbk (FORZ) and Lippo Cikarang Tbk (LPCK) made the most changes to the board of directors, with changes in 2017 and 2018. Between 2017 and 2019, the directors of Bumi Citra Permai Tbk (BCIP), Bukit Darma Property Tbk (BKDP), Sentul City Tbk (BKSL), Perdana Gapuraprima Tbk (GPRA), and Indonesia Prima Property (OMRE) only changed once. The year with the greatest changes in directors was 2018, with four samples changing hands, while the year with the fewest changes in the board of directors was 2019, with only two samples changing hands. The facts on the ground also indicate that some organizations replace directors because the former director died, rather than because they committed fraud during their employment.
6. According to the descriptive statistical study shown in table 4.1, some organizations do not include CEO photographs in their financial statements at all (minimum value 0). Bukit Darma Property Tbk (BKDP) in 2018, Binakarya Jaya Abadi Tbk (BIKA) in 2019, Megapolitan Developments Tbk (EMDE) in 2018 to 2019, Pakuwon Jati Tbk (PWON) in 2017 to 2018, and Sitara Propertindo Tbk (TARA) in 2017 to 2019 are the entities in question. Table 2 further demonstrates that in one reporting period, a maximum of 17 CEO photographs are presented. The highest valuation comes from PP Properti Tbk (PPRO) reporting in 2017 and 2019. The CEOPIC descriptive analysis also reveals that the mean value is less than the standard deviation, which is 2.5376 against 2.7408. This



demonstrates that the quantity of CEO images in annual reports of service organizations in the real estate and property sub-sector from 2017 to 2019 is inconsistent. For the period 2017 to 2019, services in the real estate and property sub-sector are 2 to 3 photos. Despite having the most CEO photographs, PPRO received an f-score of less than 1.00 in both 2017 and 2019, with an f-score of 0.7586 in 2017 and 0.1536 in 2019. This demonstrates that the frequency of CEO photos in financial statements is insufficient to determine the likelihood of a CEO committing fraud. The corporation will place a greater emphasis on the presentation of financial statements in the annual report to attract investors' attention and to demonstrate accountability for the company's performance to shareholders.

Classic Assumption Test Normality test

Figure 1. Normal P-Plot Chart



Source: company audited annual report data (data processed, 2021)

The Jarque-Bera prob value in the manufacturing business data is 0.6919 (> 0.05), indicating that the residual data is normally distributed, as seen in the figure above.

Autocorrelation Test

Figure 2. Autocorrelation Test

R-squared	0.429838	Mean dependent var	-0.051516
Adjusted R-squared	0.397070	S.D. dependent var	0.862365
S.E. of regression	0.669614	Akaike info criterion	2.098110
Sum squared resid	39.00932	Schwarz criterion	2.261504
Log likelihood	-91.56213	Hannan-Quinn criter.	2.164084
F-statistic	13.11762	Durbin-Watson stat	1.966256
Prob(F-statistic)	0.000000		

Source: company audited annual report data (data processed, 2021)

The figure above shows the statistical value of Durbin Watson (DW) of research data in manufacturing companies which is 1,996 which is in the range of du to $4-dw$ so that it can be said that there is no autocorrelation problem.



Heteroscedasticity Test

Figure 3. Heteroscedasticity

Heteroskedasticity Test: Breusch-Pagan-Godfrey			
F-statistic	0.996259	Prob. F(5,87)	0.4249
Obs*R-squared	5.036466	Prob. Chi-Square(5)	0.4114
Scaled explained SS	5.331526	Prob. Chi-Square(5)	0.3768

Source: company audited annual report data (data processed, 2021)

The results of the Breusch-Pagan test show the probability value of F-Statistics (F-Calculate) is greater than Alpha (0.05) which is 0.4249, so it can be concluded, H1 is accepted and H0 is rejected. This means that there is no heteroscedasticity problem with this data.

Panel Data Regression Analysis

$$Y = -0.218 + 4.184 X1 + 2.688 X2 + 0.304 X3 - 0.046 X4 - 0.037 X5$$

From the regression equation above, it can be seen that:

1. The constant of -0.218 states that if the value of the independent variable is ignored or is 0, then the value (Y) is -0.218.
2. The coefficient of the regression equation (X1) is 4.184 which states that for every increase in X1 units, the value (Y) will increase by 4.184 times.
3. The coefficient of the regression equation (X2) is 2,688 which states that for every increase in X2 units, the value (Y) will increase by 2,688 times.
4. The coefficient of the regression equation (X3) of 0.304 states that for every 1 unit increase in X3, the value (Y) will increase by 0.304 times.
5. The coefficient of the regression equation (X4) is -0.046 which states that for every 1 unit increase in X4, the value (Y) will decrease by -0.046 times.
6. The coefficient of the regression equation (X5) is -0.037 which states that for every 1 unit increase in X5, the value (Y) will decrease by -0.037 times.

Hypothesis Testing

Figure 4. Common Effect Model Hypothesis Testing

Dependent Variable: Y Method: Panel Least Squares Date: 07/22/21 Time: 14:59 Sample: 2017 2019 Periods included: 3 Cross-sections included: 31 Total panel (balanced) observations: 93				
Variable	Coefficient	Std. Error	t-Statistic	Prob.
X1	4.184067	1.357520	3.082140	0.0028
X2	2.688780	0.350634	7.668335	0.0000
X3	0.304020	0.218110	1.393886	0.1669
X4	-0.046679	0.239751	-0.194699	0.8461
X5	-0.037235	0.027424	-1.357752	0.1781
C	-0.218519	0.109170	-2.001632	0.0484
R-squared	0.429838	Mean dependent var	-0.051516	
Adjusted R-squared	0.397070	S.D. dependent var	0.862365	
S.E. of regression	0.669614	Akaike info criterion	2.098110	
Sum squared resid	39.00932	Schwarz criterion	2.261504	
Log likelihood	-91.56213	Hannan-Quinn criter.	2.164084	
F-statistic	13.11762	Durbin-Watson stat	1.966256	
Prob(F-statistic)	0.000000			

Source: company audited annual report data (data processed, 2021)



Coefficient of Determination (R^2)

In a panel data regression model, the coefficient of determination can be used to determine how well the independent variable can explain the dependent variable. Figure 4's regression equation reveals that the corrected R-squared value for the Random Effect Model is 0.3970, indicating that the independent variable can explain the dependent variable by 39.7%. Other factors that are not covered in this study account for the remaining 60.3 percent.

Simultaneous Significance Test

The test in Figure 4 shows the F-statistic probability of $0.000 < 0.05$, this shows that simultaneously the variable pressure, opportunity, rationalization, competence, and arrogance together have a significant effect on fraudulent financial reporting, then hypothesis H1 is accepted.

Individual Parameter Significance Test

In Figure 4 the partial test results (t test) can be explained as follows.

1. The P-value of the X1 variable in Figure 4 is 0.0028 which is smaller than 0.05. This shows that the X1 has a significant effect on variable Y, so the hypothesis H2 is accepted.
2. The P-value of the X2 variable in Figure 4 is 0.0000 which is smaller than 0.05. This shows that X2 has a significant effect on variable Y, so the hypothesis H3 is accepted.
3. The P-value of the X3 variable in Figure 4 is 0.1669, which is greater than 0.05. This shows that X3 has no significant effect on variable Y, so the hypothesis H4 is rejected.
4. The P-value of the X4 variable in Figure 4 is 0.8461 which is greater than 0.05. This shows that X4 has no significant effect on variable Y, so the hypothesis H5 is rejected.
5. The P-value of the X5 variable in Figure 4 is 0.1781 which is greater than 0.05. This shows that X5 has no significant effect on the Y variable, so the hypothesis H6 is rejected.

5. Conclusion and Suggestion

Conclusion

1. The variables of pressure and opportunity have a substantial impact on dishonest financial reporting. While the factors of rationalization, competence, and arrogance have no effect on false financial reporting, the variables of rationalization, competency, and arrogance do. Pressure, opportunity, rationalization, competence, and arrogance, on the other hand, all have an impact on dishonest financial reporting.
2. The following are two of the five parts of the fraud pentagon that have an impact on false financial reporting:
 - a) Financial target (ROA) pressure reveals that the ROA that the company can reach demonstrates better management performance and can persuade investors to invest in the company. As a result of the pressure, management is more likely to engage in misleading financial reporting.



b) Opportunity, which is proxied by the nature of the industry, indicates that a firm is labeled as not good when it has a big quantity of receivables and raises its cash, indicating that the company is committing fraud.

Suggestion

Theoretical Aspect

1. Academics should expand conversations and studies connected to references in order to deepen their thinking and understanding of accounting science's progress, particularly in the domains of fraud auditing and forensic accounting.
2. It is suggested that future researchers:
 - a) Experiment with other fraudulent financial reporting measurement proxies, such as indicators of restatements and whether the company is subject to Financial Services Authority sanctions, as well as conducting research into which fraud model has the highest accuracy in predicting fraudulent financial reporting in Indonesia;
 - b) Other proxies for the fraud pentagon include external pressure for pressure, public accounting quality for opportunity, audit opinion for rationalization, CEO tenure for competence, and the presence of CEO politicians for hubris; as well as
 - c) Continue to keep an eye on the evolution of the fraud idea since a new model could emerge.

Practical Aspect

1. Companies are encouraged not to set excessive profit targets so that performance management is not overburdened and under pressure, which could lead to dishonest financial reporting in order to meet targets and attract new investors.
2. Shareholders and other stakeholders are recommended to continue to exercise caution in their investments, for example, by employing various methods of detecting fake financial reporting, as described by the authors. Efforts to keep risk to a minimum.
3. Public accounting firms are urged to improve the quality of auditing the company's financial statements by increasing their accuracy and prudence in examining the information supplied by the company.

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