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Determinant of Auditors' Judgment on the Detection of Fraudulent Financial Statements

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ABSTRACT

This study aimed to assess auditors' capacity to detect financial statement fraud. This study examined three variables that are thought to influence auditors' judgment: (1) auditors' independence, (2) auditors' understanding of corporate governance principles, and (3) auditors' knowledge about the Electronic Knowledge Repository (EKR). The Public Accounting Firms characteristic was considered as moderating variables. The research population consisted of auditors at Jakarta's Public Accounting Firms (PAFs). Cluster sampling was used to choose the sample, which consisted of PAFs affiliated with overseas PAFs and unaffiliated PAFs. Each cluster was chosen depending on the desire of each respondent to participate. The number of respondents participating was 155 auditors, consisting of 77 foreign affiliated PAFs auditors and 78 non-affiliated PAF auditors. A questionnaire was utilized to evaluate the auditors' ability to assess possible fraud based on case studies. The study concludes that auditors' independence, corporate governance expertise, and EKR knowledge have a favorable effect on auditors' ability to detect financial statement fraud. PAFs affiliate was not a moderating variable but a predictor variable. Gender moderated the relationship between GCG and audit judgement. The Financial Services Authority and PAFs may use the research's findings to improve the service quality of Public Accountants.

Keywords: Fraud, Independency, Corporate Governance, Auditor, Electronic Repository

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INTRODUCTION

Financial statements are not only used by owners of a company but also by stakeholders such as the government, creditors, suppliers and employees. To be able to meet the expectations of these stakeholders, it is essential to have a reliable and trustworthy financial report. An auditor has 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. Setiyawati and Siahaan (2019) as well as Harun and Jan (2020) who conducted research on audit quality concluded that the competence and independence of auditors have a significant effect on audit quality. In addition, Guizani and Abdalkrim (2021), Jadiyappa et al. (2021) and Kertarajasa et al (2019) also concluded that experience, independence, competence, and professional care have an impact on the quality of audit. Integrity is an important aspect of the audit process which gives a favourable impact on audit quality (Kamil & Fathonah, 2020; Kertarajasa et al., 2019; Octaviani & Ekasari, 2021; Prabowo & Suhartini, 2021)

The novel aspects of this studyare: (1) the incorporation of a new variable concerning the Electronic Knowledge Repository (EKR) and (2) audit judgement instead of audit quality. EKR is an electronic repository of all case-related or knowledge-related content retained by an organization. EKR reflects the use of information technology to help accountants learn or acquire knowledge that can be applied to audit judgments.

Corporate governance is an organizational culture that controls and incentivizes adherence to a company's code of ethics at all organizational levels. Inadequate corporate governance will increase the likelihood of financial reporting fraud (Husaini, 2018). In addition, the Audit Committee must be aware of the risk of fraud and be sceptical about fraud detection. According to Nanayakkara (2021) quality directors and effective management are the most important variables in organizations that do not engage in fraud and implementation of GCG. Abu and Jaffar (2020) asserted that the audit committee meeting will impact audit quality.

This study aimed to provide empirical evidence regarding the impact of auditors' independence, EKR, and GCG on the detection of financial statement fraud during auditing; it used PAF's characteristic as moderating variables. This research is important as auditors' capacity to detect possible fraud is still inadequate. Regulators and Public Accounting Firms (PFAs) and regulators might consider 'the findings in developing policies and enhancing external auditors' skills.

The structure of the paper consists of five sections. The second section includes a literature review on the issues relevant to the study and establishes the research hypotheses. The third section describes the data collection and research methodology, the fourth section presents the research findings. The final section provides conclusions of the study, its implications, and suggestions for future research.

LITERATURE REVIEW AND HYPOTHESIS DEVELOPMENT

Agency Theory and Signalling Theory

The concept of agency may aid an auditor in comprehending issues involving the agent and the principal. A third party's role in an agency context is to monitor the management's actions as an agent and ensure that the agent is carrying out the wishes of the principal. Auditors are viewed as parties who can mediate between the principal and the agent in order to hold the principal accountable. It is the responsibility of the external auditor to provide a judgment on the fairness of financial statements presented by agents.

Fraud in Financial Statements

According to Jones and Pendlebury (2000), there are two types of fraud: (1) fraudulent financial reporting, which entails the manipulation, falsification, or alteration of accounting records or supporting documents and financial statements that are prepared, do not present in or purposely omit important events, transactions, and important information and financial statements, and intentionally apply incorrect accounting principles; and (2) asset misappropriation, which refers to the theft of an organization's assets. International Standards on Auditing (ISA) describes the illustration of fraud factors, namely ISA No. 240 and SAS No. 99 (Tuanakotta, 2013), which are founded on the fraud triangle hypothesis. The red flag which occurs increases the auditors' skepticism in finding the fraud and helps in understanding the root cause (Krambia, 2002). The red flag can aid the auditor in identifying potential financial statement fraud early.

A company's misappropriation of assets is influenced by issues associated with weak internal control, which includes inadequate internal control systems. According to a number of studies, an insufficient internal control system includes substandard internal control features that facilitate asset misappropriation within a company. Poor internal control is one of the leading causes of fraud, according to previous studies by Moyes et al., (2006); Association of Certified Fraud Examiners (2012); Mohamed and Jomitin, (2014).

Auditor Judgement

In order to achieve the intended results, an auditor must also apply adequate skepticism and judgment in order to collect and evaluate sufficient data in order to offer a fair and objective audit opinion regarding fraud detection. What constitutes an audit judgment is the auditor's judgment or perspective when responding to information that could have an impact on the documentation of evidence and audit findings (Sanger et al, 2016). In addition, auditors are required to utilize their professional judgment in conformity with the Auditing Standards. As part of the audit's planning phase, the auditor must perform a preliminary fraud risk assessment using the risk criteria (red flags) identified in the fraud triangle (Statement on Auditing Standards No. 99 AICPA, 2004) and International Standards on Auditing No. 240 (IFAC)): management attitudes, opportunities, and incentives. This sensitive risk assessment will have a significant impact on the fraud detection process (Hackenbrack, 1992).

The Relationship between Auditors' Independence and Fraud Detection

Independence is an attitude that is impartial and unaffected by external pressure when making decisions and acting (Tuanakotta and Theodorus M., 2014). According to Jalil (2021) and Alsughayer (2021), there is a positive and significant association between audit firm size, auditor rotation, industry specialization, auditor competence, integrity and ethics, independence of auditors' finances, audit report delays, and the updating of financial statement fraud detection. Auditors' capacity to detect and prevent financial reporting fraud is contingent on their qualifications and financial independence. According to Mukhlasin (2018), the study demonstrates that an increase in auditors' independence increases fraud detection. In order to discover fraud, independent auditors will always operate fairly, objectively, and critically (Shen et al, 2021). Several research, such as Putri et al. (2021), discovered a substantial and positive correlation between fraud and autonomy. According to Arens and Alvin (2014), the two facets of independence are actual independence and the appearance of independence. In the standpoint of the auditor, independence entails being free, truthful, and objective when conducting audits. In addition, Utami et al, (2011), Nekhili et al., (2021); Nekhili, and Nagati, H. (2021); Mnif and Cherif (2022) assert that accounting professional education and audit partner workload and auditors' gender have a significant impact on the professionalism of auditors.

H1: Auditors' independence has a positive effect on their ability to detect potential fraud.

The Relationship between EKR and Fraud Detection

According to Kankanhalli et al. (2005), an EKR is an electronic repository of all case-related or organizational information. It has been demonstrated that systems may encode and store information for future reuse (Hansen, Nohria and Tierney, 1999). Bock and Kim (2002) define EKR as a form of knowledge management system that enables people to share their knowledge and utilize it in the future. EKR has acquired appeal as a tool to assist employees in reusing and repurposing old information, collaborating with others on knowledge, and generating innovative new ideas. With the rapid advancement of technology, blockchain technology (BT) offers realistic innovation for businesses to develop a value proposition and distinctive data sharing protocols and enterprise applications, including an innovative organizational framework (Chin et al., 2021, Kabir et al., 2021a; Kabir et al., 2021b). Auditors utilize EKR to discover example spreadsheets, conduct quick literature searches, conduct research, and resolve client problems. In EKR, which is a repository for documents such as working papers and presentation materials, employees may freely upload information for everyone to find and reuse. A few notable and effective EKRs utilized by PAFs have varying sizes and knowledge domains. According to Lotfi and Mahdi (2021), investments in Intellectual Capital (IC) can improve firm performance in a variety of ways, hence decreasing managers' and owners' willingness to reveal fraud.

H2: EKR has a positive effect on auditors' ability to detect potential fraud.

The Relationship between GCG and Fraud Detection

There is a close relationship between the role of GCG in detecting fraud and the fact that GCG combines elements related to weak internal control that contribute to fraud in a company. Internal control has a favorable and significant influence on early warning fraud (Utami et al.,2020). According to previous studies (Agrawal and Chadha, 2005; Puwanenthiren, P. et al., 2022), there is a significant relationship between board size, board independence, audit committee independence and audit quality. Organizations with strong independent commissioners, backgrounds in business education and competence, and a high meeting attendance generate high-quality, transparent financial reports (Utami et al.,2021). Referring to financial services authority regulations (Indonesia): POJK No. 21/ POJK.04/2015 and SEOJK No. 32/SEOJK.04/2015, there are 5 (five) aspects of GCG as follows: (1) public companies interaction with shareholders by ensuring shareholder rights, (2) the roles and responsibilities of the Board of Directors, (3) the roles and responsibilities of the Board of Commissioners, (4) stakeholder involvement, and (5) information disclosure.

H3: Auditors' understanding of good corporate governance principles has a positive effect on the auditors' ability to detect potential fraud.

PAFs Characteristics as a Moderating Variable

PAFs or auditor characteristics in previous studies are related to the criteria of big four and non-big four public accounting firms, industry specialization, audit market's focus, gender, and audit tenure (Hussin, N et. al.,2022; Skinner, D. and Srinivasan, S, 2012). There is a positive and significant relationship between audit firm size and fraud detection (Skinner, D. and Srinivasan, S, 2012). Karami et al. (2017) and (Mukhlasin, 2018) provide empirical evidence that the audit industry's specialization provides innovative knowledge that can be used to solve industry-specific problems so that auditors can detect fraud. Female audit partners have a more transparent attitude in providing audit report disclosures and a higher ability to detect potential audit risks compared to male auditors (Hussin et al., 2022; Abdelfattah et al., 2020).

Characteristics of PAFs in this study used a proxy based on PAFs of foreign affiliates and non-foreign affiliates as well as auditor gender. These characteristics were chosen because foreign affiliated PAFs have large size criteria, industry specialist auditors, and big corporate clients. We hypothesized that APFs' characteristics can strengthen the influence of independence, GCG and AKR on the detection of potential fraud.

H4: APFs' characteristics moderate the effect of independence, GCG, and EKR on the auditors' ability to detect potential fraud.

RESEARCH METHODOLOGY

This causality research aimed to test hypotheses. Characteristics of PAFs in this study used a proxy based on PAFs of foreign affiliates and non-foreign affiliates, and auditor gender. The research population included auditors who work in PAFs registered in the Ministry of Finance Indonesia. The research respondents were auditors who had the position of supervisors or managers or partners. The samples were selected based on cluster sampling. PAFs' auditors were divided into clusters of PAFs affiliated with foreign PAFs and PAFs that were not affiliated. Each cluster was selected based on the respondents' willingness to participate. The research instrument used a closed questionnaire and an open questionnaire for the analysis of potential fraud cases analysis. The closed questionnaire, which is a questionnaire that has been given questions and should be answered by selecting the available answers, was used to collect primary data related to the independent variables, EKR and GCG. An open questionnaire was used to assess the auditors' judgment in detecting potential fraud. An open questionnaire was used to present external audit case scenarios, and the respondents were asked to assess the potential fraud to occur. The analysis used quantitative methods with Partial Least Square (PLS). The moderating effect of PAFs' characteristics was categorical moderating effect (Hair, 2017) and carried out by a two-stage approach (Chin *et.al* 2013). The first step was PLS analysis without the moderating variable and then the analysis after entering the moderating variable.

RESULTS AND DISCUSSION

Demographic Respondents

Table 1 shows the number of auditors who participated was 155 people. Description of the respondents' profile was conducted to obtain an overview of the characteristics. The majority of the respondents were supervisors and managers with a total of 72.6%. Based on PAFs, the respondents obtained 49.7% from PAF with foreign affiliation and 50.3% from PAFs not with foreign affiliation. The majority of respondents were considered to have appropriate experience in performing external audits as 80.0% of the respondents had more than 5-year experience. In terms of education background, 79.4% of the respondents had a bachelor degree, 19.4% had a master's degree and 1.2% completed a doctoral education. The majority of the respondents were undergraduates. Based on gender, 62.6% were male and 37.4% female. The following table shows that the majority of the auditors were male compared to women at the top level.

Table 1: Demographic Statistics

Area		Occurrence	%
Position	Supervisor	63	40.6
	Manager	50	32.
	Partner	42	27.1
PAF Type	Foreign affiliate	77	49.7
	Non foreign affiliate	78	50.3
Length of work	<5 years	31	20.0
	5-10 years	67	43.2
	10-15 years	28	18.1

	>15 years	29	18.7
Education	Bachelor	123	79.4
	Master	30	19.4
	Doctoral	2	1.2
Gender	Male	97	62.6
	Female	58	37.4

Partial Least Square Model Testing

Outer model test results

The coefficients of latent variables can be used to evaluate the composite dependability of a construct. Internal consistency and Cronbach's alpha are used to evaluate the reliability of composites. If the measurement's result is more than 0.70, the construct is judged to have good dependability.

Table 2: Construct Reliability Test Results

No	Variable	Cronbach's Alpha	Composite Reliability
	Independency	**0.772**	**0.836**
1	Independency in fact (X1.1)	0.785	0.809
2	Independency in appearance (X1.2)	0.744	0.808
	EKR	**0.887**	**0.907**
1	Knowledge creation (X2.1)	0.704	0.835
2	Knowledge storage (X2.2)	0.726	0.845
3	Knowledge sharing (X2.3)	0.760	0.855
4	Knowledge use (X2.4)	0.710	0.838
	GCG	**0.870**	**0.894**
1	Relationship between public company with shareholders by guaranteeing shareholders' rights (X3.1)	0.780	0.824
2	Functions and roles of the Board of Commissioners (X3.2)	0.719	0.799
3	Stakeholders' participation (X3.3)	0.724	0.779
4	Information disclosure (X3.4)	0.731	0.776
	Fraud Detection (Y)	**1.000**	**1.000**

Source: Processed Research Data (2022)

The reliability test results showed that each independence variable (X1), EKR (X2), GCG (X3), and fraud detection (Y) had met the construct's reliability criteria of greater than 0.70. This was determined by utilizing the Composite Reliability value and the Cronbach's Alpha value.

Inner model test results

The R-square of the dependent construct can be utilized to evaluate the inner model analysis. The outcome of the inner model test is the coefficient of determination

Table 3: Coefficient of Determination Test Results

No	Independent Variable	Dependent Variable	R Square	R Square Adjusted
1	Independency	Fraud detection	0.29	0.28
2	EKR			
3	GCG			

The results of the coefficient of determination of the influence of independence (X1), EKR (X2), and GCG (X3) on fraud detection (Y) yielded a R square value of 0.29, indicating that fraud detection (Y) can be explained by independence, EKR, and GCG to the extent of 29%. According to Chin (1998), the levels of explanatory power is medium (R square 0.13 to 0.33). Figure 1 depicts the results of testing with PLS to determine the total influence of exogenous variables on endogenous variables.

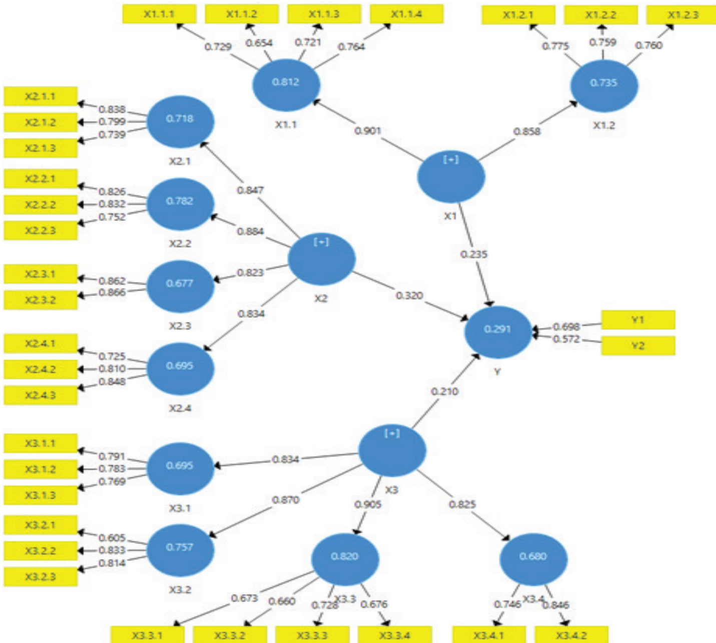

Figure 1: Model Path Diagram

Hypothesis Testing

Table 4 describes the results of hypothesis testing based on the path coefficient value and T-Statistics/P-value:

Table 4: Hypothesis Testing

No	Independent Variable	Path Coef.	T Stat	P	Remark
1	Independency	0.24	3.23	0.00	Significant
2	EKR	0.32	3.99	0.00	Significant
3	GCG	0.21	3.12	0.00	Significant

The effect of independence on fraud detection

A path coefficient of 0.24, a T-statistical value of 3.23, and a probability value of 0.003 were obtained. The results demonstrated that independence has a significant and positive effect on fraud detection, indicating that the auditors' capacity to detect fraud will increase if they are independent. The auditors' audit must be supported by an attitude of independence, so that audit results accurately reflect the actual situation and are unaffected by pressures from connected parties. These findings are consistent with those of prior research conducted by Mappanyuki (2019), William and Budiartha (2015), and Noch et al. (2022), indicating that auditor independence has a significant and positive effect on fraud detection. This means when auditor independence increases, the ability of fraud detection will also increase.

The effect of electronic knowledge repository on fraud

For the effect of EKR on fraud detection, a path coefficient of 0.32, a t-statistical value of 3.99, and a probability value of 0.005 were obtained. The probability value showed that EKR has a positive and statistically significant effect on fraud detection, i.e., the higher the EKR, the more effective an auditor can spot potential fraud. This study indicates that the development, storage, sharing, and application of knowledge in EKR have a substantial effect on the quality of audit judgement to detect fraud. Consequently, the four EKR procedures specified in the PAF are the key contributors or primary factors and have a significant impact on the performance of the PAF. It also illustrates the fundamental need for PAF to develop and accumulate more knowledge to better serve clients and to have a range of knowledge bases for knowledge storage in order to enhance PAF performance. These findings align with those of Kalsom and Fathiah (2011). Fahmi and Vivien's (2009) study concluded that EKR can produce an effective audit. This suggests that EKR is essential for producing and acquiring new knowledge in order to serve clients.

The effect of GCG on fraud detection

The relationship between corporate governance and fraud detection was examined using a route coefficient of 0.21, a T- statistic value of 3.12, and a probability value of 0.026 were obtained. These data indicated that corporate governance has a considerable impact on fraud detection and a positive direction; the auditors' ability to detect fraud increases as their understanding of corporate governance increases. Auditors who are familiar with the GCG's guiding principles can detect any potential for fraud during the audit. These findings are supported by Agrawal and Chadha (2005), Puwanenthiren, P. et al., (2022), and Utami et al., (2020). Establishing GCG appropriately in an organizational environment will have a positive impact on fraud prevention.

The effect PAF's characteristic as a moderating Variable

Testing whether PAFs' characteristics (affiliate and non-affiliate PAF and gender of auditors) moderated the exogenous variable against the endogenous variable was done by entering the moderating variable into the PLS analysis.

Table 5: T Statistics Categorical Moderating Effect

Affiliate PAFs	T Statistics	PV Value	Gender	T Statistics	P Value
PAFs →Y	2.905	0.004	Gen→Y	1.230	0.219
X1 →Y	3.181	0.002	X1→ Y	3.069	0.002
X1*PAFs→Y	0.983	0.326	X1*Gen→Y	1.399	0.162
X2 →Y	4.155	0.000	X2→Y	4.031	0.000
X2*PAFs → Y	0.998	0.319	X2*Gen→Y	0.808	0.419
X3 → Y	3.015	0.003	X3→Y	3.242	0.001
X3*PAFs →Y	0.685	0.494	X3*Gen→Y	2.186	0.029

The results of the moderating affiliated PAF showed (Table 5) that the direct effect of independence (X1), RPE (X2), and corporate governance (X3) had a significant influence on fraud detection (Y), while PAFs did not serve as a moderating variable (P>0.05). Based on p Value of PAFs, which was 0.004, the predictor variable was not a moderating variable. This finding is consistent with Skinner and Srinivasan, (2012); Karamiet al. (2017); and Mukhlasin, (2018).

The results of the testing of moderating auditor gender showed that the direct effect independence (X1), RPE (X2), and corporate governance (X3) had a significant effect on fraud detection (Y), while gender served as a moderating variable in the relationship between GCG and audit judgement. The finding that gender moderates the relationship between GCG and audit judgement is supported by Hussin et al., (2022) and Abdelfattah et al., (2020).

CONCLUSION

Auditors must apply skepticism and judgment to detect potential fraud. This study aimed to provide empirical evidence regarding the impact of auditors' independence, EKR, and GCG on detecting financial statement fraud during auditing. First, the research finding showed that the impact of external auditors' independence on fraud identification is enormous and beneficial. This indicated that auditors' ability to detect client fraud is proportional to their level of independence. Second, the auditors' use of EKR, which PAF owns, had a substantial impact on their ability to detect fraud, enabling them to detect possible fraud sooner when auditing financial statements. Third, Auditors whose knowledge of the criteria of good governance is comprehensive had a substantial impact on their capacity to detect fraud in a firm at an early stage.

The research implies that PAF must maintain an up to date EKR, provide continuous education for auditors to retain their independence, and comprehend the rules and regulations of corporate governance. The EKR aspect has the most significant path coefficient. This means that EKR improves the auditor's ability to detect potential fraud. Therefore, regulators and PAF must make a structured policy for improving auditors' technology knowledge.

The weakness of the research is related to the audit fraud case design, which is relatively complex for the supervisor level. Measuring the auditor's judgment is relatively tricky because each stage of the audit process requires an auditor's judgment. This study used a judgment case related to the substantive test on land sales and investment transactions. The substantive test requires a relatively complex judgment 40.6% of the respondents were supervisors, so supervisors have not been able to make an audit judgment of potential fraud of substantive test. Therefore, further research needs to consider a case design that follows the level of auditor position (respondent) and can use an audit risk case design.

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