

THE INFLUENCE OF AUDIT COMMITTEE QUALITY AND INTERNAL AUDITOR OBJECTIVITY TOWARD THE PREVENTION OF FRAUDULENT FINANCIAL REPORTING

(A Survey in BUMN of Indonesia)

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Abstract

It requires information quality, and free from distortion. 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 has not functioned optimally, resulting in low quality of financial reporting. The research study uses explanatory method. The data were collected through survey technique by distributing questionnaires to SOEs in Indonesia. The respondents involve audit committee and internal auditors. Before the data were used to test the hypothesis, it should test the validity and reliability of data. The data have been analyzed by using partial least square descriptive analysis modeling to test the hypotheses.

The results concluded that, 1) the quality of the audit committee has an effect on the prevention of fraudulent financial reporting, 2) objectivity of internal auditor has an effect 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 superiors in order to show better report than the actual report (Albrecht 2003: 97)

The cause of the fraud and financial scandal which recently have been revealed is regarding with the weak corporate governance (Cohen et al. 2004). This fraudulent financial reporting misguides the investors. This report which usually functions as a guidance sometimes misguides the investors in their decision (Verdi, 2006). Fraudulent financial report can give bias and misleading information (Belkaoui, 2004:53-54)

These fraudulent cases have recently happened because the internal audit function is still not effective yet (Anwar Nasution, 2009). It is also supported by the research by 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 (Josh Luhukay, 2011).

Research by COSO (2007) explains that there is income claim by managements by 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% loss which is caused by fraud, this loss has not changed yet since 1996, the most common fraud that has happened is asset misappropriation (85%), corruption (13%), and fraudulent financial report is only (5%), but it gives the most significant loss for about \$ 4.25 million.

Audit by BPK within 2005-2011 explains that there are 24 suspected corrupt BUMN, these frauds happen because of some factors, and the most factor is the weak system in internal control and accountant control.

The general director of PT. Waskita Karya, TBK (M. Choliq, 2011) found an excess of report of 4 billion Rupiah which is made by previous director in doing fraudulent financial report within 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 valas finance 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. (Hadi Purnomo, 2011).

The reveals of some cases in India also shows 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 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 override 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 is done by accounting standard board (FASB, 2008) and American Institute of Certified Public Accountants (AICPA, 2005) which is done by issuing standards and rules which may prevent the fraud action.

The director of micro Bank Mandiri, Budi Gunadi Sadikin stated that the fraud is not only happening through physical action but also through electronic which can be shown from fraud cases through credit card. This statement is supported by the data of Bank Indonesia as per April 2010 that the total fraud cases notified is 2.829 cases and the lost is about Rp. 16,72 billion, the volume of credit card transaction reaches 62,9 million which is equal to Rp. 49,85 trilliun and the number of credit cards is 12,61 million cards. The money laundry case of Citibank costumer reaches Rp 17 billion also indicates the weak system of internal control. That is also the same to the money laundry effort in BNI which ups to 4 billion which has been reported recently.

The gouvernor deputy of bank Indonesia in Banking Efficiency Award discussion 2011 stated that the happening of many fraud cases is 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 does not really implement know your employee (halim Alamsyah, 2011)

The preventive action of fraud has been done by the regulators like bank Indonesia and Bapepam LK through regulation of Bank Indonesia No: 5/8/PBI/2003 which explains that Fraud Risk magement must have the active control of hous of comisariat and direction, sufficient policy, procedure and limit sufficient identification, measurement, controlling and risk control, also management information sytem and thoroughly internal control by introducing risk prevention with "No fraud Tolerance" through optimalization of Principle based-regulation through optimalization of obedient direction function, internal audit, and risk management which operates independently (KNKG, 2006).

In Bapepam notification letter No. SE-03/PM/2000 is stated that audit committee helps comisariat in: 1) improve the quality of report, 2) setting up the environment which can prevent the fraud action in company management, 3) increasing the activity of internal audit, and 4) identifying things which need comisariat concern.

The TELKOMSEL Tbk case in 2002 indicates the weakness of audit committee, especially in terms of auditor recruitment which did not confirm the qualification. This weakness of audit committee and the weakness of internal control also happened to PT. Kimia Farma (Tbk) which related to total benefit mark-up of PT. Kimia Farma Tbk in 2001 for about Rp. 32,668 billion (which was actually Rp. 99,594 billion but written as Rp. 132 billion). 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 1996, 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, 2002). Standards for the Profesional Practice of Internal Auditing (SPPIA) also stated that the internal auditors must be able to use their position in doing internal control carefully, payin attention to any possibility of fraud, errors, manipulation, in-efficiency, non-effectiveness an conflict of interest and condition and activities which might cause irregularity (IIA, 2003).

Internal auditor also helps management in designing and sustaining the intern 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.

Based on the background above, the researcher is interested in finding the clarity and empirical evidence about “the influence of audit committee quality and internal auditor objectivity toward the prevention of Fraudulent Financial reporting” in BUMN Indonesia. The objective of the research 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. METHOD

The object of this research is audit committee quality, objectivity of internal auditor, and the prevention of fraudulent financial reporting in BUMN Indonesia.

The method of the research in this research is (explanatory research), which explains the cause-effect relationship amon variables (Cooper and Schindler, 2006:154). Explanatory research is concerning on the theory or hypothesis which will be examined as a cause of a phenomenon.

There are two variables in this research:

1. Independent variable (eksogen) which consists of audit committee quality variable (X1) and internal auditor objectivity variable (X2).
2. Dependent variable (endogen) which consists of the prevention of fraudulent financial reporting (Y).

The population of this research is 141 BUMN in Indonesia. This research uses the probability sampling technique and proportioned stratified random sampling because the population has heterogenous members and in proportional level (Sugiyono, 2009:83). The minimum number of sample in this research is 58 BUMN in Indonesia.

The variable of research is measured by using likert scale which is elaborated as te returning point in making research instrument items which are in form of statement item. The range which is used in examining the answers of the questions is from 1-5.

The analysis device which is going to be used in this research is Structural Equation Modelling (SEM) which is based on component or variance which 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 (Imam Ghozali, 2008).

The measurement model in this research will be convergent validity anddiscriminan validity. Inner model will be evaluated by seeing three quantities by using R-square for dependent construct, Stone-Geisser Q-square test, t value and significancy from structural parameter coefficient (Imam Ghozali, 2008:26).

The hypothesis test in this research will be as follows:

1. The first hypothesis, to test the infuence of audit committee quality (KAA) toward the prevention of fraudulent financial reporting (PFFR).
2. The second hypothesis, to test the influence of internal auditor objectivity (OAI) toward the fraudulent financial reporting (PFFR).

3. RESULT AND DISCUSSION

3.1. Test of the first hypothesis: the influence of audit committee quality toward the prevention of fraudulent financial reporting

Through coefficient value the eksogen 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 (KKA) Toward The Prevention of Fraudulent Financial Reporting (PFFR)

Variable	Coefficient	Direct Influence	Indirect Influence		Total
			KKA	OAI	
KKA	0,468	21,8%		12,0%	33,8%
Total					33,8%

Based on the above result it can be seen that t value of variable KKA (2,586) is higher than t critical (1,96), with the degree of freedom 5% it can be concluded that KKA has positive influence and significance towards PFFR and BUMN 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 fraudulent financial reporting in BUMN in Indonesia is 33,8%.

3.2. The second hypothesis test: the influence of internal auditor objectivity toward the prevention of fraudulent financial reporting

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

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

Variable	Coefficient	Direct Influence	Indirect Influence		Total
			KKA	OAI	
OAI	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 OAI (2,738) is higher than t critical (1,96), based on the degree of freedom 5% it can be concluded that OAI has positive and significant influence toward PFFR in BUMN Indonesia. Directly, OAI gives contribution 10,6% toward PFFR, indirectly because of its correlation with KKA is 12,0% so the total influence toward PFFR in BUMN Indonesia is 22,6%.

4. CONCLUSION AND SUGGESTION

4.1. Conclusion

1. There is influence of audit committee quality toward the prevention of fraudulent financial reporting. The function of audit committee in preventing the fraudulent financial reporting is not optimal and is caused by the weak control function and internal control by audit committee it is because of the lack of knowledge and experience audit committee in financial accountancy; lack training and coaching in accountancy, finance, and auditing which is held by professional organization; and the decreasing of etiquette value.
2. There is internal auditor objectivity influence toward the prevention of fraudulent financial reporting. The internal control and the controlling function are not yet optimal because of not all the internal auditors have sufficient ability in detecting the existence of symptom 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 control function and internal controlling to prevent the fraudulent financial reporting.

4.2. Suggestion

1. Audit committee quality optimization must be improved through the standard recruitment process, like having experience as auditor in public accountant office and obeying the fixed standardization, the recruitment is handed to professionals in order to be free from any intervention from companies. Besides, audit committee activity as member in professional organization must be improved in order to enhance knowledge and experience in recent accountancy and finance, so it can ease the implementation of controlling function and internal control.
2. Internal auditor objectivity must be improved through quality improvement of internal auditor responsibility by placing experienced internal auditor in terms of business process and the certified auditor is more preferable (QIA/CIA), in order to be easier in doing analysis for prevention of fraudulent financial reporting.

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