Fraud Triangle Theory and Accounting Irregularities: A Conceptual Framework

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Abstract

Financial statements are a very useful tool for economic decision-making and they are produced as a result of the accounting process which comes from all transactions that occur within a company. Nowadays, economic development is fast growing which inevitably leads to stiff competition among companies, hence they strive to present financial statements. In this case, preserving shareholders' confidence is of utmost importance as they might withdraw their money from the invested companies if they do not feel safe. This causes the company to think of various strategies to increase the company's value and present a sound figure of financial statements. Thus, companies might involve themselves in accounting irregularities and other financial statements fraudulent to present an attractive financial statement. Fraud can happen through manipulation of the value of the account and reported values that are not following the real situation. The objective of the study is to examine the influence of the dimension of fraud triangle theory namely pressure, opportunity, and rationalization on accounting irregularities. This study provides more insights into fraud theories and accounting irregularities.

Keywords: Financial statement, fraud theory, pressure, rationalization, opportunity

1.0 Introduction

Financial reporting serves as the most essential tool in a company that can be used as the benchmark of a company's financial condition. Financial reporting is a result of the accounting process that is taken from the overall transactions in the company. Financial reporting provides incredible benefits for useful economic decision making for the internal and external parties of a company, hence companies tend to present their financial reporting as perfect as possible. The rapid development of current economic conditions leads to increasing tense competition in various aspects, therefore companies try to maintain and increase their values to attract investors and creditors to keep them investing and giving loans for companies' survival.

In this development, a company may conduct various works and strategies to improve its value and present sound financial reporting including conducting accounting irregularities and other financial reporting fraudulent so that it can present attractive financial reporting. Factors leading to accounting irregularities and fraudulent financial reporting are issues surrounding the fraud triangle theory developed by Cressey (1953). This theory provides a model to identify factors that caused fraudsters to commit fraud expressed in three fraud dimensions, namely pressure, opportunity, and rationalization.

This paper develops a conceptual model of the fraud triangle theory dimensions and its elements on accounting irregularities, consisting of pressure dimension with financial stability, leverage, personal financial need, and financial target variables, opportunity dimension with the board independent and nature of industry variables and rationalization dimension with auditor quality variable.

2.0 Background of Study

Numerous financial scandals in the world involving accounting irregularities and fraudulent financial reporting have taken place, some of which include the Enron case in 2001, Worldcom in 2002, and Toshiba in 2015. In Indonesia, there have been problems related to fraudulent financial reporting and accounting irregularities such as in manufacturing companies of PT. Kimia Farma in 2001 and Lippo Bank in 2002. Financial Service Authority (OJK) examined 77 cases that are alleged to be involved in any violation of the provision of financial reporting presentation and charged administration sanctions to industrial actors in capital markets. The case was related to 60 administrative sanctions in the forms of a written warning and, 13 administrative sanctions in the form of suspension of permits (OJK, 2014). Fraudulent financial reporting and accounting irregularities actions are an endless issue, implying that studies on fraudulent financial reporting and accounting irregularities are relevant and in fact crucial to be conducted.

3.0 Development of Conceptual Framework

3.1 Accounting Irregularities

Accounting irregularity is an accounting term in practice that does not conform to the normal laws, practices, and rules of the accounting profession, having the deliberate to deceive or fraud (Hendrikse and Hendrikse, 2003). It consists of intentionally misstating amounts and other information in a financial statement or omitting information required to be disclosed. Accounting irregularities are commonly distinguished from unintentional mistakes or errors and the phenomena have victimised prominent companies including Enron, Tyco, World Com, and Health South, and shaken investors' confidence. A survey by Beasley et al. (2010) shows that initial publication in the press of an alleged fraudulent financial reporting resulted in an average 16.7 percent abnormal share price decline in just the two days surrounding the announcement. More serious accounting irregularities incidences are reflected with more severe negative market reaction. The problem of accounting irregularities can happen everywhere including an emerging market such as. Worries about accounting irregularities are widely cited as the reason for the undermining of investors' trust following these scandals (Jaswadi et al., 2012).

3.2 Dimensions of fraud triangle theory

Fraud triangle theory can be categorised into the following dimensions: pressure, opportunity, and rationalization. Each dimension comprises various elements associated with the theory.

3.2.1 Pressure

Every perpetrator must face some type of pressure to commit fraud while perceived pressure is defined as the motivation that leads the perpetrator to engage in unethical behaviours. It is important to point out that perceived pressures can occur with all employees at any level of the organisation and can occur for various reasons. Such pressure does not have to be real, if the perpetrators believe they are being pressured, it can lead to fraudulent behaviour (Albrecht et al., 2006). Salman (2005) explained that pressure is an incentive encouraging a person for fraud because of lifestyle demands, financial incapability, gambling, trying to defeat the system, and work dissatisfaction. There are four variables under pressure dimension, namely financial stability, leverage, personal financial need, and financial targets.

i. Financial Stability

Financial stability refers to the financial problems experienced by a company caused by economic conditions, industry conditions, or conditions of the operation of the company. At a time when competition between one company with other companies is high, a company is claimed to have always been competitive in order to win the market competition. Companies are expected to be always ahead in using the latest technology, to be in a current state, and to improve the quality of the products it produces. Skousen et al (2009), Mantatya and Daljono (2013), Sihombing (2014), also Tessa and Harto (2016) indicated that financial stability significantly affects financial reporting fraud. The results of the Loebbecke, Eining, and Willingham (1989) and Bell, Szykowny, and Willingham (1991) also showed that cases in which the company experienced growth below the industry average, the management may manipulate financial statements to improve the company's prospects.

ii. Leverage

Leverage is a ratio used to measure the magnitude of assets financed by debt or the proportion of total debt to average shareholders' equity. The leverage ratio gives an overview of the structure of capital owned by a company, so it can be seen as the risk of uncollectible debt. Leverage/external pressure is excessive pressure from a third party to meet the expectations desired by third parties that seek for the place to stay investing. The company must show that it can perform very well so that it can secure for example banking loans. This is done in order for the company to have additional funds to manage its business and increase its capital. The additional loan from the company will increase the company's debt, however, those funds can be used to do research and promote the company. Dalnial et al. (2014) found that total debt to total assets affects the existence of fraud.

iii. Personal financial need

Meeting the financial target set by a company's internal party is excessive pressure on the management or internal parties of an organization or firm (Widarti, 2015). Managers should make sure whether the target can be achieved by selling to prove that these companies have a good sales level and dominate the market competition. High sales levels can improve the bottom line of companies and can boost the dividend that will be distributed by the company. Sales targets should be achieved by the companies to prove the company's performance (AICPA, 2002).

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3.2.2 Opportunity

Opportunity that exists in organizations has a major impact on an individual's decision to commit fraud. Rae and Subramaniam (2008) suggested that, if a susceptible individual perceives opportunities due to a lack of or inefficient internal controls and has the ability or power to exploit these opportunities, that individual may perpetrate a fraud. Perceived opportunity is similar to perceived pressure; the opportunity does not have to be real, the perpetrators simply have to believe or perceive that the opportunity exists to take fraudulent action (Albrecht et al., 2006). Nurbaiti and Hanafi (2017) described that opportunity is a condition giving possibility for a person to act or obtain certain position or place.
There are two variables under opportunity dimension, namely:

i. Independent Board of Director

Ineffective monitoring is the ineffectiveness of an entity in overseeing the performance of the entity because there is no effective supervisory unit to perform the monitoring. The control is not effective because management is dominated by one person or a small group of people without the counterbalance resulting from control. Ineffective monitoring can be caused by a weak internal controls. Ineffective supervision will trigger the onset of the problem of fraud in the entity (Widarti, 2015). A company that has a weak internal controls can complicate a company to oversee the performance of internal party such as manager. If the company is not effective in controlling his company, it will cause a person to have the opportunity for financial reporting fraud (AICPA, 2002*)*. Independent board of directors are believed to have better ability to monitor managers. Firms with boards that are more independent also have a lower incidence of accounting fraud (Agrawal & Chadha, 2005). Yusof et al. (2015) hypothesized less percentage of outside director member (independent nonexecutive director) in BODs indicates higher tendency towards the likelihood of fraud financial reporting.

ii. Nature of industry

The nature of the industry is the situation of the environmental industry that can provide the opportunity for parties to conduct internal financial reporting that is not in accordance with the actual circumstances. This can arise because companies make deals not closely related to business activities. In addition, the company has a strong financial or the ability to dominate the industrial sector that can provide opportunities for cheating by way of dictating terms or provisions to suppliers or customers that resulted in no match with the established conditions.

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Nature of industry related to the emergence of risk for entities that are in industries that involve estimation and significant considerations far greater (Skousen, Smith, Wright &, 2008). Summers and Sweeney (1998) state that when managers intend to conduct financial statement fraud, the manager will focus on accounts receivable that are not collectible and obsolete inventory account for the manipulated (Tiffani & Marfuah, 2015). The inventory contains the risk of misstatement for the manufacturing entity because its preparation consists of raw materials, goods in process, and finished goods. Misstatement supplies would be risky if increasing inventories of obsolete (Kusumawardhani, 2012). Therefore, this research uses the proxy changes to inventories (INVENTORY) to measure the nature of the industry. Changes in inventories (INVENTORY) which affects the occurrence of presumed high financial statements fraud and accounting irregularities.

3.2.3 Rationalization

An attitude or morally acceptable rationalization needs to occur before fraudulent behavior emerges. It is pertinent to acknowledge that fraud perpetrators sometimes do not consider their actions as unethical; they merely justify their actions as ethical before fraud takes place (Dorminey et al., 2010). In other words, rationalization allows the fraudster to view his or her illegal actions as acceptable implying that, if a person cannot justify unethical actions, it is unlikely he or she will engage in fraud. That person, however, may rationalize those actions in different ways using various justifications.

3.2.4 Auditor Quality

Auditor quality is the variable dimension to be tested in this study. Apriliana and Agustina (2017) described that auditor quality is seen as the ability to enhance the quality of financial reporting for a company. The bigger size of public accounting firm leads to better audit quality and minimize the opportunity for financial reporting fraudulent and accounting irregularities (Ardiyani & Utaminingsih, 2015). The quality of the external auditors in detecting fraud could affect financial statements, therefore it needs an auditor who has adequate expertise and capabilities in the audit of the financial statements. The quality of the external auditor is determined based on the difference in the election of the audit of the public accountant appointed by the company that is incorporated in the BIG 4 (PWC, KPMG, Deloitte, Ernest & Young) and Non-BIG 4.

4.0 Conceptual Framework

There are many previous studies on fraud triangle dimensions focusing on fraudulent financial reporting such as Dorminey et al. (2012); Aghghaleh et al. (2014); Rachmawati, K.K., & Marsono, M. (2014), Abdullahi and Mansor (2015); Ruankaew (2015). However, there is a lack of study on the fraud triangle theory concerning accounting irregularities in Indonesia. This study extends the theory of accounting irregularities by using different measurements deemed to be more appropriate. This study will extend the application of agency, and fraud theory within a context of fraud dimension and accounting irregularities.

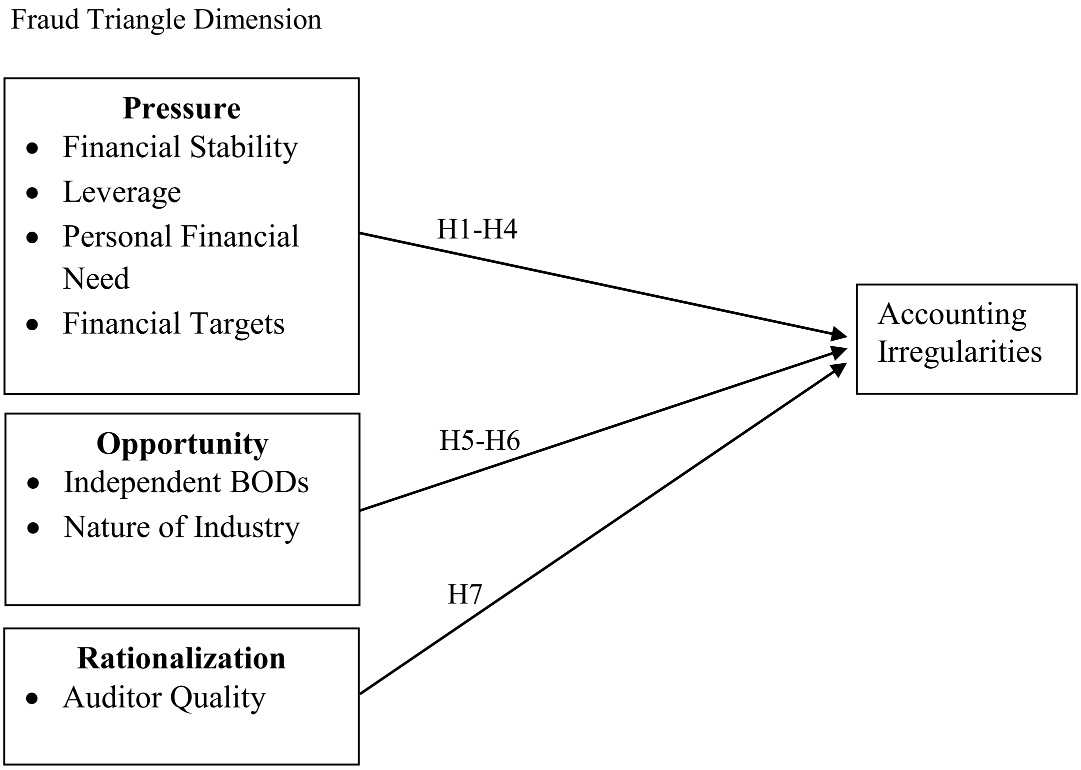

Figure 1: Conceptual Framework of Fraud Triangle Dimension and Accounting Irregularities

5.0 Development of Research Hypothesis

The relationship between variables of the three dimensions under fraud triangle theory and accounting irregularities are discussed as follows:

5.1 Variables of Pressure Dimension

i. Financial Stability

Kurnia and Anis (2017) stated that unstable company conditions lead to pressure for management since the public can see a decrease in company performance so that it can provide obstacles for investment fund flow in the future. Company financial stability is measured based on the number of total asset addition from year to year (Tessa & Harto,2016; Kurnia& Anis, 2017). The number of a total asset owned by a company is attractive for investors, creditors, and other stakeholders. If a company has enormous total assets, it will be considered to be able to provide maximum return for the investors, but in another way, if there is decreased or negative total assets, then, investors, creditors and other stakeholders will not be attracted since the condition of the company is considered to be unstable, incapable to operate appropriately and to be disadvantaged (Tessa& Harto,2016). For the company to conduct various ways to make its financial condition to be stable, one of which is by manipulating their owned assets (Skousen, et al., 2009) hence leading to the conduct of accounting irregularities (Jaswadi et al., 2012).

H1: The financial stability is negatively related to accounting irregularities

ii. Leverage

Leverage is the ratio of total debts on total assets. In running a company, the management is required to have the ability to meet its financial needs one of which is obtained from additional loans or other external financing resources (Skousen et al., 2009). If there is a high ratio of company leverage, it means that the company has large loans and high credit risk. The company will get pressure from the outside party to meet the obligation. Thus, the company will try to engage in fraudulent financial reporting, one of which is by reporting high profitability (Rachmawati & Marsono, 2014). This financial reporting fraudulent is one of the causes of accounting irregularities (Jaswadi et al., 2012).

H2: The leverage is positively related to accounting irregularities

iii. Personal Financial Need

Yesiariani and Rahayu (2016) conducted research using managerial ownership as the measurement of variables for personal financial need in the pressure dimension. The authors described the effects of some stocks owned by the company executive on management policy in expressing the financial performance of a company. By managerial ownership, the manager will have claims on the income and assets of a company, hence there is an effect on a company's financial condition. This means that higher managerial ownership will lead to an opportunity for accounting irregularities to have an impact on the financial condition of a company.

H3: Personal financial need is positively related to accounting irregularities

iv. Financial targets

Financial target is to be achieved by a company in the form of business return while higher profit desired by the company will lead to more works by the management to present its financial reporting as good as possible (Apriliana & Agustina, 2017). There is an implication that the higher the ability of a company to achieve its financial target, the better its performance, but if the company cannot achieve its desired target then the existence of the company will be doubtful (Tessa& Harto, 2016). Any pressure on this target achievement causes financial reporting fraudulent in conducting accounting irregularities.

H4: Financial target is positively related to accounting irregularities

5.2 Variables of Opportunity Dimension

i. Independent Board of Director

Independent board of directors (BODs) are believed to have better ability to monitor managers, and firms with boards that are more independent also have a lower incidence of accounting fraud (Agrawal & Chadha, 2005). Yusof et al. (2015) hypothesized less percentage of outside director member (independent nonexecutive director) in BODs indicates higher tendency towards the likelihood of fraud financial reporting. Hypotheses in this research refer to the hypotheses expressed by Yusof et al. (2015).

H5: The percentage of independent board of director is negatively related to accounting irregularities

ii. Nature of Industry

The measurement used in nature of industry is the total receivable account ratio (Manurung & Hardika, 2015; Kurnia & Anis, 2017), and in this case, a company is said to be in good condition if it has small receivable accounts and an increase in company's cash (Kurnia & Anis, 2017). Summers & Sweeny (1998) asserts that assessment of receivable account and inventory must be conducted subjectively in determining bad credits. Since the assessment is objective, then there is any possibility of the management party to use the account as a tool for financial reporting fraudulent and accounting irregularities.

H6: Nature of industry is positively related to accounting irregularities

5.3 Variable of Rationalization Dimension

i. Auditor quality

Apriliana and Agustina (2017) described that auditor quality is seen as the ability to enhance the quality of financial reporting for a company. Fraud triangle theory describes that a company can have the opportunity to choose the Public Accounting Firm (KAP) and cooperate with them to committ fraud. Bigger size of Kantor Akuntan Publik (KAP) leads to better audit quality and minimize opportunity for financial reporting fraudulent and accounting irregularities (Ardiyani & Utaminingsih, 2015).

H7: Auditor quality is negatively related to accounting irregularities

6.0 Research Contribution and Conclusion

This study extends the fraud triangle theory on accounting irregularities since previous studies employed the theory on the fraudulent financial statements and in particular, there is a lack of study on fraud triangle theory concerning accounting irregularities in the context of Indonesia. in the conceptual framework that is proposed in this study is to determine whether there is any significant relationship between the dimensions of fraud triangle theory on accounting irregularities by using level/type sanction imposed by Financial Services Authority or Otoritas Jasa Keuangan (OJK) on the Indonesian public listing companies categorised as cases of accounting irregularities, as a measurement of accounting irregularities (Jaswadi et al., 2012).

From the theoretical perspective, this study will extend the application of agency theory and fraud theory within a context of fraud dimension and accounting irregularities. However, the context of fraud is very much important in today's research, because this dimension is an endless issue, hence it is relevant and crucial to conduct study to maintain empirical data in overcoming the problems associated with accounting fraud matter.

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