

Fraud Disclosure: Determinants and Implication

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Abstract: The purpose of this research is to analyze factors affecting fraud disclosure and its implication on market reaction. Audit committee, internal audit, managerial ownership, and internal control play important role to reach good governance that can reduce fraud. Whistleblowing system is a part of internal control and expected to strengthen good governance. Minimizing the possibility of fraud is expected to improve the company's reputation as reflected in market reactions. This research was analyzed by using path analysis. Target population is banking industries listed on the Indonesia Stock Exchange. Results showed that audit committee, internal audit, and managerial ownership have a positive effect on whistleblowing system. Internal audit and whistleblowing system have a negative effect on fraud disclosure. Audit committee and whistleblowing system have a positive effect on market reaction, and fraud disclosure has a negative effect on market reaction. This research provides empirical evidence that the better the governance structure the better the whistleblowing system. The better implementation of the whistleblowing system, the less disclosure of fraud. Furthermore, the less fraud disclosure the better the market reaction.

1 INTRODUCTION

Accounting fraud cases still occur until now, including one of the big companies in the UK. At the beginning of the second quarter of 2017, British Telecom known to perform accounting fraud at one of its business lines in Italy. Accounting fraud was detected by a whistleblower. The modus operandi is to perform an increase in the profits of the company for several years through corruptive cooperation with corporate clients and financial services. The practice of accounting fraud has occurred since 2013 with the motive of obtaining a bonus as a stimulus. The fraud scandal caused losses to shareholders and investors where British Telecom's share price plummeted when it announced a correction of its 530 million earnings in January 2017 (Priantara, 2017).

Accounting fraud scandals also occurred on large companies in Japan, namely Toshiba. In May 2015 it was revealed that Toshiba did a lie through accounting fraud, with a value of 1.22 billion US dollars. Toshiba then was removed from the stock index and a significant sales decline occurred. (Sari, 2017).

Accounting fraud cases in Indonesia are dominated by the banking industry. According to the

statement of the Chief Executive of the OJK Banking Supervisor, Nelson Tampubolon, from January to the end of the third quarter of 2016, the Financial Services Authority (OJK) recorded 26 cases of banking crime (OJK, 2016).

Indonesia still has a high risk of fraud and the most detrimental fraud is fraudulent financial reporting (ACFE, 2016). One of the most effective ways to prevent fraud is through a whistleblowing system mechanism where the effectiveness can be seen from the number of frauds that have been detected as well as the shorter time of action compared to other methods. The Whistleblowing System is a part of the internal control system in preventing the practice of irregularities and fraud and strengthening the application of good governance practices (KNKG, Pedoman Sistem Pelaporan Pelanggaran - SPP (Whistleblowing System - WBS), 2008) (KNKG, Pedoman Sistem Pelaporan Pelanggaran - SPP (Whistleblowing System - WBS), 2008). An effective internal control system requires the support of directors as the management of the company, an audit committee that carries out overall supervision, and an internal audit as part of its duties and responsibilities (KNKG, Pedoman Umum Good Corporate Governance Indonesia, 2006).

The market penalizes fraud firms significantly when the prospective fraud news is released to the public (Christensen, Paik, & Williams, 2010). Investors perceive fraudulent reporting to be more prevalent in the economy or rely more on financial statement information relative to other sources of information, they place greater importance on conducting their own fraud risk assessments. In turn, investors who deem fraud risk assessment to matter in investment decision making make greater use of fraud red flags to avoid potentially fraudulent investments (Brazel, Jones, Thayer, & Warne, 2015).

This study is a replication of the research of Cahyo & Sulhani (2017) which indicated that the audit committee had a negative effect on whistleblowing system while the internal audit had no effect on the whistleblowing system. Furthermore, the whistleblowing system did not affect fraud disclosure and fraud disclosure had a significant negative effect on the market reaction. This study intends to reexamine the variables that have been studied by adding managerial ownership variables as one element of the governance structure.

2 THEORETICAL FRAMEWORK

2.1 Audit Committee and Whistleblowing System

The audit committee must have members who are experts in the financial sector to improve the supervision of the company. Increasing oversight of companies has an impact on improved internal control and reduced fraud practices (KNKG, Pedoman Umum Good Corporate Governance Indonesia, 2006). The Audit Committee which has expertise in finance reduces problems in internal control. This means that Audit Committee members who have expertise in finance can increase the effectiveness of internal controls (Khrisnan, 2005). According to Lee and Fargher (2018), higher-quality audit committee is associated with the implementation of a stronger internal whistleblowing system, so the first hypothesis in this study is formulated as follows:

H₁: The audit committee has an effect on the whistleblowing system.

2.2 Internal Audit and Whistleblowing System

The importance of appropriate whistleblowing policies and procedures to the effective discharge of an organization's corporate governance is significant.

Corporate governance is fundamental to effective risk and control within organisations, which means that whistleblowing policies must be at the heart of internal auditors' responsibilities (Cowan, 2014). In other words, internal audit is a party that plays an important role in implementing the whistleblowing system (Read & Rama, 2003).

Internal audit function effectiveness influenced by internal auditor competency (Arum, 2015). Therefore internal audit competencies that measured by expertise in finance will improve the implementation of a whistleblowing system, so the second hypothesis in this study is as follows:

H₂: The internal audit has an effect on the whistleblowing system.

2.3 Managerial Ownership and Whistleblowing System

Managerial ownership can help reduce opportunistic actions to maximize personal interests, in addition managers will also be more careful in making decisions that are in accordance with the interests of the company because it is related to their interests as owners, so that disclosure of internal control information will be more qualified (Wardani & Sulhani, 2017). Therefore the third hypothesis in this study is as follows:

H₃: The managerial ownership has an effect on the whistleblowing system

2.4 Whistleblowing System and Fraud Disclosure

Whistleblowing system can detect the majority of fraud in an organization. Whistleblowing system is a device that can be used to warn management about fraud within the company (KNKG, Pedoman Sistem Pelaporan Pelanggaran - SPP (Whistleblowing System - WBS), 2008). The disclosure of fraud has become an early detection of company management to prevent ongoing fraud (Khan, Anuar, & Mahzan, 2014). So that the fourth hypothesis in this study is as follows:

H₄: The whistleblowing system has an effect on the fraud disclosure

2.5 Fraud Disclosure and Market Reaction

According to ACFE (2016), companies that are indicated to have fraud can reduce their business reputation so that it can cause losses to the company. Disclosure of fraud and the use of financial statement information have an effect on investor perceptions in conducting investment risk assessments (Brazel,

Jones, Thayer, & Warne, 2015). Companies that indicated fraud cases experienced a decline in the stock market reaction (Christensen, Paik, & Williams, 2010). So the fourth hypothesis in this study is as follows:

H₅: The fraud disclosure has an effect on the market reaction.

3 RESEARCH METHOD

The type of research is quantitative research that uses secondary data in its analysis. According to Sekaran & Bougie (2013), secondary data is the data or information collected from available sources. Secondary data for this study was obtained from annual reports of research subject. The data can be downloaded on the relevant company website pages as well as on the Indonesia Stock Exchange website. While the company's stock price data was obtained from the Indonesia Stock Exchange website.

The target population in this study were banking companies listed on the Indonesia Stock Exchange in 2017. All members of the target population were used as samples in the study. Data analysis in this study was tested by using path analysis with SPSS 22 Program.

The object of this research is the audit committee, internal audit, managerial ownership, whistleblowing system, fraud disclosure, and market reaction. The audit committee variable was measured by the ratio of the number of members who have accounting and financial backgrounds to the total number of audit committee members. The internal audit variable was measured by dummy variable, if the head of the division of internal auditors have a background in finance experts then rated 1, and if otherwise then rated 0. The managerial ownership variable was measured by percentage of share ownership by the companies manager. The fraud disclosure was measured by the amount of fraud reported in that period on the annual report, and the market reaction was measured by stock returns.

Hypothesis testing is done to obtain empirical evidence of the influence of the audit committee, internal audit, and managerial ownership on the whistleblowing system. Hypothesis testing is also done to obtain evidence of the influence of the whistleblowing system on fraud disclosure and its implications for market reaction.

4 RESULTS AND DISCUSSION

4.1 The Effect of Audit Committee on Whistleblowing System

Based on statistical testing, it is empirically proven that the audit committee has a positive effect on the whistleblowing system. This can be seen from the direction of the regression coefficient and the significance level of 0.045 which is smaller than 0.05 (table 1). Thus Hypothesis 1 in this study was accepted.

The background of the financial expertise of the audit committee has a role in improving internal control in the implementation of the whistleblowing system. The results of this study indicate that the audit committee has carried out overall supervision including internal control and the Whistleblowing system..

4.2 The Effect of Internal Audit on Whistleblowing System

The result of statistical test showed that internal audit has a positive effect on the whistleblowing system. This is indicated by the direction of the regression coefficient showing a positive number and a significance level of 0.027 which is smaller than 0.05 (table 1). Thus hypothesis 2 in this study was accepted.

The head of the internal audit division with an accounting and financial education background is proven to be able to improve internal control in a whistleblowing system. The internal audit division has a large responsibility in overseeing and ensuring that the internal control function has been running effectively.

4.3 The Effect of Managerial Ownership on Whistleblowing System

The result of statistical test showed that managerial ownership has a positive effect on the whistleblowing system. This is indicated by the direction of the positive coefficient and the significance level obtained is 0.036 which is smaller than 0.05 (table 1). Managerial ownership is indicated by the number of shares owned by the board of commissioners, directors, and management in a company. The results of the observations in this study indicate the percentage and number of share ownership by management is still few. But managerial ownership proved to have a positive effect on the whistleblowing system.

Table 1: Test Results of the Effect of Audit Committee, Internal Audit, and Managerial Ownership on Whistleblowing System

		Coefficients ^a				
Model		Unstandardized Coefficients		Standardized Coefficients	t	Sig.
		B	Std. Error	Beta		
1	(Constant)	.299	.053		5.642	.000
	AC	.074	.096	.120	.764	.045
	IA	.147	.064	.360	2.295	.027
	MO	.141	.179	.115	.787	.036

a. Dependent Variable: WBS

Source: SPSS 22 output based on research data

4.4 The Effect of Whistleblowing System on Fraud Disclosure

Based on the results of statistical testing using SPSS, the whistleblowing system has a negative effect on fraud disclosure. This can be seen in the direction of the negative regression coefficient and the level of significance smaller than 0.05 (table 2). Thus it can be said that hypothesis 4 in this study was accepted.

The existence of a whistleblowing system is to prevent and reduce fraud. Based on the results of this study it can be said that the whistleblowing system is proven to reduce fraud disclosure.

Table 2: Test Results of the Effect of Whistleblowing System on Fraud Disclosure

		Coefficients ^a				
Model		Unstandardized Coefficients		Standardized Coefficients	t	Sig.
		B	Std. Error	Beta		
1	(Constant)	1.077	.179		6.005	.000
	AC	.483	.245	.236	1.973	.056
	IA	-.189	.172	-.139	-1.100	.027
	MO	.384	.454	.094	.845	.040
	WBS	-2.333	.399	-.701	-5.848	.000

a. Dependent Variable: FD

Source: SPSS 22 output based on research data

The direct effect of the audit committee on fraud disclosure is 0.236 while the indirect effect is -0.084, so the total effect is 0.152. The direct effect of the internal audit on the fraud disclosure was -0.139 while the indirect effect was -0.252, so the total effect was -0.391. Furthermore, the direct effect of managerial ownership on fraud disclosure is 0.094 while the indirect effect is -0.081, so the total effect is 0.013.

4.5 The Effect of Fraud Disclosure on Market Reaction.

Based on the result of the study, fraud disclosure has a negative effect on market reaction as measured by stock returns. This can be seen from the direction of the negative regression coefficient and the significance level of 0.002 which is smaller than 0.05 (table 3). Thus it can be said that Hypothesis 5 in this study was accepted.

Based on the research result showed that the lower the level of fraud disclosure, the higher the stock return, and conversely the higher the level of fraud disclosure, the lower the stock return.

The direct effect of the audit committee on the market reaction is 0.363 while the indirect effect is -0.138, so the total effect is 0.225. The direct effect of the internal audit on market reaction is -0.159 while the indirect effect is 0.081, so the total effect is -0.078. The direct effect of managerial ownership on the market reaction is -0.141 while the indirect effect is -0.055, so the total effect is -0.196. Furthermore, the direct effect of WBS on the market reaction is 0.052 while the indirect effect is 0.409, so the total effect is 0.461.

Table 3: Test Results of the Effect of Fraud Disclosure on Market Reaction

		Coefficients ^a				
Model		Unstandardized Coefficients		Standardized Coefficients	t	Sig.
		B	Std. Error	Beta		
1	(Constant)	-.027	.024		-1.137	.263
	AC	.066	.025	.363	2.675	.011
	IA	-.019	.017	-.159	-1.147	.259
	MO	-.051	.044	-.141	-1.162	.253
	WBS	.015	.053	.052	.293	.071
	FD	-.052	.015	-.583	-3.374	.002

a. Dependent Variable: MR

Source: SPSS 22 output based on research data

5 CONCLUSIONS

This research examined the effect of audit committee, internal audit, managerial ownership, and whistleblowing system on fraud disclosure and their implication on market reaction. The results indicated that the better the audit committee, the better the whistleblowing system. The better the internal audit, the better the whistleblowing system. The better the managerial ownership, the better the whistleblowing system. Whistleblowing system has a negative effect

on fraud disclosure and fraud disclosure has a negative effect on market reaction.

This research is only conducted on banking companies listed on the Indonesia Stock Exchange in 2017, therefore the further research is expected to expand observations on other type companies. This study also only used stock returns to measure market reaction, therefore further research is expected to use other indicators to measure market reaction, such as abnormal returns and cumulative abnormal returns. Further research is also expected to examine other variables that related to good governance to explain their effect on fraud disclosure and market reaction.

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