# CHAPTER II

# LITERATURE REVIEW AND HYPOTHESIS DEVELOPMENT

## 2.1 THEORETICAL FRAMEWORK

### *2.1.1 The Agency Theory*

Agency relationships are defined by (Jensen & Meckling, 1976) as "a contract under which one or more persons (the principals) engage another person (the agent) to perform some service on their behalf, which involves delegating some decision-making authority to the agent." An agency relationship is a contract in which one or more individuals (principals) instruct another individual (agent) to execute a service on their behalf and authorize the agent to make the best decisions for the principal. If both parties share the same goal of increasing the value of the company, it is assumed that the agent will work in accordance with the principal's interests. The relationship between shareholders as principals and management as agents is described by agency theory. Management is a party hired by shareholders to work in their best interests. Because they were chosen, management must account to the shareholders for all of their activities. The relationship between principal and agent can result in the existence of asymmetries in information, as the agent is able to have more knowledge about the organization than the principal. Under the assumption that individuals work to maximize their own interests, the agent will conceal knowledge that is unknown to the principal due to asymmetrical information. Under this asymmetrical scenario, an agent can falsify the financial report's accounting numbers as an effort to improve personal welfare or to cover up poor management performance in managing the company.

### *2.1.2 Financial Statement Fraud*

Financial statement fraud is a fraud committed by presenting financial statements that do not present the actual state of the company so that it can give the reader a wrong picture of the company's performance. Based on (Rezaee, 2009) define fraudulent financial reporting as follows: "Financial statement fraud is a deliberate attempt by corporations to deceive or mislead users of published financial statements, especially investors and creditors, by preparing and disseminating materially misstated financial statements". Fraud in financial statements can be done by increasing the value of assets, income, and profits excessively and reducing the value of liabilities, costs, and losses excessively.

### *2.1.3 Fraud Triangle*

Sutherland introduced the concept of fraud triangle initially in 1949, and it was developed and reintroduced by the Criminologist Dr. Donald R. Cressey (1953) in his study on embezzlement. The act of misappropriation of company money by the perpetrators comes from a pressure (pressure). With regard to pressure, there are four conditions that can lead to financial statement fraud according to SAS No.9: financial stability, external pressure, personal financial need, and financial objectives. The opportunity, on the other hand, is comprised of three distinct sets of circumstances: the character of the sector, inefficient monitoring, and the current organizational setup. Rationalization is the final contributing factor to fraud. Rationalization causes fraud perpetrators to seek justification for their actions.

### *2.1.4 Fraud Diamond*

According to (Wolfe & Hermanson, 2004), to enhance the prevention and detection of fraud, the fourth element must be considered. In addition to pressure, opportunity, and rationalization, the capability of the individual must also be taken into account. Capabilities are personal characteristics and abilities that play a significant role in the fraud that can occur even when the other three elements are present. These four components are collectively referred to as "Fraud Diamond" (Wolfe & Hermanson, 2004).

Wolfe and Hermanson argue that the addition of a fourth element, capability, to the renewal fraud triangle will enhance the ability to detect and prevent fraud. "Many frauds, particularly those involving billions of dollars, would not have occurred if the right person with the right skills had not been in place. Opportunity is the key that unlocks the door to fraud, and incentives and rationalization can entice a person to commit it. However, the individual must have the capacity to recognize the open doorway as an opportunity and to take advantage of it by walking through it repeatedly. Accordingly, the crucial question is, "Who could turn a fraud opportunity into a reality?" This implies that many frauds that are typically large in nominal terms would not have been possible if the company lacked specific individuals with specialized skills. Opportunity creates opportunities or entrances for committing fraud, as well as pressure and rationalization that encourage fraud.

From the above explanation of the theory, it is clear that fraud generally occurs due to the pressure to commit fraud, the desire to take advantage of opportunities, the existence of generally accepted justification for these actions, and the existence of individuals with the ability to commit fraud. Also, in this research, to review arrogance or ego in fraud pentagon and hexagon, the data that is needed is the company that shows the existence of multiple positions in the CEO (Board of Directors) of a company. Then for this sector, only 9 companies list multiple positions on their Board of Directors. Therefore, it cannot be done to review Ego in this sector, so it can only be reviewed up to Fraud Diamond.

## 2.2 PREVIOUS RESEARCH

The following is a table consisting of previous studies that are related to the title of the author's research topic. The table consists of the name of the previous researchers and the years of research published, the title, the variables used, along with the research results.

| No | Researcher | Title | Variables | Findings |
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| 1 | (Yesiariani & Rahayu, 2017) | Fraud Financial Statement Detection: Testing With Fraud Diamond | $X_1$ = Financial Stability<br>$X_2$ = External Pressure<br>$X_3$ = Personal Financial | The results of this study, namely External pressure and Rationalization, have proven to have a significant positive effect on Fraud Financial Statements. Then, Financial Stability and |

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| | | | Need<br>$X_4$ = Financial Target$X_5$ = Nature of Industry<br>$X_6$ = Ineffective Monitoring<br>$X_7$ = Change inAuditor<br>$X_8$ = Rationalization$X_9$ = Capability<br><br>Y = Financial Statement Fraud | Financial Target have a significant negative effect on the Fraud Financial Statement.<br>Meanwhile, Personal Financial Need, Nature of Industry, Ineffective Monitoring, Change in Auditor and Capability have no effect on Fraud Financial Statements. |
| 2 | (Rahmayuni ,2018) | Analysis of the Effect of Fraud Diamond on Fraud Financial Statements (Empirical Study of Manufacturing Companies Listed on the IDX in 2013-2016) | $X_1$ = Financial Stability<br>$X_2$ = External Pressure<br>$X_3$ = Financial Target$X_4$ = Nature of Industry<br>$X_5$ = Change inAuditor<br>$X_6$ = Capability<br><br>Y = Financial | The result showed that Financial Stability variable has significant positive effect on Financial Statement Fraud. Financial targets variable has a significant negative effect on detecting Fraudulent Financial Statements. Auditor change variable has no significant positive effect. External pressure, Nature of Industry, and Capability has no significant negative effect |

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| | | | Statement Fraud | in detecting Fraudulent Financial Statements. |
| 3 | (Rengganis et al., 2019) | The Fraud Diamond: Element in Detecting Financial Statements of Fraud | $X_1$ = Financial Stability $X_2$ = External Pressure $X_3$ = Financial Target$X_4$ = Number of Audit Committees $X_5$ = Effective Monitoring $X_6$ = Number of Audit Committee Meetings $X_7$ = The Audit Opinion Report $X_8$ = Changes ofDirectors<br><br>Y = Financial Statement Fraud | The results of the analysis of this study are elements of Pressure indicating that only Financial Target variables have a positive effect on Financial Statement Fraud. The Opportunity element shows the variable Number of Audit Committees, Independent Commissioners and The Number of Audit Committee meetings that have a negative effect on Financial Statement Fraud. The Rationalization element shows that the Audit Opinion variable has no effect on Financial Statement Fraud. The Capability element shows that the Change of Director's variable has no effect on Financial Statement Fraud. |
| 4 | (Prastyo et al., 2022) | Analysis of Determination of | $X_1$ = Financial | The conclusion in this study is that Financial |

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|---|---|---|---|---|
| | | Fraud Diamond in Detecting Fraudulent Financial Statements | Stability $X_2$ = External Pressure $X_3$ = Financial Target$X_4$ = Ineffective Monitoring $X_5$ = Change onAuditor $X_6$ = Change inDirector<br><br>Y = Financial Statement Fraud | Stability has an effect on fraudulent financial statements. External Pressure has no effect on fraudulent financial statements. Financial Target has no effect on fraudulent financial statements. Ineffective Monitoring (KAP BIG4) has no effect on fraudulent financial statements. Rationalization (Change On Auditor) has significant effect on fraudulent financial statements. Capability (Change In Director) has significant effect on fraudulent financial statement. |
| 5 | (Pratiwi & Ghozali, 2022) | Diamond Fraud Dimension Analysis in Detecting Financial Statement Fraud in Companies Manufacturers Listed on the Indonesia Stock | $X_1$ = Financial Stability $X_2$ = External Pressure $X_3$ = Financial Target$X_4$ = Nature of Industry $X_5$ = | Financial Stability has a significant effect, Financial Targets have a significant effect, Nature of industry has a significant effect, and Monitoring Effectiveness has a significant effect. Related Party Transaction, External Pressure, Auditor |

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| | | Exchange | Effective Monitoring<br>$X_6$ = Related Party Transaction<br>$X_7$ = Auditor Change<br>$X_8$ = Changes ofDirectors | Change, and Director Change has no significant effect. |

## 2.3 HYPOTHESES DEVELOPMENT

**External Pressure**. External Pressure is excessive pressure exerted by third parties on management, for instance in the form of goals or expectations. To overcome these constraints, companies require additional debt or external sources of financing, such as financing research and development or capital expenditures, in order to remain competitive (Wolfe & Hermanson, 2004). The need for external financing is proportional to the cash flow generated by debt financing (Skousen et al., 2008). In this research, external pressure is proxied by the leverage ratio (LEV). This ratio can be used to determine the proportion of a company's liabilities and equity that are used to finance the company. A high ratio of debt-to-equity will put pressure on management, which will result in financial statement deceit.

Based on these arguments, this study hypothesizes that:

**H1: External Pressure has positive effect to the possibility of fraudulent misstatements.**

**Ineffective Monitoring.** The existence of fraudulent practices in companies is the impact of a low supervision conducted by managers. This phenomenon provides opportunity to company’s agent, which is the manager to behave defiantly. Fraud can be minimized by applying a good monitoring system. The existence of board of independent commissioner, the company’s monitoring system is expected to be more effective, and the fraud can be minimized. Therefore, monitoring effectiveness can be proxied by the ratio board of independent commissioner (BDOUT) (Cressey, 1953).

Based on these arguments, this study hypothesizes that:

**H2: Ineffective Monitoring has positive effect to the possibility of fraudulent misstatements.**

**Auditor Change.** Auditor is an important supervisor in financial report. Information regarding a company which is indicated having fraud usually comes from the auditor. Nauval, M. (2014**)** stated that the more often a company changes its auditor, then the higher the risk of financial shenanigans in the company, because the fraud perpetrators feel confident that their actions will not be detected due to the auditor change. Rationalization is self-justification for a mistake or fraud that has been done before. Rationalization is measured using a proxy AUDCHANGE for external auditor turnover in a company. Changing the external auditor in a company is considered to eliminate traces of fraud found by the previous auditor.

Based on these arguments, this study hypothesizes that:

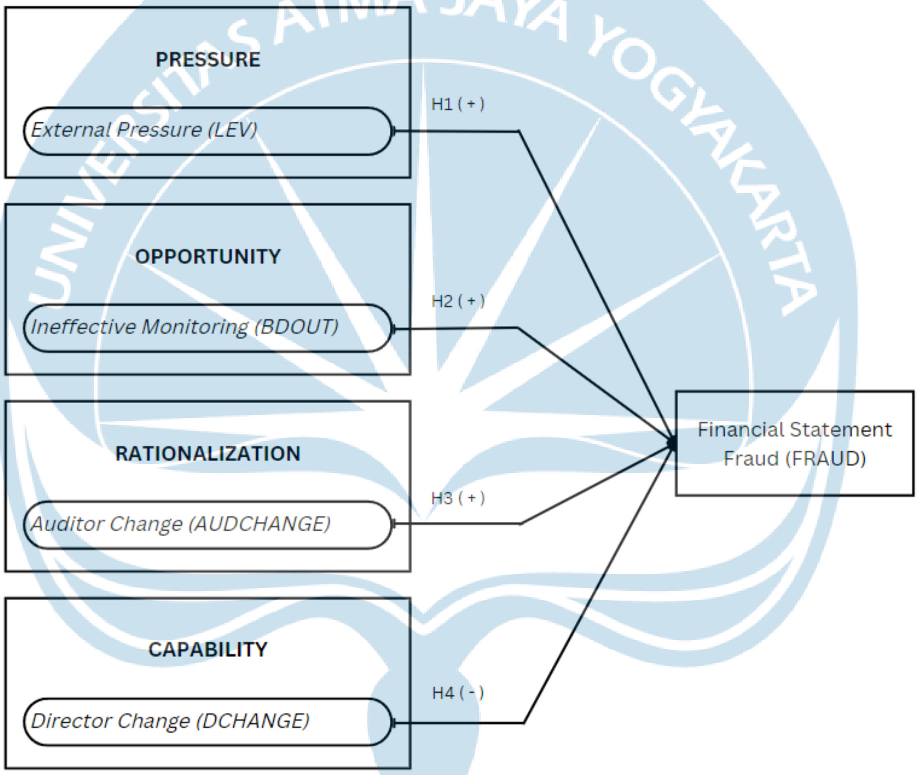
**H3: Auditor Change has positive effect to the possibility of fraudulent misstatements.**

**Director Change.** Capability as one of the fraud risk factors underlying the occurrence of fraud and concluded that changes in directors may signal fraud (Wolfe & Hermanson, 2004). Changes in company leadership do not always have positive effects. Changes in directors can be an endeavor by a company to improve the performance of previous directors by altering the composition of the board or by recruiting new directors who are viewed as more competent. Because it takes time to adapt, a change in the board of directors can result in inferior initial performance by the new board. During such circumstances, the board has an opportunity to engage in fraudulent acts. Principals may also make changes to the board of directors to replace the former directors who committed fraud. Principals expect that the new, competent directors will increase the company's performance with the change in the board. Therefore, the director change is measured using a proxy DCHANGE. The researcher proposes the following hypothesis based on this description.

**H4: Director Change has negative effect to the possibility of fraudulent misstatements.**

Based on those explanations, the conceptual framework in this study is as follow:

*Figure 1 Conceptual Framework*




Source: Researcher Analysis (2023)