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The Factors Affecting Fraudulent Financial Reporting in the Fraud Triangle Perspective

Lintang Wahyuningrum[a], Iswajuni[b*], [a,b]Department of Accounting, Faculty of Economics and Business Universitas Airlangga, Email: [b*]iswajuniunair@gmail.com

Earlier studies suggest that fraudulent practice in financial reporting reflects weakness of an internal control in management. Due to this reason, sufficient understanding about factors affecting fraudulent financial reporting is needed, especially in the fraud triangle perspective. This study aims to identify the effects of financial stability, external pressures, personal financial needs, financial targets, effectiveness of supervision, and auditor turnover for fraudulent financial reporting. The sample used in this study were non-financial companies listed in Indonesia Stock Exchange 2008-2013. Sampling was done using purposive sampling technique. The total obtained sample was 87 companies. Analysis was done using logistic regression analysis technique with the significance level of 5%. The results showed that the financial stability variable with the proxy of total assets change (ACHANGE) obtained a positive coefficient of 1.342 with a significance of 0.483, an external pressure variable with a proxy for leverage (LEV) obtained a negative coefficient of 1.320 with a significance of 0.411, a variable of personal financial needs with a proxy of share ownership by insiders (OSHIP) obtained a positive coefficient of 7.640 with a significance of 0.429, a financial target variable with a return on asset (ROA) proxy obtained a negative coefficient of 7.652 with a significance of 0.043, a variable effectiveness of supervision with a proxy proportion of independent commissioners (IND) obtained a negative coefficient of 0.729 with a significance of 0.788 and a significance of 0.788 and auditor change variable (AUDCHANGE) obtained a positive coefficient of 1.076 with a significance of 0.118. Financial targets have a significant negative effect on fraudulent financial reporting while financial stability, external pressures, personal financial needs, effectiveness of supervision, and auditor changes do not significantly influence fraudulent financial reporting. This study contributed to the addition of literature and can be used as a reference in company management to minimise fraud.

Key words: *Fraud Triangle, Financial Statement, Company Management.*

Introduction

Fraudulent practices in financial reporting continue to occur, both individually and in groups by working together in an organisation to commit fraud (Hermansyah, 2017; Soewarno & Mardijuwono, 2018). Management arrangements are important to be carried out in every company (Agustia, Sawarjuwono, & Dianawati, 2019; Rochmah, Ratnasari, & Robby, 2019; Setianto & Pratiwi, 2019; Tjahjadi, Shanty, & Soewarno, 2019). This reflects the weakness of internal control in management. According to Cressey (in sparking the concept of the fraud triangle, hereinafter known as an illustration that depicts three key elements that encourage a person or group to commit fraud, namely pressure, opportunity, and rationalisation), the concept of the fraud triangle was introduced in professional literature in SAS No.99, Consideration of Fraud in a Financial Statement Audit. It was concluded that the three key elements are always present in fraud practices (Dorminey, Fleming, Kranacher, & Riley Jr, 2010; Kassem & Higson, 2012).

A stable financial condition of a company will increase the value of the company in the eyes of investors, creditors, and the public (Skousen, Smith, & Wright, 2009). These pressures encourage the management to always maintain the financial stability of the company. However, when they have to face an unstable financial condition, there is a possibility that management will state the opposite conditions in the financial statements. The poor condition of financial stability motivates the management to use financial statements as a tool to cover the condition by committing fraud in order to make up the company image.

Management is often under pressure to meet the requirements or expectations of external parties. In relation to creditors as lenders of funds, managers feel obliged to always display the company's financial condition in good condition in order to gain the trust of creditors. When management fails to achieve good conditions, manipulation of financial reporting will be done to cover up the actual conditions from external parties so that they can still gain trust, even though the company's condition is not good.

The personal financial needs of company executives who have a portion of ownership in the company will affect the company's financial condition. This ownership is considered to be able to overcome agency conflicts between shareholders and management team because then management team will also feel the right to be the owner, so that the interests between the two parties are aligned (Martantya, 2013). This condition was strengthened by a research conducted by Skousen et al which proved that the higher the percentage of share ownership owned by insiders, the less likely the occurrence of fraud in financial reporting (Skousen, Smith, & Wright, 2009).

The management team as a contracted party appointed by shareholders is obliged to meet certain financial targets, which is in accordance with the requests of shareholders. However, in reality the financial targets given to the management team sometimes cannot be achieved; the failure reflects the poor performance of management. In order to cover up the failure, management will manipulate the financial statements so that they still appear successful in achieving the financial targets, which become their obligations, despite the opposite occurring in reality.

The ease of manipulating financial statements is supported by the asymmetric information between shareholders and management. As an internal party, the management team has more information about the company compared to shareholders. This situation provides an opportunity for management to hide information that they deem as unnecessary to shareholders. Effectiveness of supervision is needed to avoid management taking advantage of this opportunity. The effectiveness of supervision is very dependent on the level of good corporate governance of a company because fraudulent financial reporting is often associated with corporate governance. Dechow, Sloan, & Sweeney concluded that companies who had weak corporate governance and were dominated by insiders tended not to have an audit committee so that they experienced the highest incidence of fraud (Dechow, Sloan, & Sweeney, 1996). This statement is reinforced by Dunn's opinion which stated that fraud is more likely to occur when there is a concentration of power in the hands of insiders (Dunn, 2004).

Indications of fraudulent practices in financial reporting can also be reflected in frequent auditor changes in the cycle of a company. According to Skousen et al, the audit failure rate increases when there is a change of independent auditors. Skousen *et al* argued that the change of auditors was carried out by the company to prevent the discovery of fraudulent financial reporting because independent auditors who are still new do not fully understand the condition of the company. Besides, the limited audit process period also became an obstacle for the auditors in detecting hidden fraud. (Skousen, Smith, & Wright, 2009).

Fraudulence in financial reporting is usually not only done by company management. It can also occur with the assistance of auditors who conduct audit assignments, whose independence decreases. This action can be fatal and detrimental to many parties in the future. Not only will the company's reputation be bad, but the auditors involved will also be penalised for collaborating in violation of their professional code of ethics. Responding to this, Indonesia requires periodic change of accountant offices and audit partners as stipulated in the Decree of the Minister of Finance of the Republic of Indonesia Number 359/KMK.06/2003 article 2 concerning "Public Accountant Services" which is then updated with the Minister of Finance Regulation Number 17/PMK .01/2008. It provides that the provision of general audit services on the financial statements of an entity can be done by the

Public Accounting Firm (KAP) for a maximum of 6 (six) consecutive financial years and by a public accountant (AP) for a maximum of 3 (three) consecutive book years.

Literature Review

Agency Theory

Agency theory is the basis for companies to understand corporate governance concepts. This theory describes a relationship between shareholders as principal and management as agents in a company. The relationship is stated as a contract between shareholders and management. Shareholders authorise management to carry out all activities on behalf of shareholders in their capacity as decision-makers (Hellwig, 2009). The relationship between shareholders and management can lead to asymmetric (gaps) information because management's position as an internal party allows them understand the company conditions better than shareholders do.

In reality, profit targets set by shareholders cannot always be achieved by managers. This unachieved target creates pressure on managers, and moves them to process information in such a way that the unachieved target profit will be covered by other conditions. The description is in accordance with the assumptions of Eisenhardt's theory which reveals three basic human traits in agency theory, namely: (1) humans are generally selfish, (2) humans have limited thinking power about future perceptions, (3) humans always avoid (Fayezi, O'Loughlin, & Zutshi, 2012). Thus, based on human nature, managers will prioritise their personal interests over the interests of the owners, or better known as opportunistic.

Cressey coined a theory that says that there are three conditions that are always present when fraudulent financial reporting occurs. The three conditions are pressure, opportunity, and rationalisation. All three support each other, which is then known as the fraud triangle. Cressey thinks that people who are trusted will become violators of trust when he/she is experiencing financial difficulties; this is an illustration of the pressure factor (Dorminey et al., 2010; Kassem & Higson, 2012). Then they would feel that the difficulties would be resolved by secretly abusing their authority in the financial sector; this was the opportunity factor. Behaviour allows people to adjust as a person who could be trusted to use the wealth entrusted, and this situation is called a factor of rationalisation. Therefore, this study aims to identify and analyse the effects of financial stability, external pressures, personal financial need, financial target, effectiveness of supervision, and auditor turnover for financial statement fraud.

Financial Stability

Financial stability is a condition that describes the company's financial condition in a stable condition. Companies which are stable financially may increase the value of the company to the investors, creditors, and the public (Skousen, Smith, & Wright, 2009). This condition demands management to be committed fraud to improve the firm's outlook. According to SAS No. 99, the management tends to commit fraud when financial stability is threatened by economic, industry, and entity operating conditions. Management often gains pressure to represent properly management assets. Then assets become a reflection of the company's wealth that can show the company's outlook. The total assets growth means company growth, the possibility below assets, and the company resorts to financial statement manipulation for improving the investor, creditor, and public's outlook. Therefore, the turnover of the ratio of total assets of the company is used as a proxy for financial stability. Based on this description, this study proposes the following hypothesis:

H1: Financial stability affects financial statement fraud.

External Pressure

The company operation performing is inseparable from debt or competitive equity financing, including research funding and development or capital expenditure (Skousen, Smith, & Wright, 2009), so that companies often get pressure from external parties to fulfill their obligations. The company can return to obtaining debt. The high leverage ratio reflects that the company has a large amount of debt and a large amount of credit risk. Then a large amount of credit risk raises the companies' concern about the difficulty of repaying debt. This condition encourages the management to manipulate financial statements to fulfill the obligations. Therefore, in this study, leverage is used as a proxy for external pressures. This study proposes the following hypothesis:

H2: External pressure influences financial statement fraud.

Personal Financial Need

The previous studies state that when the executives have a significant financial stake in a firm, their financial situation may be threatened by the firm's financial performance (Beasley, 1996; COSO, 1999; Dunn, 2004). The existence of executive company shares may affect management policies of the company's financial performance so that this ownership creates the manager's power in managing the company (Martantya, 2013). Based on this description, this study proposes the following hypothesis of personal financial needs:

H3: Personal financial needs affect fraudulent financial statements.

Financial Target

Managers as parties are contracted by shareholders and should achieve the targets set by shareholders. The demand to always show the best performance to achieve the planned targets, and to motivate managers to do various things so that performance always looks good, because managers do not want to be deemed unable to manage the company. Bonuses or compensation received by managers is influenced by the performance produced. Low profits are generated by companies and causes the pressure for managers to commit fraud by serving more of financial statements (Subroto, 2012). This study proposes the following hypothesis:

H4: Financial targets affect fraudulent financial statements.

Effectiveness of Supervision

Based on previous theories, management and shareholders have different interests; however, both of them have needs that are mutually wanted. Then as an internal party, management has more information than shareholders. This asymmetry of information provides a loophole for management to commit fraud. One of the ways in minimising fraud is by controlling the oversight mechanism maximal until impossible the fraud occurred. Then it stated in Statement on Audit Standards (PSA) No. 70, that some financial statement fraud can arise from the dominance of earnings management or small groups without any control that compensates for these conditions, for example, supervision by the board of commissioners or the audit committee. Therefore, another party is needed such as the board of commissioners, which increases the level of supervision until it is prevented. The board of commissioners acts like an independent person who has no relationship with directors, managers, shareholders, or other parties. Having a board of commissioners is expected to create corporate supervision more effective and fraud practices that can be minimised. Therefore, in this study, the effectiveness of supervision is proxied by the proportion of independent commissioners' boards. Below is the following hypothesis about the effectiveness of supervision:

H5: The effectiveness of supervision affects financial statement fraud

Change of Auditors

Auditors are important parties in overseeing financial statements. From these auditors, we can find out the existence of fraud in a company. The changing of the auditor is often applied by companies that commit fraud. According to Skousen et al statement, a company can replace auditors to reduce the possibility of detecting fraudulent financial statements by the auditor

(Skousen, Smith, & Wright, 2009). This condition can be caused by management tending to choose auditors who have the same interests as the company's management (Trisnawati & Wijaya, 2009). Based on this description, this study proposes the following hypothesis:

H6: Auditor change influences financial statement fraud.

Methodology

This study applied an explanatory approach that aimed to get an explanation of the relationship (causality) of each variable through hypothesis testing. The object of the research was companies engaged in the non-financial sector that have published financial reports for the years 2008 to 2013 on the Indonesia Stock Exchange and fulfilled the criteria set out in purposive sampling. According to the sanction report issued by the Jakarta Financial Services Authority, the predetermined criteria include non-financial companies that commit fraud, non-financial companies that do not commit fraud and are listed on the Corporate Governance Perception Index (CGPI) which is used as a partner for companies that commit fraud, companies that publish financial statements, non-financial companies that present financial reports in units of Rupiah, and companies have the data needed in this study, such as certain accounts to meet financial ratios that serve as variable proxies.

Based on these criteria, there are 87 companies as a sample. The sample size is 11 companies in 2008, 15 companies in 2009, 14 companies in 2010, 20 companies in 2011, 12 companies in 2012, and 15 companies in 2013.

Fraudulent Financial Reporting

The Association of Certified Fraud Examiners (ACFE) defines fraudulent financial reporting as an intentional act or negligence that affects financial reports for investors or creditors. The measurement of the financial statement fraud uses a dummy variable by giving a score of 1 to companies that commit financial statements' fraud and a score of 0 to companies that do not commit financial statements' fraud.

Financial Stability

The variable of percentage change in assets for two years prior to fraud (ACHANGE) can be calculated using the following formula:

$$\text{ACHANGE}=\frac{\text{Total Assets}_t\text{-Total Assets}_{t-1}}{\text{Total Assets}_t}$$

External Pressure

Managers may feel pressure as a result of the need to obtain additional debt or equity financing to remain competitive. Below is a formula of the external pressure variable including leverage ratio (LEV) as a proxy:

$$\text{LEV}=\frac{\text{Total Debt}}{\text{Total Assets}}$$

Personal Financial Need

An insider share indicates the manager has claimed the rights to the company's income and assets. Based on this statement, personal financial needs related to ownership in the firm held by insiders (OSHIP). Below is the formula to calculate the personal financial need:

$$\text{OSHIP}=\frac{\text{Total Insider Stocks}}{\text{Total Issued Stocks}}$$

Financial Targets

ROA is a profitability ratio that is usually used to measure a company’s operational performance. It also presents the efficiency of using assets. Furthermore, ROA is also used as an indicator to decide the amount of bonus for a manager. According to those utilities, ROA becomes a proxy of the financial goals that can be counted with a formula as follow:

$$\text{ROA}=\frac{\text{Net Income}}{\text{Total Assets}}$$

Supervision Effectiveness

Supervision effectiveness is proxied by the proportion of the independent board commissioners (IND) that is measured with a formula as follow:

$$\text{IND}=\frac{\text{Total Independent Commissioners}}{\text{Total Commissioners}}$$

Auditor Change

This study used a proxy of independent auditor change (AUDCHANGE), which is measured using dummy variables by giving a score of 1 for the company that does auditor change and a score of 0 for the company that does not do auditor change.

Finding and Discussion

Effect of Financial Stability on Fraudulent Financial Reporting

Table 1: The effect of variables on fraudulent financial reporting

		B	**S.E.**	**Wald**	**Df**	**Sig.**
Step 1[a]	Achange	1.342	1.913	.492	1	**.483**
	Lev	-1.320	1.605	.677	1	**.411**
	Oship	7.640	9.658	.626	1	**.429**
	Roa	-7.652	3.776	4.107	1	**.043**
	Ind	-.729	2.717	.072	1	**.788**
	Audchange	1.076	.688	2.449	1	**.118**
	Constant	**-.902**	**1.336**	**.455**	**1**	**.500**

The hypothesis testing shows that the financial stability variable with the proxy of total assets' change towards the probability of a company making the fraudulent financial reporting practice, has a positive coefficient of 1,342 with the significance of 0,483. The higher significance value than the significance level (0.05) accounted for the fact that the total assets' change does not have a significant effect on the probability of a company making fraudulent financial reporting practice. The company deficient in financial stability will not motivate the management to do fraudulent financial reporting, namely by manipulating the assets' wealth related to the growth of assets owned to improve the company's prospects.

This study is in line with Lou and Wang and Diane and Ratmono's studies, which stated that a significant total assets' change would not predispose to the fraudulent financial reporting done by the management. However, these studies failed to prove the studies of Skousen *et al.* and Martantya that indicate if the assets increase, so the fraudulent financial reporting trend will also increase (Diany & Ratmono, 2014; Lou & Wang, 2009; Martantya, 2013; Skousen, Smith, & Wright, 2009).

Effect of External Pressure on Fraudulent Financial Reporting

Based on the hypothesis testing, external pressure with the leverage (LEV) proxy on the probability of a company doing fraudulent financial reporting practice has a negative coefficient of 1,320 with the significance of 0.411. The higher significance value compares to the significance level (0.05) shows that leverage does not have a significant effect on the probability of a company doing fraudulent financial reporting practice. This indicates that the degree of leverage does not provoke pressure on management, so it does not motivate management to make fraudulent financial reporting.

The result of this study substantiates the empiric proof found by Skousen *et al.,* Sukiman and Siti, and Martantya, which stated that external pressure with leverage proxy does not have a significant effect on fraudulent financial reporting (Martantya, 2013; Skousen, Smith, & Wright, 2009; Sukirman & Sari, 2013).

Effect of Personal Financial Need on Fraudulent Financial Reporting

The hypothesis testing reveals that the personal financial need variable with insider stock ownership (OSHIP) proxy on the probability of a company doing fraudulent financial reporting practice has a positive coefficient of 7.640 with the significance of 0.429. The higher significance value than the significance level (0.05) explains that insider stock ownership does not have a significant effect on the probability of a company doing fraudulent financial reporting practice. This statement concludes that insider stock ownership percentage does not affect the fraudulent financial reporting done by the management.
This study is in line with Martantya's study, which stated that insider stock ownership has no significant effect on fraudulent financial reporting. However, the result of this study contradicts Skousen *et al.*'s study that showed there is a significant effect between insider stock ownership and fraudulent financial reporting. Skousen *et al.* managed to prove that a large insider stock ownership percentage will increase the chance for the management to take control of the company's internal affairs (Skousen, Smith, & Wright, 2009).

Effect of Financial Targets on Fraudulent Financial Reporting

According to the tested hypothesis, the financial target variable with return on asset (ROA) proxy on the probability of a company doing fraudulent financial reporting practice has a negative coefficient of 7.652 with the significance of 0.043. The significance value that is lower than the significance level (0.05) explains that ROA has a significant negative effect on the probability of a company doing fraudulent financial reporting practice. This means that the lower the ROA score, the higher the probability of a company doing fraudulent financial reporting practice. This condition happens because the management felt pressured to achieve the profit target, which is at least the same with previous year profit, that motivates management to do fraudulent financial reporting.

The result shows H_4, which stated that the financial target affects fraudulent financial reporting. This result is consistent with the study conducted by Manurung and Hardian, and Martantya which stated that the financial target with return on assets' proxy has a significant effect on fraudulent financial reporting (Manurung & Hadian, 2013; Martantya, 2013). However, the results of this study are contradictory to Skousen *et al.* and Sukirman and Sari's studies, which revealed that there is no influence between return on assets and fraudulent financial reporting (Skousen, Smith, & Wright, 2009; Sukirman & Sari, 2013).

Effect of Supervision Effectiveness on Fraudulent Financial Reporting

The hypothesis testing shows that the supervision effectiveness variable with an independent commissioner proportion proxy on the probability of a company doing fraudulent financial reporting practice has a negative coefficient of 0.729 with the significance of 0.788. The significance value that is lower than the significance level (0.05) explains that the proportion of the independent commissioners has no significant effect on the probability of a company doing fraudulent financial reporting practice.

The appointment of an independent commissioner board by the company can merely be carried out for compliance with regulations. However, it is not intended for good corporate governance (GCG) in the mechanism of attempts to prevent the misstatement of financial reporting (Susanti, 2014). Furthermore, Susanti added that it is not the proportion of independent commissioners that affect fraudulent financial reporting practice. However, the quality of the independent commissioners is believed to affect the fraudulent financial reporting. The Independent Commissioners board, who have much work to do and do not have time for the company because of their schedules, will give a loophole for fraudulent financial reporting. Thus, it can be concluded that the presence of independent commissioners as the controller does not work optimally. This state shows that appointment or expansion in the number of independent commissioner board members could merely comply with the formal provisions. Meanwhile the majority of stockholders (controllers) still hold an important role so that the board performances do not increase or even decrease.

Effect of Auditor Change on Fraudulent Financial Reporting

The tested hypothesis shows that the auditor change variable (AUDCHANGE) on the probability of a company doing fraudulent financial reporting practice has a positive coefficient of 1.076 with the significance of 0.118. The higher significance value than the significance level (0.05) explains that auditor change has no significant effect on the probability of a company doing fraudulent financial reporting practice. This can be caused by observational data used as the company's sample has a relatively similar condition in terms of auditor change, which is mandatory. This is carried out as a form of compliance with government regulations governing auditor rotation obligations.

This result objects H_6, which stated that auditor change affects fraudulent financial reporting. This means that auditor change does not significantly affect the probability of a company doing fraudulent financial reporting practice. The result of this study substantiates the empiric prove found by Skousen *et al.,* which does not find the effect on auditor change and fraudulent financial reporting (Skousen, Smith, & Wright, 2009). However, these studies failed to prove the studies of Skousen *et al.* and Sukirman and Sari which stated that rationalisation components in the Fraud Triangle significantly affect the probability of a company doing fraudulent financial reporting practice (Skousen, Smith, & Wright, 2009; Sukirman & Sari, 2013).

Conclusion

Based on the result discussed previously, it can be concluded that financial target has a negative effect and proved to be significant on the probability of a company doing fraudulent financial reporting practice. This result explains that a low return on assets allows the manipulation of the financial statement. That state can occur when the manager wants always to look good with a higher return of assets achievement to get a higher bonus, so that when the return on assets is low, the manager will tend to manipulate the financial statements. As for the variables of financial stability, external pressures, personal financial needs, supervision effectiveness, and auditor change, they have not been proven to be related to fraudulent financial reporting.

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