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Internal Control Disclosure, Ethics Disclosure and Earnings Management as Signal to Detect Fraudulent Financial Reporting

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Abstract

The information asymmetry between management and owners raises an opportunistic attitude of management to attach importance to its own interests. In this case, investors need additional information in addition to financial statements as a signal that can reduce information asymmetry. This study aims to prove empirically about the influence of internal controls and ethics disclosures against possible fraudulent financial reporting. This study also examines the relationship between management intentions that are reflected in earnings management with fraudulent financial reporting. The sample in this research is 740 data consist of 708 data fraud and 32 data non fraud. The study was conducted in non-financial companies listed on the Indonesia Stock Exchange for the period 2012-2015. The result of logistic regression analysis proves that information asymmetry can be reduced by voluntary disclosure ie internal control disclosure and ethics disclosure. Voluntary disclosure negatively affects fraudulent financial reporting. However, this study fails to identify earnings management as a sign of management intentions that can reduce information asymmetry.

Keywords: Fraudulent, Ethics, Internal Control, Disclosure, Earnings Management, Signaling.

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Introduction

Financial reporting aims to provide financial information about an entity that is useful to investors and potential investors, lenders and other creditors in making decisions about the provision of resources to entities.The financial statements become the media for the company to convey financial information regarding the accountability of the management company or board of directors to meet the needs of external parties is the acquisition of corporate performance information. With regard to the benefits of economic decision-making, in reality there is often a condition in which the information conveyed is inconsistent with actual company conditions. Major accounting scandals among prominent companies, such as Enron, WorldCom and Health South, greatly undermined the integrity of financial reporting and the confidence of investors in investing their hard-earned savings in US stock markets.

The 2016 Association of Certified Fraud Examiners (ACFE) Indonesia Chapter report found that 77% of the fraud came from corruption, 19% from assets missapropriation and 4% from fraudulent financial reporting. The percentage of fraudulent financial reporting is small, due to fraudulent cases of financial reporting in Indonesia has not been much revealed. Although the total percentage of fraud financial reporting is relatively small, but the impact of losses caused by this fraud is relatively large. About 40% of losses from fraudulent financial reporting are greater than Rp 10 billion. This proves that fraudulent financial reporting in Indonesia is really happening and causing huge lossesn connection with this, fraudulent financial reporting is important to investigate.

In agency theory, fraudulent financial reporting occurs due to information asymmetry. Furthermore, both agents and principals try to maximize their own interests, so agents often ignore the interests of the principal. Differences in the interests of both parties' cause agency problems (Jensen and Mackling, 1976). The information asymmetry between management and owners becomes an opportunity for management to select the information provided. The financial and account statements are common shareholder information of the company's management, because of the effect of entrenchment, the investor does not fully trust the financial statements and requires additional information to provide confidence before making a decision. Investors need signals to detect the quality of financial statements because of the complexity and number of transactions. Management provides information or signals stemming from the desire to uncover superior performance to enhance the reputation of the manager (Persons 2009). Voluntary disclosure and earnings management can reduce asimetry signals that can be used to detect fraudulent financial reporting.

This study examines the effect of voluntary disclosure and earnings management on fraudulent financial reporting. Based on agency theory, this study examines then information asymmetry through voluntary disclosure and earnings management as a signal of fraudulent financial reporting. This study tested two research objectives. The first aims to test of the effect voluntary disclosure on fraudulent financial reporting. Previous research on voluntary disclosure and earnings management is mostly related to stock prices or returns. Previous research examined the relationship between voluntary disclosure and earnings management. Healy and Palepu (2001), Lambert, et.al. (2007), present voluntary disclosure as a factor that contributes to the reduction of information asymmetry. Meanwhile, voluntary disclosure and fraudulent financial reporting has not been widely studied. Persons (2010) proves that ethics disclosure affects the likelihood of fraudulent financial reporting. Persons (2009) found that fraud firms were less likely to make earlier ethics disclosure. Ying (2016) documented that the quality of internal control information disclosure is negatively related to the degree of earnings management, the high quality of internal control information disclosure has a significant inhibitory effect on earnings management. Testing of voluntary disclosure is expected to contribute to the development of agency theory, in particular to reduce information asymmetry through voluntary disclosure as a signal to management intention. For regulators, this study hopes to contribute to establishing a policy of voluntary disclosure, in specialy the internal controls disclosure and ethics disclosure.

Second objective of this research to examine impact earnings management on fraudulent financial reporting. Earnings management may start small without the intention to deceive investors or regulators, but then grow over time to exceed the limits of GAAP and result in full-blown “cooking the books” causing the financial statement to be fraudulently misstated that leads to fraudulent financial reporting (Hasnan et al., 2013). The previous research, Shong, et.al. (2013) suggest that the accrual basis of accounting provides a clue towards uncovering management’s misappropriation of assets and thus, plays an important role in reducing existing information asymmetry. Nevertheless, the results of Rahman, et.al. (2016) research could not prove the relationship between earnings management and fraudulent financial reporting. The inconsistency of the results of this study makes the relationship between earnings management with fraudulent financial reporting feasible to be verify. This research is expected to contribute to the users of financial statements to view the financial statements comprehensively and do not see partially only from the accounts, so as to determine management intentions.

Review Literature and Hypothesis

The demand for additional resources always increases when new investment opportunities appear and new investment opportunities are themselves likely to be associated with a widening gap in the information asymmetry between “insiders” and “outsiders” (Healy & Palepu, 2001; Consoni, et.al., 2017). Information asymmetry can be reduced through voluntary disclosure and tighter regulation (Scott, 2012). However, regulation in the context of agency conflict works only if the regulator can require the disclosure of information that market participants are unwilling to disclose voluntarily (Beyer, et.al., 2010). It is interesting to note that the benefits of corporate disclosure typically result in voluntary information disclosure, but not of all the information to which company management is privy. As noted by Dye (2001), the best information for the purpose of negotiating contracts is not necessarily the best information on which an investor should base a decision. Therefore, managers can strategically choose what to disclose and when to disclose it, provided that investors are uncertain as so what information the managers possess.

Under the signaling theory, financial reporting stems from management's desire to disclose superior performance, where good performance will enhance the reputation and position of the management services market manager, and good reporting includes the internal control disclosure that is positively considered to be one of the aspects of good performance (Persons, 2009). Razali and Arshad (2014) state the growing incidences of corporate fraud indicates that ineffective emphasis on fraud prevention and deterrence mechanisms are being prioritized by organizations. In many recent corporate misconducts, failure of internal control an effective monitoring tool has been highlighted to be one of the reasons to prevent fraudulent financial reporting. Bryan and Lilien (2005) examined public filing of firms with internal control weaknesses, and found that they were generally smaller, riskier, and not high performers in their industry, thus confirming the importance of internal control in organisations. Signals arise because of information asymmetry, where management has more information than investors, voluntary disclosure of good internal control information is a signal that management performs well. Based on the above explanation can be prepared hypothesis as follows:

H_1: The probability of fraudulent financial reporting is negatively related to internal control disclosure.

Voluntary disclosure may indicate current income and prospects to those interested in the financial position of the company or they can clarify and clarify the criteria adopted for the formulation of a company regarding its accounting policies and estimates (Lundholm, 2003). This voluntary disclosure according to Lambert et al. (2007) as an effort aimed at reducing information asymmetry and thereby enhancing the ability of investors to make informed decisions and monitor their investments accurately. Huang et al. (2008) finds that ethics-financial-reporting firms signaled they're high-quality of financial information, and were rewarded for their efforts via enhanced firm value.The assumption built into this frame of mind is that the level of corporate ethics disclosure reflects how ethicsly firm it is in practice. Employees believe that if a company operates with honesty and integrity it will have a higher level of commitment in terms of job satisfaction and company pride than companies with low ethics values. Accordingly, companies without ethics fraud may wish to demonstrate their pride and signal their commitment to ethics practice by making more ethics disclosure of unethics fraud firms (Person 2009). Ethics no-fraud firms may want to show pride in their performance and signal a commitment to ethics practice by making more ethics disclosures than unethics fraud firms. According to the signaling theory, companies that commit to ethics practices would likely ask the firm to make voluntary ethics disclosures to enhance the firm’s positive image, reputation and credibility. Persons (2009) state that an incidence of fraudulent financial reporting is the best evidence not only of highly unethics conduct, but also of an outright violation of securities law. Such highly unethics conduct implies that these fraud firms tone-at-the-top is ethicsly weak. Based on the argument above can be prepared as follows hypothesis:

H_2: The probability of fraudulent financial reporting is negatively related to ethics disclosure

Research was conducted by Ball, et.al., (2003); Bhattacharya, et.al., (2003); and Leuz, et.al., (2003) reported that earnings management practices are prevalent in companies listed on the stock exchange. This is alarming, as previous research has shown that earning management practices started on a small scale, pressure and incentives can then lead to larger scales and can ultimately lead to fraudulent financial reporting (Powell et al., 2005). A common consequence of improper earnings management practices is that once started, the company must continue to earnings management activities to meet the performance targets to fit analyst expectations (Magrath and Weld (2002).) Often analyst expectations require the action of profit management through sophisticated accounting techniques to ensuring that analyst expectations are met. Finally, companies must engage in fraudulent activity by using creative accounting practices, or manipulating against GAAP (Suhaily et.al., 2016). Rahman, Sulaiman, et.al. (2016) state that apart from this fraud risk factor, earnings management arises from agency frictions, possibly when managers want to maximize their private benefits or due to pressure to provide high-quality financial information to external stakeholders. They are constrained into managing earnings and later when the pressure heightens to achieve earnings target, the earnings quality is no longer the priority; instead, achieving their private benefits becomes their main goal. Later, when the performance of firms is the utmost concern, ample opportunity, capability, and pressure harmonizing with the rationalization will lead firms to commit fraud. Based on the description above can be prepared as follows hypothesis:

H_3: The probability of fraudulent financial reporting is positively related to earnings management

Research Methodology

The population and sample in this study are companies listed on the Indonesian stock exchange except financial companies for the period 2012-2015. In addition, the company also has at least 1 internal disclosure control indicator and 1 indicator of ethics disclosure, complete data and presented in rupiah currency. The samples studied were 740 consisting of 32 fraudulent financial reporting data and 708 non fraudulent financial reporting data. In this study no match pair samples were used for the real fact that fraudulent financial reporting was not much, but could be a bad signal for investors. Annual financial report data is sourced from the Indonesia stock exchange web except fraudulent financial reporting data.Fraudulent financial reporting data is obtained from the financial services authority (OJK). The hypothesis in this research is analyzed and tested by using logistic regression.

$$Ln\frac{FFR}{1-FFR} = \alpha + \beta_1 ECI + \beta_1 ICD + \beta_1 EM + \beta_1 ROA + \beta_1 DTA + \epsilon$$

Fraudulent Financial Reporting (FFR) is one type of fraud committed by companies related to financial reporting. ACFE divides cheating into corruption, assets misappropriation, and fraudulent financial statements. Measurement of FFR is by assigning a value of 1 to the company contained in the OJK Case List, whereas the value 0 (null) to the company is not contained in the OJK Case List.

Ethics Commitment Index (ECI) is used to measure the level of ethics disclosure. This measurement refers to 11 indicators from Choi and Jung (2008) which include: Top corporate managers regularly emphasize the importance of business ethics. The ethics behavior based on a formal business philosophy becomes the norm of the company, The company has a system of discipline and any behavior that violates ethics will be punished, the Company has a code of ethics, In the company, employees can report ethics violation behavior through anonymous channels (closed), Inside the company, ethics education, training, or workshop aims to improve employee business ethics, the Company regularly places most of its profits on generosity, the Company has an independent ethics and supervisory department. In the company, employees can get help on business ethics through open communication channels, the Company has an ethics committee, and Thecompany has an ethics evaluation system measured by an independent party outside the company.

The internal control disclosure variable is measured by measurement of He and Wang (2013). The internal disclosure index (ICDI), which includes internal environment, risk evaluation, control activities, information & communication, internal supervision, internal control defects, internal assessment, and external assessment.

The earnings management in this study will be proxied by the discretionary accrual calculated by the Modified Jones model. The reason for modifying the Jones model is that it is considered the best model for detecting earnings management over other models because it separates non-discretionary accruals from discretionary accruals (Dechow et al., 1995). Discretionary Accruals (DA) can be calculated as follows:

$$\mathrm{DA}_{\mathrm{it}} = \mathrm{TAC}_{\mathrm{it}}/\mathrm{TA}_{\mathrm{it}-1} - \mathrm{NDA}_{\mathrm{it}}$$

where:

$\mathrm{DA}_{\mathrm{it}}$ = Discretionary accruals of firm i in period t

$\mathrm{TAC}_{\mathrm{it}}$ = Total accruals of firm i in period t

$\mathrm{TA}_{\mathrm{it}-1}$ = Total assets of firm i in period t

$\mathrm{NDA}_{\mathrm{it}}$ = Non-discretionary accruals of firm i in period t

Total accruals represent the difference between the net income attained by the firm in period t and the cash flows from operating activities in period t. The measurement model of total accruals is described as follows:

$$\mathrm{TAC}_{\mathrm{it}} = \mathrm{NI}_{\mathrm{it}} - \mathrm{CFO}_{\mathrm{it}}$$

Where:

$\mathrm{TAC}_{\mathrm{it}}$ = Total accruals of firm i in period t

$\mathrm{NI}_{\mathrm{it}}$ = Net income of company i in period t

CFO_{it} = Cash flow from operation firm i in period t

Then the total value accruals (TA) is estimated through the Ordinary Least Square (OLS) regression analysis model as follows:

$$TAC_{it}/TA_{it-1} = \beta_1(1/TA_{it-1}) + \beta_2(\Delta Rev_{it}/TA_{it-1}) + \beta_3(PPE_{it}/TA_{it-1}) + e$$

Where:

TA_{it-1} = Total assets of firm i in period t

ΔRev_{it} = Period of company earnings i from period t-1 to period t

PPE_{it} = Property, plant and equipment company i in period t

$\beta_1, \beta_2, \beta_3$ = Regression coefficients

e = Sample error

By using the above regression coefficients $(\beta_1, \beta_2, \beta_3)$, non discretionary accruals (NDA) values can be calculated by the formula:

$$NDA_{it} = \beta_1(1/TA_{it-1}) + \beta_2(\Delta Rev_{it}/TA_{it-1} - \Delta Rec_{it}/TA_{it-1}) + \beta_3(PPE_{it}/TA_{it-1}) + e$$

Where:

NDA_{it} = Nondiscretionary accruals of firm i in period t

TA_{it-1}= Total assets of firm i in period t-1

ΔRev_{it}= Changes in corporate income i from period t-1 to period

ΔRec_{it} = Change of company's net receivable i from period t-1 to period t

PPE_{it}= Property, plant and equipment company i in period t

$\beta_1, \beta_2, \beta_3$ = Regression coefficients

e = Sample error

Total accruals consist of Discretionary Accruals (DA) and Non-Discretionary Accruals (NDA) components. Discretionary Accruals are components of accruals that are in the management policy while no- discretionary accruals are components of accruals outside of management policies.

ROA is Return On Assets company i in period t divided by Assets company i in period t, and DTA is Debt company i in period t divided by Total Assets company i in period

t. ROA dan DTA on this research as control variabel that explaine about conflict interest management and stockholder, and management and debtholders.

Result and Discussion

Results and discussion in this study assesses about the descriptive analysis and inferential test of logistic regression to test the hypothesis and discussion of the research results. Descriptive statistical analysis described in the table below.

Table 1 Descriptive Statistics

	ICD	ECI	DA	ROA	DTA
Mean	0.70456	0.36020	-0.04247	0.52362	7.30448
Median	0.75000	0.36364	-0.01202	0.04859	2.03713
Std. Deviation	0.07766	0.15873	0.21468	6.39748	114.91003

Mean and median ICDs over 0.5 in Table 1 show that most of the sample firms reveal internal controls of firms, whereas for ECIs prove that ethics disclosure has not been widely practiced by corporations. DA as a proxy of earnings management get evidence that the value of most samples is negative which means that the tendency of companies to decreasing income.

The Godness of Fit model test in this logistic regression regression is seen from the value of Hosmer Lemeshow Test and Omnibus test. Hosmer Lemeshow test shows Chi-square value of 7.959 with significance level of 0.438 indicates that the model in this study fit with the data. The Godness of fit model in this study is also supported by Omnibus test results. Chi-square omnibus of 12.810 with significance 0.025 proves that this model fit with the data.

Negelkerke R square indicates the magnitude of the ability of the independent variable to explain the dependent variable. Table 2 shows the value of Negelkerke R square of 0.074 which means that the independent variable in this study is only able to explain fraudulent financial reporting of 7.4%, this value is very small compared with the percentage of other variables that are not examined.

The internal controls disclosure in table 2 shows the wald value of 3,945 significant at the 5% level with the regression coefficient of -5,233. This result proves that internal control disclosure negatively affects fraudulent financial reporting, or in other words it can be stated that the low internal control disclosure gives the company signal of fraudulent financial reporting. Financial reporting comes from management's desire to disclose superior performance, where good performance can improve reputation so that it has high bargaining power. The capture of internal control information is positively regarded as one of the aspects of good performance. Internal control is a mechanism that fails to prevent fraud within the company (Persons, 2009, Razali and Arshad 2014). This result consistence with Hunziker (2013) that found four company-specific characteristics derived from agency theory do significantly explain the variability in the level of voluntary disclosure on internal control, i.e. management ownership, blockholder ownership, board size and leverage. Overall, agency cost theory seems to be a powerful theory to explain voluntary disclosure strategies of Swiss companies.

Table 2 Analysis regression logistic of this model

	B	Wald
ICD	-5,233	3.945
ECI	-2.679	4.104
DA	-1.080	1.841
ROA	0.016	0.940
DTA	-0.055	0.651
Constanta	1.456	0.667
Negelkerke R square		0,074
	Chi-Square	Sig
Hosmer Lemeshow Test	7.959	0.438
Omnibus	12.810	0.025

Ethics commitment index as a proxy of ethics disclosure proved to negatively affect fraudulent financial reporting. The logistic regression wald value of 4.104 with regression coefficient -2.679 is significant at 5% level, the result indicates that there is information asymmetry between management with stockholder and ethics disclosure is a signal that needs to be paid attention by investors. The disclosure of ethics is a signal in line with the opinion of Persons (2009) which states that the voluntarily adopted the code does not bother to distinguish the audit committee in terms of an ethics oversight. On the other hand, an ethicsly conscientious audit committee would be more vigilant in overseeing the firm's ethics compliance, and would likely ask the firm to make voluntary disclosure about its code of ethics. Furthermore Persons (2010) reinforces this opinion by proving that ethics disclosures than unethics fraud firms. In addition to the findings of Person (2010) and Person (2009), the results of this study are also in line with research on voluntary disclosure based on information asymmetry, Healy and Palepu (2001), Lambert, et.al. (2007), and Verrecchia (1983) which proves to the reduction of information asymmetry.

Internal controls disclosure and ethics disclosure negatively affects fraudulent financial reporting proves that voluntary disclosure can be a signal of management intentions. Negative signals prove that the more voluntary disclosure the probability of fraudulent financial reporting will be less. In other words, internal control and ethics disclosure may reduce information asymmetry. This result is in line with Richardson's (2000) opinion explores these arguments, suggesting that the level of earnings management increases as the level of information asymmetry increases; testing this relationship, he finds a positive correlation. When information asymmetry is high, parties interested in the accounting data can not obtain access to information necessary to prevent accounting manipulation.

The value of Wald 1.841 for the variable DAC (earnings management) indicates that the profit management does not affect the fraudulent financial reporting. This shows that this study can not prove management intentions through earnings management to detect financial reporting fraud, in other words earning management can not be used as a signal. Kalbers (2009) explained, while external forces, such as capital market incentives, may create certain motivations for managers, intent is also influenced by internal and personal factors. These factors include the identity and role of a manager within an organization and a profession. Within the organization, intent is influenced by the norms and culture of the organization and the reward structure, to name just two factors. Beyond general capital market incentives, external influences may include professional responsibilities and codes of conduct. Personal psychological attributes and characteristics of a manager may also impact decisions about earnings management.

The results of this study are consisten with Hussain et.al. (2016) who failed to prove that earnings management had an effect on financial misstatement in Malaysia. The results of this study contradict the research of Shong, et.al. (2013), which is related to missapropriation asset, and Selahudin et al. which proves that earning management has an effect on fiancial misstatement. Shong et.al (2013) state that the accrual basis of accounting provides a clue towards uncovering management's misappropriation of assets and thus, plays an important role in reducing existing asymmetry information. Furthermore Rahman et.al. (2016) significantly finds evidence that fraud firms manage earnings on a sequential basis between accruals earnings management and real earnings management prior to fraud year.

Like earnings management, ROA and DTA also have no effect on fraudulent financial reporting. ROA and DTA are commonly delivered information and no privat information. Earnings management, ROA and DTA are inherent information in financial statements, so it is not appropriate to detect fraud in the preparation of financial statements.

Additional Analysis

The result of hypothesis testing using univariate with Mann Whitney presented in table 3 is consistent with multivariate logistic regression testing. Mann Whitney is used to test the differences between ICD, ECI, and DA between companies that commit fraud and do not commit fraud independently.

Table 3 Univariate test

	Mann-Whitney U	Wilcoxon W	Z	Asymp. Sig. (2-tailed)
ICD	8771,500	9299,500	-2,421	0.015
ECI	8869,000	9397,000	-2,110	0.035
DA	9448,000	260434,000	-1,589	0.112
ROA	8515,000	9043,000	-2,378	0.017
DTA	11211,000	11739,000	-,099	0.921

Volountary disclosure through ICD and ECI indicates a difference between those who commit fraudulent financial reporting and who do not commit fraudulent financial reporting. Table 3 shows the Z value for ICD of -2.421 and the Z value of - 2,110 for the

ECI variable, this means that voluntary disclosures proxyed with ECD and ECI can be a signal of fraud in financial reporting. In univariate terms, the value of Z for DA of -1.589 indicates that there is no difference between the DA for fraud in the preparation of financial statements with those who do not fraud. The univariate analysis reinforces the results of multivariate analysis with logistic regression. In contrast to multivariate testing for ROA that can not prove the relationship between ROA and cheating, the univariate test results found that the control variable ROA of MannWhitney testing proved the effect of ROA on financial reporting fraud. However, for the DTA control variables, the results are aligned between univariate and multivariate.

Conclution

This study examines the effects of voluntary disclosure and earnings asymmetric information to detect fraudulent financial reporting. The results show that voluntary disclosure negatively affects fraudulent reporting both for disclosure of internal controls and ethics disclosures. This proves that internal control disclosure and ethics disclosure can reduce the asymmetry of information arising from agency. In other words, internal controls disclosure and ethics disclosures is a good way to detect the possibility of fraudulent financial reporting. However, earning management has no effect on financial reporting fraud, so it can be stated that earning management is not a proper tool for measuring management intentions.

The results of this study contribute to the development of agency theory, especially voluntary disclosure that can reduce the information asymmetry and make it a signal to detect fraud. The results of this study are also useful for investors not to fully believe in the financial statements, investors should pay attention to private signals to detect intention and performance management, such as voluntary disclosure. The results of this study can also be used as a reference for capital market regulators in Indonesia to make additional disclosure policies that have been mandatory at this time. Suggestions for further research, researchers can use a proxy other than earnings management to describe management intentions, such as bonus plan or management changes.

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