Management Incentives And Corporate Fraud: An Effectiveness Review Of Corporate Governance In Indonesia

Suwarno, Mu'minatus, Suwandi, Syaiful, Anwar

Abstract : Fraudulent financial statements do not only harm investors but damage the integrity of the capital market, socio-economic order and economic growth. Fraud Diamond indicated four factors that encourage management to commit fraud. This study examines the effect of the effectiveness of corporate governance in reducing fraudulent financial statements in relation to incentive management. The study was 131 manufacturing companies on the Indonesian stock exchange in 2017. The sample of companies indicated to have committed fraud was 66 samples. The test results show that incentive management have no effect on fraudulent financial statements, while the effectiveness of corporate governance is proxies by the audit committee, the number of board of directors, and institutional ownership. Institutional ownership, profitability and savings have a positive and significant effect on fraud. Good corporate governance can reduce the opportunity for management to commit fraudulent financial statements.

Index Terms: incentive management, fraud, corporate governance, profitability

1 INTRODUCTION

Reports from the Association of Certified Fraud Examiners (ACFE) in 2017 estimated that 5% of the Gross World Product (GWP) of USD 79.6 trillion had experienced fraud (ACFE, 2014). While the results of the Indonesian fraud survey (SFI) show that corruption (31%), misuse of state or company assets (67%) and fraudulent financial statements (2%) (ACFE, 2016). The results of the SFI survey show that management behavior to commit corporate fraud is still high. The potential for corporate fraud in Indonesia is due to many factors such as low salary or bonus managers, political interests, and moral hazard. Bad behavior like this is detrimental to the company and its stakeholders (Harris & Bromiley, 2007). The impact of corporate fraud is not only detrimental to investors, customers, creditors, employees but damages the integrity of the capital market, social economy and economic growth. Corporate fraud will result in high operational costs of the company, and reduce profitability. Ethical point of view, corporate fraud as a result of individual failure to accept responsibility for managing the company and top management has neglected to run it (Staubus, 2005). The motivation of management to commit corporate fraud includes (Johnson, Ryan, & Tian, 2009), (Conyon & He, 2016) (Chen, Firth, Gao, & Rui, 2006a) incentive management and weak corporate governance. Management bonus is the right tool to reduce agency problems. Information asymmetry (Jensen & Meckling, 1976) causes agency problems. Management that behaves opportunistically conducts activities that can benefit themselves without considering the interests of the owner.

These two conflicting interests will incur agency costs. Incentive management aim to reduce agency conflict and align managers' interests with shareholders to encourage efficient company management (Johnson et al., 2009). Management incentives can improve company performance (Unite, Sullivan, Brookman, Majadillas, & Taningco, 2008), however this is one of management's motivations for corporate fraud. Research (Harris & Bromiley, 2007) shows top incentive management related to financial statement fraud. Incentive management can be given in two types, financial incentives and equity incentives (Johnson et al., 2009). Incentive management in the form of equity-based incentives will increase efficiency and a long-term perspective. However, it can produce unintended consequences, namely corporate fraud (Bertrand & Mullainathan, 2001). Financial incentives have a greater chance of corporate fraud compared to equity-based incentives. Financial incentives provide opportunities for management to improve short-term performance to pursue targets given by the owner. We analyze corporate fraud by asking a question: Will management commit corporate fraud with greater financial incentives? The results of the study (Johnson et al., 2009) show that equity-based incentives have a greater chance of corporate fraud. Equity-based incentives in the form of stock options, where managers will get an increase in share prices in the future. So that equity-based incentives will be linear with stock prices. Managers will experience a substantial loss if the share price decreases. Thus, managers will commit financial fraud to avoid greater share price reductions. Managers will commit financial fraud with accounting methods to improve profitability. Incentive management will provide opportunities for management to commit corporate fraud. Incentive management in financial or equity incentives encourage management to increase bonuses through increased profitability. Weak corporate governance will contribute to corporate fraud (Core et al., 1999), where corporate fraud is one of the problems. Corporate governance is proxies by supervision conducted by the board of commissioners. Firms with audit committee members with less financial background do earnings restatements compared to companies without audit board members with non-financial backgrounds (Agrawal & Chadha, 2003). The restatement of earnings is one indicator of

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error correction or changes in accounting principles in the preparation of financial statements. Financial reporting errors can be caused by intentional factors managers have deliberately cheated financial statements. Where one of the motivations of managers to commit fraud is to increase management incentives. Corporate governance is related to the company's operating performance and future stock price increases. The results of the study (Larcker, Richardson, & Tun, 2007) showed an abnormal accrual relationship with corporate governance and company performance. Abnormal accruals in the form of restatement of financial statements as a result of the correction of accounting errors or changes in accounting principles (Staubus, 2005). Restatement of financial statements indicates weak corporate governance. The structure of corporate governance involves oversight by the board of commissioners and the audit committee (Dechow, Sloan, & Sweeney, 1995). The audit committee carries out its function in examining financial statements, if the audit committee performs its duties correctly then abnormal accrual actions can be avoided. The characteristics of the board of commissioners are an important factor in explaining corporate fraud (Chen et al., 2006a). The characteristics of the board of commissioners include the term of office of the chairman of the board of commissioners, the number of meetings each year, and independent commissioners. The three characteristics of the board of commissioners indicate the activities of the board of commissioners in running their function, namely controlling managers. The number of meetings shows that increasingly intense surveillance activities will reduce the level of corporate fraud. Meeting activities provide space for the board of commissioners and managers to coordinate problem solving or evaluate company plans. An evaluation of the company's target achievements can be done with a board of commissioners meeting.

2 LITERATURE REVIEW AND HYPOTHESIS

2.1 Incentives Management and corporate fraud
Incentive management are given in the form of financial incentives and equity incentives (Johnson et al., 2009). Financial incentives are bonuses given to management in the form of cash payments, where payments are calculated in top management salaries. While equity incentives are incentives given to top management by providing stock options. Both types of Incentive management are generally based on manager performance. Research (Johnson et al., 2009) shows that equity incentives are associated with corporate fraud. On the other hand financial incentives will improve company performance (Adithiyangkul, Alon, & Zhang, 2011) (Unite et al., 2008) (Bebchuk & Fried, 2012). Incentive management in the form of payments are more common in Indonesia than equity incentives. Payment of performance allowances is a natural occurrence in companies in Indonesia. The question is whether financial or financial incentives can increase corporate fraud. Financial incentives given to managers provide opportunities for earnings management. Corporate fraud can be done in the form of fraudulent financial statements. There are several forms of measurement of financial statement fraud including real earnings management (Siddiq, Fatchan, & Zulfikar, 2017) (Perols & Lougee, 2011) (Roychowdhury, 2006), M-Score (Beneish, 2001). Some studies show that earnings management in previous years is associated with fraudulent financial statements (Lo, Ramos, & Rogo, 2017). Some companies that conduct earnings management will increase opportunities to cheat financial statements (Wijaya & Christiawan, 1989) (Elfira, 2014). Earnings management is an effort made by management to maximize profitability using the accrual accounting method. Where accrual income is recorded earlier or is postponed for a future period, or recognizes an accrual expense earlier or is postponed for an accounting period to come. The motivation of management to manage earnings is to maximize Incentive management in addition to giving positive signals to investors. Earnings management is often associated with corporate fraud. Some studies use real earnings management to detect corporate fraud. Companies that conduct earnings management will constantly be associated with corporate fraud. Earnings management is one indicator to detect fraudulent financial statements or companies (Du, Jian, & Lai, 2017), (Cohen, Dey, & Lys, 2008). Based on the explanation above, the research hypothesis is:

H1: Incentive management influences financial statement fraud

2.2 Corporate Governance related to Financial Statement Fraud
The ownership structure and characteristics of the board of commissioners are able to explain the level of corporate fraud (Chen, Firth, Gao, & Rui, 2006b). The ownership structure can be classified into foreign, institutional, and family ownership. Foreign ownership has no significant effect on fraud (Shan, Graves, & Ali, 2013). The ownership structure does not provide space for the owner to conduct company supervision so it does not contribute to preventing corporate fraud. The majority ownership structure in companies in Indonesia generally gives the owner the right to be the manager or commissioner of the company. The characteristics of the board of commissioners are related to financial statement fraud. Boards of commissioners with a greater composition of independent directors will commit less fraud than with a smaller amount of ownership (Beasley, 1996). Independent Commissioners are commissioners from outside parties who are appointed based on the decision of the General Meeting of Shareholders (GMS). Requirements for Independent Commissioners include not being affiliated with any party, especially major shareholders, members of the Board of Directors and / or other members of the Board of Commissioners stipulated in the Articles of Association. The composition of the board of commissioners will enhance their role in carrying out their duties. The likelihood of fraud is lower if the audit committee and independent commissioners have fewer positions on other companies (Persons, 2005). The audit committee’s role is to supervise the auditing of financial statements. Audit committees with financial or accounting backgrounds are expected to reduce financial statement fraud. The educational background of the audit committee can carry out checks to detect early on fraudulent financial statements. Thus the company's greater losses can be prevented by the role of the audit committee.

H2a: Institutional ownership influences financial statement fraud.

H2b: The Audit Committee influences financial statement fraud.
H2c: Independent commissioner influences financial statement fraud

2.3 Profitability is related to Fraudulent Financial Statements.

Profitability that underlies the magnitude of management incentives or bonuses will encourage top managers to commit fraudulent financial statements. Some of the actions of managers to improve profit rates include earnings management. Earnings management that is carried out continuously or over several periods will lead to financial statement fraud (Perols & Lougee, 2011). Managers create fraud opportunities in financial statements, where this can be measured by restatement of financial statements in the previous period. Top manager bonuses in the form of financial incentives based on company profits will provide opportunities for managers to increase profit figures so that incentives are greater.

H3: Profitability influences financial statement fraud

2.4 Leverage is related to Fraudulent Financial Statements.

Many factors encourage management to cheat financial statements. One of the factors driving fraud is pressure (Wolfe & Hermanson, 2004), (Siddiq et al., 2017) (Sayekti, 2015). A form of external pressure is the company’s ability to settle debt payments or get debt from creditors. This pressure encourages management to manage earnings or fraudulent financial statements to convey company performance information. Debt contract theory in the agency theory states that when a company is unable to repay debt, then the manager will do earnings management so that financial statement information shows good performance.

H4: Leverage influences financial statement fraud

3 RESEARCH METHODS

The research sample was 148 manufacturing companies listed on the Indonesia Stock Exchange in 2017. The research sample is a company that does not generate negative profits or losses. Because the company that loses is less likely to commit financial statements. The research variables consist of fraudulent financial statements, corporate governance and management bonuses. Financial statement fraud is the dependent variable, while corporate governance and Incentive management are independent variables. Corporate governance is proxied by an audit committee and the size of an independent commissioner. In this study, the control variable that is profitability will be used. Profitability is the result of manager’s performance that will encourage opportunities for financial statement fraud. Because the magnitude of profitability will provide encouragement to top managers to get a bigger bonus. Incentive management are financial incentives given to top managers and are paid in the form of monthly or annual salary payments. Financial incentives are given based on company profitability. The management bonus is measured by the amount of the annual bonus given to top managers. This study does not use equity bonuses because the practice of giving equity bonuses is very rare in Indonesia. Incentive management are measured by Ln (financial incentives). Audit committee is the number of audit committees with financial background. As explained above, that a person with a financial or accounting background has competence in the field of financial statements, so that he will be more careful in examining financial statements. The audit committee variable is measured by the proportion of the number of audit committee members with financial backgrounds compared to the total audit committee. Independent Commissioners are the number of independent commissioners of the company. Independent commissioners who have experience in other companies will have the ability to carry out their duties as supervisors of managers in carrying out their responsibilities as company managers. Experience as an independent commissioner in other companies will be faced with many company problems. The independent commissioner variable is measured by the proportion of the number of independent directors who have experience in other companies compared to the total independent commissioners. Profitability is the amount of annual profit generated by a company. The emergence of fraudulent financial statements due to top manager bonuses is based on the amount of profitability. In research profitability is a control variable. Profitability is measured by the ratio of net profit margin (NPM). Fraudulent Financial Statements are the actions of top managers cheating financial statements. The action of the top manager is cheating financial statements by measuring with a formula developed by M-Benies, while the measurement scale uses dummy where 1 if the company is cheating financial statements and 0 there is no cheating financial statements. In the next stage in conducting data analysis with logistic regression. Logistic regression is used because the cheating variable uses dummy. Test data with regression is to measure the magnitude of the coefficient or effect of management bonuses, corporate governance, profitability on financial statement fraud. The regression equation is:

\[
FRAUD = \alpha + \beta_1 OWNERSHIP + \beta_2 AUDIT + \beta_3 BoD + \beta_4 LEV + \beta_5 NPM + \beta_6 INCENTIVE
\]

Where is FRAUD = fraudulent financial statements, OWNERSHIP = institutional ownership, BoD = board of directors, LEV = leverage ratio, AUDIT = audit committee, NPM = net profit margin, INCENTIVE = Incentive Management

4 RESULT

The research sample was manufacturing companies listed on the Indonesia Stock Exchange in 2017. Data is selected using purposive sampling to obtain 131 companies. Detection of financial statement fraud using the M-Benies formula, where 66 samples are in the Non-Fraud category and 65 samples in the Fraud category. The average institutional ownership of the non-fraud category company is 67% and the fraud category company is 74% (table 1). Table 1 shows that companies with greater institutional ownership tend to cheat financial statements. While the average company’s audit committee non-fraud category is 80% and the company category of fraud is 78%, demonstrating the company by the number of audit committee less likely to commit financial statement fraud.

**TABLE 1

DESCRIPTIVE STATISTICS**

<table>
<thead>
<tr>
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<th>Non Fraud</th>
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<tbody>
<tr>
<td></td>
<td>Min</td>
<td>Max</td>
<td>Mean</td>
<td>SD</td>
</tr>
<tr>
<td>OWNERSHIP</td>
<td>0.24</td>
<td>0.94</td>
<td>0.67</td>
<td>0.19</td>
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<tr>
<td>AUDIT</td>
<td>0.33</td>
<td>1.00</td>
<td>0.80</td>
<td>0.22</td>
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</table>
Hypothesis testing in this study by comparing the significant value with a significant level (5%), if the significant value is less than 5%, then the hypothesis one (H1) is accepted. Hypothesis 1 (H1) states that Incentive management is related to financial statement fraud. The results showed that the management bonus did not significantly influence financial statement fraud. This is based on statistical tests that a significant value of 0.821 or greater than 0.05 (Table 2). Incentive management in the form of incentives based on earnings encourage management to cheat financial statements (Conyon & He, 2016), (Harris & Bromiley, 2007), (Huang, Lin, Chiü, & Yen, 2017). Table 1 shows that there is a positive relationship between Incentive management and fraudulent financial statements, but the relationship is not statistically significant, so H1 is not accepted. These results are not consistent with findings (Johnson et al., 2009), (Pertiwi & Pratama, 2011), (Elfira, 2014), and (Wijaya & Christiawan, 1989). These results indicate that the management bonus does not encourage management to cheat financial statements. Why does the management bonus not encourage management behavior to commit financial statements? Companies in Indonesia have generally set the amount of Incentive management based on company performance and are decided by the board of commissioners.Hypothesis 2a (H2a) states that the ownership structure is related to financial statement fraud. Table 2 shows that the ownership structure is significantly affected by fraudulent financial statements. this is based on statistical tests that show a significant value of 0.046 or less than 0.05. Ownership structure is ownership of shares by an institution or organization. Public ownership of shares requires companies to submit information transparently. Jensen (1976) states that public ownership will improve management much better because of the company's supervision by the owners. The greater the public ownership, the more parties will supervise the manager in presenting financial statement information in a timely manner. So that managers in managing the company will act more cautiously because actions to cheat financial statements will have an impact on the company's reputation or a bad manager. Hypothesis 2b (H2b) states that the audit committee is related to financial statement fraud. Table 2 shows that the audit committee has no effect on financial statement fraud. This is based on statistical tests showing a significant value of 0.734 or greater than 0.05 (Table 3). The task of the audit committee is to supervise the company's financial management. The audit committee periodically conducts an internal audit of the financial statements to ensure there is no fraudulent financial statements. The intensity of the audit committee meeting will result in oversight of optimal financial management. Increasing the role of the audit committee in conducting surveillance will detect early or prevent fraud in financial statements. Hypothesis 2c (H2c) states that the board of commissioners deals with fraudulent financial statements. The results showed that the variable number of the board of commissioners did not significantly influence financial statement fraud. these results are based on statistical testing that a significant value of 0.979 or greater than 0.05 (Table 2). Management control by the board of commissioners will be more effective if it can improve company performance and reduce the risk of financial statement fraud (Shan et al., 2013). The task of the board of commissioners is to supervise and provide advice to directors in carrying out the company's operational activities. The effectiveness of company policies, performance and decision making processes will always be monitored by the board of commissioners. The composition and number of the Board of Commissioners will be effective in decision making and can act independently if they pay attention to the company's vision, mission and strategic plan. Hypothesis 3 (H3) states that leverage is related to financial statement fraud. the results of the study indicate that leverage has a significant effect on financial statement fraud. these results are based on statistical tests that show a significance value of 0.04 less than 0.05 (table 2). According to diamond cheating theory, one of the causes is external pressure (Wolfe & Hermanson, 2004). Companies that have large debts will do earnings management to give creditors confidence in their ability to pay debts. Hypothesis 4 (H4) states that profitability is related to financial statement fraud. The results showed that profitability proxied by Net Profit Margin had a significant effect on financial statement fraud. These results are based on statistical tests that show a significance value of 0.046 or less than 0.05 (Table 3). Agency theory states that the relationship between owners and managers in managing a company (Bebchuk & Fried, 2012). The owner's interest is to get high returns on investments invested in the company, while the manager's interest is to get consistent returns. This demand encourages managers to maintain company performance in various ways, one of which is cheating.

### Table 2: Descriptive Statistics

<table>
<thead>
<tr>
<th></th>
<th>Min</th>
<th>Max</th>
<th>Mean</th>
<th>SD</th>
</tr>
</thead>
<tbody>
<tr>
<td>OWNERSHIP</td>
<td>0.48</td>
<td>1.00</td>
<td>0.74</td>
<td>0.14</td>
</tr>
<tr>
<td>AUDIT</td>
<td>0.25</td>
<td>1.00</td>
<td>0.78</td>
<td>0.22</td>
</tr>
<tr>
<td>BoD</td>
<td>2.00</td>
<td>10.00</td>
<td>4.89</td>
<td>1.96</td>
</tr>
<tr>
<td>LEV</td>
<td>0.12</td>
<td>1.73</td>
<td>0.51</td>
<td>0.25</td>
</tr>
<tr>
<td>INCENTIVE</td>
<td>0.00</td>
<td>1.00</td>
<td>0.38</td>
<td>0.49</td>
</tr>
<tr>
<td>NPM</td>
<td>-0.45</td>
<td>0.76</td>
<td>0.05</td>
<td>0.14</td>
</tr>
</tbody>
</table>

Table 2 above shows that institutional ownership, leverage, and net profit margins have a significant effect on financial statement fraud. While the audit committee, board of commissioners and Incentive management have no effect on management bonuses.

### 5 Hypothesis Testing

Hypothesis testing in this study by comparing the significant value with a significant level (5%), if the significant value is less than 5%, then the hypothesis one (H1) is accepted. Hypothesis 1 (H1) states that Incentive management is related to financial statement fraud. The results showed that the management bonus did not significantly influence financial statement fraud. This is based on statistical tests that a significant value of 0.821 or greater than 0.05 (Table 2). Incentive management in the form of incentives based on earnings encourage management to cheat financial statements (Conyon & He, 2016), (Harris & Bromiley, 2007), (Huang, Lin, Chiü, & Yen, 2017). Table 1 shows that there is a positive relationship between Incentive management and fraudulent financial statements, but the relationship is not statistically significant, so H1 is not accepted. 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financial statements.

6 CONCLUSION
Management bonus does not significantly influence financial statement fraud. According to cheating theory (Wolfe & Hermanson, 2004) there are several factors that encourage management to commit fraud, including external pressure, opportunity, justification and capability. External pressure is the pressure that causes someone to commit fraud such as debt or luxury lifestyle. The size of the company’s debt encourages management to commit financial statements. Management can do earnings management with the aim of company performance impressed by investors. While the opportunity is due to the opportunity caused by weak supervision by the board of commissioners or the owner of the company. The amount of institutional ownership will increase supervision to management in managing the company.

7 REFERENCES