JCA JOURNAL OF CONTEMPORARY ACCOUNTING

Journal of Contemporary Accounting, Volume 4, Issue 3, 2022, 169-178

Journal of Contemporary Accounting

Volume 4 | Issue 3

The effect of financial stability, financial targets and rationalization on financial statements fraud

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Meihendri, Yunilma, Dandes Rifa, Nurhuda, Irda, Siti Maharani Tasrif. (2022). The effect of financial stability, financial targets and rationalization on financial statements fraud. *Journal of Contemporary Accounting*, 4(3), 169-178. doi:10.20885/jca.vol4.iss3art4

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The effect of financial stability, financial targets and rationalization on financial statements fraud

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JEL Classification:
D73, G32

Keywords:
Financial stability, financial targets, rationalization and fraud of financial statements

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DOI:
10.20885/jca.vol4.iss3.art4

Abstract

This study aims to empirically investigate the impact of financial stability, financial targets, and rationalization on instances of financial statement fraud in State-Owned Enterprises operating in the financial services and insurance sector listed on the Indonesia Stock Exchange from 2016 to 2021. The research is motivated by alleged incidents of financial statement manipulation, particularly the practice of window dressing, observed in various financial corporations during 2015 and 2016. The study utilizes secondary data collected from a sample of 14 companies observed over a six-year timeframe. The sample selection employed a purposive sampling technique, and data analysis involved conducting multiple linear regression analysis using the SPSS version 25 software. The findings indicate that financial targets and rationalization have a significant impact on instances of financial statement fraud, while financial stability does not demonstrate a comparable influence.

Introduction

Some public companies are taking steps to present financial statements that are of interest to stakeholders, even to increase their share prices and reflect good financial statements to outsiders. The quality of financial reporting is considered good if the information presented in the financial statements can be understood, relevant and reliable in meeting the needs of users of decision-making, free of misleading bias and material error, and can be compared with the financial statements of previous statements and or similar companies (SFAC No.4, FASB, 1980).

However, in running a company in an environment of constant growth and competition sometimes cannot give the best results (Santoso & Surenggono, 2018). This allows and encourages management to dishonestly manipulate financial statements, in order to maintain the company's reputation in the eyes of stakeholders. According to the American Institute Certified Public Accountant (AICPA) (2017), the frame of financial reporting is a deliberate misrepresentation or omission of information in financial statements with a view to harming investors or the user of the report.

There are several factors that cause companies to manipulate financial statements. The first factor is financial stability, the company's position is stable, the value of the company increases from the point of view of investors, creditors and the public. In the study of Pratiya et al. (2018), Kayoi and Fuad (2019), and Jao et al. (2020) found that financial stability affects financial fraud. However, this result is not in line with research conducted by Fajri (2018) and Zakaria (2018) stating that financial stability does not have an influence on financial statement fraud.

Furthermore, the factor causing the company to manipulate financial statements is financial targets. Financial targets are seen as unsustainable pressure on management to achieve the goals set by the board. Pratiya et al. (2018), Kayoi and Fuad (2019), and Jao et al. (2020) found that financial targets affect financial statement fraud. However, this result is not in line with research conducted by Fajri (2018) and Zakaria (2018) found that financial targets have no effect on financial statement fraud. The third contributing factor to the cheating of the report is rationalization. Sasongko et al. (2019), Andriani (2019), Janrosl and Yuliadi (2019) found that rationalization affects financial statement fraud. Meanwhile, research conducted by Listyawati (2016), Salim and Riady (2021), found that rationalization has no effect on financial statement fraud.

In Indonesia, research on financial stability, financial targets and rationalization of financial statement fraud has been carried out a lot, but there are inconsistencies in the results of the research previously, so that researchers were motivated to conduct this study by replacing relevant research variables, so that there were differences with those that had been previously studied.

In this study, researchers specifically focused on SOEs operating in the financial services and insurance sectors. The rationale behind this choice stems from notable incidents of window dressing at PT. BRI and PT. Jiwasraya Insurance during the period of 2015-2016. Additionally, the case of PT Asuransi Bumi Putra in 2017, where the company failed to fulfill its customers' insurance claims, further emphasized the significance of investigating this sector. It is worth noting that prior research predominantly concentrated on manufacturing companies. Therefore, this study contributes to bridging the gap in research by examining the financial services and insurance sector, particularly SOEs, providing valuable insights for investors to inform their investment decisions.

Literature Review

Agency Theory

Jensen and Meckling (1976) define agency theory as the relationship between the agen (administrator) and the principal (owner). Principals are business owners or investors, and agents are managers. In an agency relationship, there is still a contract in which the person hires an agent to work on his behalf and empowers the agent to make the best decision for him. The customer is obliged to provide facilities and easiress for the running of the company as the owner of the company, and the representative as the owner of the company is obliged to take care of the company entrusted to him for the benefit of shareholders (Santoso, 2015). Agency theory in accounting fraud arises due to differences in goals that give rise to conflicts of interest between principals and agents that can give rise to information asymmetry. This indirectly gives agents the ability to hide information that the principal does not know about. In this situation, the manager (agent) has the opportunity to make fraud by manipulating the financial statements presented to the investor (Rahmanti & Daljono, 2013).

Fraud Triangle Theory

Cressey (1953) in his study concluded that there are three conditions that can lead to fraudulent financial statements, namely pressure, opportunity, and rationalization. According to Norbarani and Rahardjo (2012), pressure is caused by several factors, namely financial stability and financial targets. Financial stability is a condition that describes the financial condition of a company in a stable state. When a company is in a stable state, the value of the company will increase in the eyes of investors, creditors and the public. Pressure can also arise due to the financial goals that management must meet to provide the best performance expected by the business. Some of the things that management can do to increase profits and achieve financial goals are to increase sales efforts in business. Another thing that can be done is the fraud of financial whistleblowers by providing unreasonable reporting or manipulating figures that do not match reality.

According to the fraud triangle theory, the second condition that causes financial statement fraud is opportunity. According to SAS No. 99 AICPA (2017), opportunities are created due to weaknesses in internal controls, ineffective management oversight or abuse of office and authority. Inadequate internal control systems create opportunities for fraudulent activities to take place (Hamdani & Albar, 2016). Failure to establish proper procedures to detect fraudulent activity also increases the risk of cheating. Rationalization is an important factor in fraud, where the perpetrator seeks to justify his actions. Rationalization is the hardest part of the deception triangle to measure. For those who used to be dishonest, rationalizing fraud can be easier. The fraudster is always looking for logical arguments to justify his actions (Priantara, 2013).

Research uses the fraud triangle as a theoretical basis because it can be seen from several studies that have been carried out before, generally using the fraud triangle as a theoretical basis and finding that the fraud triangle theory is able to detect fraudulent actions in financial statements. Therefore, there is a strong correlation when researchers use these two theories (agency theory and fraud triangle theory) in, one discusses differences in interests, the next thing that triggers/encourages management in committing fraud.

Financial Statement Fraud

According to AICPA (2017), fraudulent financial reporting is defined as a deliberate misstatement or omission of amounts or disclosures in financial statements with a view to harming users of such reports. In Indonesia, regulations related to fraud in financial reporting are regulated in the Criminal Code 378 and ITE Law No.11 of 2008. According to IFAC (2009), fraudulent financial reporting can be carried out by taking several actions, namely, 1) manipulation, falsification or alteration of accounting documents, supporting documents for the preparation of financial statements, 2) significant deliberate omission of information in the financial statements, and 3) intentional abuse in every policy relating to the number, classification, form of presentation or disclosure.

Financial Stability

If the company's financial stability is in poor condition, the company will try its best to keep the company's finances looking good. According to Loebbecke (1989) and (Bell et al., 1993) shows that if a company falls below the industry average, management will manipulate financial statements to improve the company's prospects. Research conducted by Pratiya et al. (2018), Kayoi and Fuad (2019) and Jao et al. (2020) found that financial stability affects financial statement fraud in manufacturing company. In contrast to research conducted by Fajri (2018) and Nuryuliza and Triyanto (2019) found that financial stability has no effect on financial statement fraud. Based on the description above, the hypothesis can be formulated as follows:
H1: Financial stability affects financial statement fraud.

Financial Targets

Financial targets are believed to put excessive pressure on management to achieve the goals set by the Board of Directors. According to Skousen et al. (2009) in its performance, management is required to perform the best performance to achieve the planned finances. The higher the financial targets set for an enterprise, the greater the responsibility of the company to meet those targets, the more vulnerable management is to manipulate financial statements to achieve predetermined financial targets. Pratiya et al. (2018), Kayoi and Fuad (2019), Afiah and Aulia (2020) and Jao et al. (2020), found that the financial targets had an impact on financial statement fraud. Meanwhile, research by Fajri (2018) and Rianti (2020) found that financial targets did not affect financial statement fraud. Based on the description above, the hypothesis can be formulated as follows:
H2: Financial targets affect financial statement fraud.

Rationalization

Rationalization is the idea that fraudulent behavior is legal and socially acceptable. This is because perpetrators believe that they deserve more compensation for what they do. In this case, managers manipulate financial statements to increase the company's profits, thereby manipulating what is considered good in the eyes of investors to improve the company's reputation. In research conducted by Sasongko et al. (2019), Andriani (2019) and Janrosl and Yuliadi (2019) found that

rationalization with a profitability ratio proxy affects financial statement fraud. Meanwhile, research conducted by Listyawati (2016) and Salim and Riady (2021) found that the rationalization proxied by the profitability ratio has no effect on financial statement fraud. Based on the description above, the hypothesis can be formulated as follows:
H3: Rationalization affects financial statement fraud

Research Methods

The population in this study is State-Owned Enterprises (SOEs) in the financial services and insurance sector listed on the Indonesia Stock Exchange (2016-2021) where there are 14 companies. The sampling technique uses purposive sampling technique. The sample calculation is presented in Table 1.

Table 1. Sample Selection Summary

Criterias	Sum
State-Owned Enterprises in the financial and insurance services sector listed on the Indonesia Stock Exchange in 2016-2021	19
State-owned companies in the financial services and insurance sector that do not publish their financial statements during the period 2016-2021	-1
Companies that do not report profit during the period 2016-2021	-2
Companies that do not provide the data needed during the research period	-2
A total of companies were included in the research sample	**14**

From all the selection criteria, sample of 14 companies was obtained. This research was conducted for 6 periods, namely 2016-2021.

Dependent Variables

Financial statement fraud

Financial statement misrepresentation is a deliberate misconduct by omitting important information in a financial statement whose purpose is to mislead users of financial statements. According to Loebbecke (1989), profit management occurs when managers use considerations in financial reporting and carry out transaction manipulations to change financial statements, both for mislead some users of financial statements called stakeholders regarding the economic performance of the company or to influence the results of contracts that depend on the figures in the report financial.

Rezaee and Riley (2002) explained that financial statement fraud often begins with misstatements or profit management from quarterly financial statements that are considered immaterial and eventually grow into fraud thus giving rise to a misleading annual report.

Therefore, in this study, profit management was used as a proxy for fraud in financial statement. In measuring profit management can use discretionary accruals (DA) with the following formula:

1. Determining the accrual value of the difference between net profit and operating cash flow.
   $TA_{it} = NI_{it} - CFO_{it}$
2. Estimating the total value of accruals to obtain the regression coefficient.
   $TA_{it} / A_{it<=} = \alpha_{=}(1/A_{it<=}) + \alpha_{H}(\Delta REV_{it}/A_{it<=}) + \alpha_{N}(PPE_{it}/A_{it<=}) + \varepsilon_{it}$
3. Calculates the value of Non Discretionary Accruals (NDA) using the regression coefficient that has been obtained.
   $NDA_{it} = \alpha_{=}(1/A_{it<=}) + \alpha_{H}[(\Delta REV_{it} - \Delta REC_{it})/A_{it<=}] + \alpha_{N}(PPE_{it}/A_{it<=})$
4. Determines the discretionary accrual (DA) value of the difference between total accruals and Non Discretionary Accruals.
   $DA_{it} = TA_{it} / A_{it<=} - NDA_{it}$

Description:

TA_{it} = total accruals of the company i in the period t
NI_{it} = net profit of the company i in the period t
CFO_{it} = company cash flow i in period t
NDA_{it} = non discretionary accrual (NDA) of the company i in the period t
DA_{it} = discretionary accrual (DA) of the company i in the period t
$A_{it<=}$ = total assets of the company i in the period t-1
ΔREV_{it} = change in net sales of company i in period t
ΔREC_{it} = change in receivables of the company i in the period t
PPE_{it} = property, plant, and equipment of the company i in the period t
$\alpha_{=}, \alpha_{H}, \alpha_{N}$ = parameters obtained from the regression equation
$\varepsilon_{@t}$ = error company term i in period t

Financial stability

Financial stability is a condition when the company's finances are in stable condition. The financial stability of the company is reflected in the condition of the company's assets. Total assets describe the wealth that the company has (Norbarani & Rahardjo, 2012). According to Skousen et al. (2009), the form of manipulation of financial statements by management relates to the growth of the company's assets. Therefore, in this study financial stability is proxied by the ratio of changes in assets for two years. The ratio of asset changes denoted by ACHANGE can be calculated by the formula:

$$ACHANGE = (Total\ Assets\ t – Total\ Assets\ t\text{-}1) / Total\ Assets\ t\text{-}1$$

Financial targets

SAS No. 99 AICPA (2017) explained that the financial target is the risk of excessive pressure on management to meet the financial targets set by the party responsible for the management including the receipt of incentives from sales as well as profits. The managers will do the best to achieve the company's financial goals when they do their job. The proxy used to assess financial targets is Return on Asset (ROA) because it is useful for assessing the company's ability to realize profits based on the assets owned (Skousen et al., 2009). Return on assets (ROA) which can be measured by the formula:

$$ROA = Net\ profit\ after\ Tax / Total\ Assets\ (or\ average\ Total\ Assets)$$

Rationalization

Rationalization is a thought that states that actions in committing fraud are legal and acceptable in society. This happens because fraudsters feel that they deserve more profit from what they do for the company. Therefore, in the research of Rachmania et al. (2017) on the measurement of rationalization using the measurement of profitability. The profitability ratio used to measure rationalization in this study is the ratio of operating profit margin. Such measurements may indicate unstable profits. This is considered to be able to show fraudulent actions in the financial statements. This ratio can be measured by the following formula:

$$Operating\ profit\ margin = Profit\ operational/Revenue$$

Research Model

The model in this study is as follows**:**

$$DAit = \beta 0 + \beta 1ACHANGE + \beta 2ROA + \beta 3PROFIT + e$$

Description:

DAit = Financial Statement Fraud
B0 = constant regression coefficient

ACHANGE = Financial stability
ROA = Financial targets
PROFITABILITY = Rationalization

Results and Discussion

The descriptive statistics consisting of the values of minimum, maximum, average, and standard deviations for the variable of the study are presented in Table 2.

Table 2. Descriptive Statistics

	N	Minimum	Maximum	Average	Std. Deviation
Financial Stability (X1)	84	-0.7926	0.8063	0.100443	0.2420491
Financial Targets (X2)	84	0.0007	0.3391	0.040687	0.0602007
Rationalization(X3)	84	0.0159	0.2416	0.263772	0.2136519
Financial Statement Fraud (Y)	84	-0.5210	1.6948	0.041539	0.2149709
Valid N (listwise)	84				

Source: Data Processing Results (2022)

Based on the test results using descriptive statistical tests on independent variables, namely financial stability (X1) shows a minimum value of -0.79, a maximum value of 0.8, a mean of 0.10 and a standard deviation of 0.24. The descriptive statistical test against the financial target (X2) showed a minimum value of 0.00, a maximum value of 0.33, a mean value of 0.04 standard deviation of 0.06. Descriptive statistical tests against rationalization (X3) showed a minimum value of 0.01, a maximum value of 0.24, a mean of 0.04 and a standard deviation of 0.21.

Normality test

Table 3. Normality Test

One-Sample Kolmogorov-Smirnov Test		
N		84
Normal Parameters[a]	Mean	0.0000000
	Std. Deviation	1.03275093
Most Extreme Differences	Absolute	0.133
	Positive	0.133
	Negative	-0.071
Kolmogorov-Smirnov Z		1.218
Asymp. Sig. (2-tailed)		.103

Source: Data processing results 2022

Based on the normality test in Table 3, it produces a large value of 0.05 which is 0.103 and it can be concluded that all research variables used are normally distributed, because the data processing stage can be continued immediately.

Multicholinearity Test

Table 4. Multicholinearity Test

Information	Tolerance	VIF	Information
Financial z Stability (X1)	0.991	1.009	No multicholinearity
Target zFinance (X2)	0.972	1.029	No multicholinearity
Rationalization (X3)	0.970	1.031	No multicholinearity

Source: Processing data 2022

Based on Table 4 it can be concluded that the variables of financial stability, financial targets and rationalization do not occur symptoms of multicholinearity.

Autocorrelation Test

Table 5. Autocorrelation Test

Durbin Watson	Conclusion
1.985	No Autocorrelations occurred

Source: Data processing results 2022

Based on Table 5, it can be seen that the Durbin-Watson value is 1.985. Dw values are between du and 4-du values of 1.4100 and 2.5900, respectively. So it can be said that in the regression model there are no symptoms of autocorrelation.

Heteroscedasticity Test

Table 6. Heterochedasticity Test

Variable	Sig	Alpha	Conclusion
Financial Stability	0.268		No heterochedasticity occurs
Financial Targets	0.151	0.05	No heterochedasticity occurs
Rationalization	0.758		No heterochedasticity occurs

Source: Data processing results (2022)

Based on Table 6, it can be seen that each independent variable in this study has explained a significant value above 0.05 so it can be concluded that there are no symptoms of heteroskedasticity.

Hypothesis Testing

Multiple linear regression analysis was carried out to determine the seven independent variables, namely financial stability, financial targets and rationalization can be used to detect financial statement fraud in the company state-owned enterprises in the financial and insurance services sector listed on the IDX for the period 2016-2021. The following are the results of multiple linear analysis according to the regression model:

$$DAit = \mathbf{0.081 +} 0.031\mathbf{ACHANGE} + 1.888\ \mathbf{ROA} - 0.188\ \mathbf{PROFIT}$$

Table 7. Multiple Regression Analysis

	B	Std. Error	t	Sig.
(Constant)	0.081	0.032	2.533	0.013
Financial stability (X1)	0.031	0.032	0.963	0.339
Financial targets (X2)	1.888	0.837	2.257	0.027
Rationalization (X3)	-0.188	0.078	-2.422	0.018
R^2 0.116				
Sig 0.019				

Source: Data Processing Results (2022)

The results of the study shown in Table 7 saw that the significance value formed on the change in assets was greater than $\alpha = 0.05$, which was 0.339. The results show that H1 was rejected and it can be concluded that financial stability proxied by changes in assets (ACHANGE) did not have a significant effect on fraudulent reports financial. This happens because in order to maintain good financial stability, the management not only increases profits, but the presence of party funds flowing into the company continues to increase year by year. With a stable or good financial condition, business leaders do not feel pressure from the management to improve their finances. The results of this study are in line with the research of Fajri (2018) and (Nuryuliza and Triyanto, 2019).

The results of the study shown in Table 7 show that the significance value formed on the return on assets is less than α = 0.05, which is 0.027. These results show that H2 is accepted and it can be concluded that the financial target proxied with return on assets (ROA) has a significant effect on financial statement fraud. This means that management faces pressure to produce the financial performance set by the company's owner. The management will benefit from the use of assets to generate the desired profit by the company and show good performance. Using assets to achieve the company's financial goals encourages management to take discretionary actions or make decisions freely. This can lead to dysfunctional behavior. This behavior has the potential to cause fraud because it presents incorrect financial statements. The results of this study are in line with Pratiya et al. (2018), Kayoi and Fuad (2019) and Jao et al. (2020) which found that financial targets affect financial statement fraud.

The results of the research shown in Table 7 show that the small significance value of α = 0.05, which is 0.018. These results show that H3 is accepted and it can be concluded that the rationalization proxied by the operating profit margin ratio affects the fraud of financial statements. Operating profit margin ratio is the ability of a company to make a profit. This ratio can also be used to measure the level of manager performance by looking at the size or size of the profit obtained by the company both from sales and from investment returns. If the company is not able to generate profits according to what has been targeted, then this encourages managers to commit fraud so that the profits presented look high, when the actual state of affairs the profits generated by the company are low. This result is in line with research conducted by Sasongko et al. (2019), Andriani (2019) and (Janrosl & Yuliadi, 2019).

Conclusion

Based on the multiple linear analysis, the conclusion can be drawn that financial stability does not have an impact on financial statement fraud, whereas financial targets and rationalizations do affect financial statement fraud. The findings of this research contribute valuable information and serve as a reference in the financial field regarding the factors influencing financial statement fraud. Moreover, these findings can be particularly useful for auditors in gaining a better understanding of different industries and businesses, enabling them to effectively detect potential fraud within client companies.

However, it is important to note that this study only utilized a sample of service companies over a six-year period. Consequently, there is a possibility that the research might not fully capture the complete picture of the relationship between financial stability, financial targets, rationalizations, and financial statement fraud. Additionally, the research solely relied on secondary data in the form of audited reports, which may not provide a comprehensive understanding of all the variables influencing fraudulent financial reports.

Taking into account the limitations of this research, there are recommendations for further investigation. It is suggested that future studies expand on the proxy variables utilized in the analysis of the fraud triangle. Additionally, there is a need to consider replacing or including other relevant variables, such as external pressure, nature of the industry, ineffective monitoring, auditor opinion, and changes in auditors. By incorporating these suggestions, future research can provide a more comprehensive and nuanced understanding of the topic at hand.

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