THE EFFECTIVENESS OF FRAUD EARLY WARNING SYSTEM IN FINANCIAL REPORTING: WHAT IS THE MOST EFFECTIVE METHOD AND TECHNOLOGY USED?

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ABSTRACT

This research aims to examine the perceptions of internal and external auditors regarding the effectiveness of methods of detection and prevention of financial fraud actions, procedures or techniques are believed to be effective in reducing measures of financial fraud and software or technology that is effective to detect and prevent financial fraud actions. The research was conducted by dividing the questionnaire directly to the External Auditor who works at Big Four Public Accountant Firm and Internal Auditor at one of the largest telecommunications companies in Indonesia. This study analyzed by independent sample T-test. Results of this research shows that from 35 methods and software used to detect and prevent financial fraud, there are 3 (three) methods have significant differences between the perceptions of internal auditors and external auditors on the effectiveness of methods of detection and prevention of financial fraud action those are code of sanctions against suppliers/contractors, increased attention of senior management, and fraud reporting policy Software or technology that are believed to be effective in reducing measures of financial fraud are password protection, continuous audit and filtering software. Overall, the inventory observation, bank reconciliation, and review of internal control are procedures or techniques which are believed to be effective in reducing financial fraud.The theoretical implications of this research deals with the theory relating to fraud and internal control, especially in relation to the theory of Internal Control over Financial Reporting (ICOFR).

Key words: perception, financial fraud, internal auditors, external auditors, the effectiveness of methods of detection and prevention of financial fraud.

Introduction

A business entity in running their business would always strive to maintain the viability of its business, beside increase the profitability. In improving their profitability, there is often a clash between business owners and managers in several ways, one of which is the problem of information asymmetry. Related to the problem, the agent (management) has more information so that agents tend to manipulate the financial statements because the agent does not have the courage to disclose information that is not in line with expectations principal (shareholders). Therefore, in this case the auditor's role is very important because the audited financial statements is required by shareholders and stakeholders to assess the performance of management.

Because all parties want to a benefit as much as possible, sometimes things are not good was done to realize their ambitions. There are a lot of companies that has committed the crime of corruption, collusion and nepotism or fraud. Some examples of companies that have revealed the imposture scandals are Enron, Tyco, Adelphia and Worldcom (Wibowo 2009).

In the case of Enron there is an occurrence of moral hazard behavior such as manipulation of financial statements. Company record profit when the company suffered. Manipulation of profits caused the company's desire that the stock remains attractive for investors. This is one example of a case of violation of the professional ethics of accountant which occurred in the United States, a country that has the Act of business and a complete capital markets. Fraudulent financial reporting is the result of a unfair, deceit or unethical business practices that cause suffering for many parties beside judicial process and lawsuits.

The damage caused by acts of fraud could exceed the direct financial losses. Such damage includes external relations business, employee morale, corporate reputation and branding (PriceWaterhouseCoopers 2016). In fact, some of the effects of acts of fraud, such as bad company's reputation, can have long term effects. Because of the fraud damage can have a significant impact for the company; many companies are trying new and different ways to dealing fraud. Growth in cases of fraud occurring action lately shows that there is a very strong need to overcome these problems.

In addition, there is a need a coordination and information sharing between internal and external audits and a better research that allows internal auditors and external auditors know each other's perceptions of both sides regarding the methods and techniques of detection and prevention of acts of fraud so that the efficiency and effectiveness of the audit process can be achieved.
Several previous studies about fraud detection show inconsistent results over time, there are also different results in different places. Therefore, researchers wanted to re-test the fraud prevention and detection methods that are considered effective to measure financial fraud. The difference between prior and current study is the addition of variable used as a method for fraud detection.
In this paper, our objective is to answer three separate but related questions based on theories of fraud, internal control, and diversity. First, Does the internal auditor and the external auditor have the same perception of the effectiveness of fraudulent

financial detection and prevention method ? If so, which procedure or technique that is believed by Internal Auditor and External Auditor in order to reducing financial fraud action? And third question is which software or technology that is believed by Internal Auditor and External Auditor for effectively detecting and preventing financial fraud action?

Literature Review and Hypotheses Development

Fraud and Fraud Awareness

In the broadest sense, fraud can encompass any crime for gain that uses deception as its principal modus. General term of fraud is a form of deception or fraud committed by people who are not responsible. Fraud is an intentional deception made to incur losses unconsciously by the injured party and provide profits for perpetrators of fraud. Cheating or fraud is generally come from the pressure to perform fraud or encouragement to take advantage from opportunities that exist and their justification (generally accepted) against the action (fraud). It includes all surprises, tricks, cunning or dissembling, and any unfair way which another is cheated.

Auditors, accountants, investors, financial analysts, regulators, and others need financial statements free of material misstatement, whether caused by error or fraud, and therefore are interested in identifying fraudulent financial reporting. Fraudulent Financial reporting (FFR) may occur anywhere and has become increasingly prominent in the eyes of the public and the world's regulators as it may be committed by individuals across all professions.

According to the auditing standard, the factor that distinguishes fraud and error is action background, which resulted in the misstatement in the financial statements of the action intentional or unintentional. If fraud as an intentional act that cannot be detected by an audit , it can have an negative effect for the financial reporting process (Koroy 2008).

On the other hand, there is an example of a professional standard applicable to fraud is proposed by the Institute of Internal Auditors (IIA). The IIA standards contain a section called "What is Fraud?". According to the IIA standard, fraud is perpetrated by a person knowing that it could result in some unauthorized benefit to him or her, to the organization, or to another person, and can be perpetrated by persons outside and inside the organization. After defining the fraud, it is important to make fraud risk assessment which is essential for analyzing the determinants of fraud cases. The fraud triangle is commonly accepted as the major process of identifying and assessing fraud risk. In the fraud theory, there needs to be rationalization, pressure, and opportunity for fraud to take place. The AICPA has referred to these three elements as the fraud risk factors or conditions of fraud, i.e. fraud triangle. The three elements of fraud triangle coexist at different levels within an organization and also influence each personality differently.

Therefore, the fraud risk assessment process must consider the fraud conditions as a whole. It is a fact that measuring the three elements of the fraud triangle is not easy. The audit process is expected to identify and understand how the fraud conditions lead to the likelihood of fraud. In practice, identifying the fraud condition is easier than measuring these elements (Aksoy, 2012).

In addition, the key factors leading to fraud are personal financial needs, opportunity and greed (Brock, 2012). Although eradicating fraud is impossible, it is possible to reduce the risk that occurs (Brock, 2012). Some key deterrence for fraud as noted by Brock (2012) were assessing the risk to delimit high risk areas (with the awareness that fraud occurs most frequently in the finance department), conduct audits prior to hiring, especially for key positions (including police record, credit bureau), review employment contracts (whistleblowing, code of conduct) and set up a whistleblowing program and reporting mechanism (telephone line, mailbox or any other anonymous was of exposing an irregularity).

Similarly a study by Heerden (2011) in Switzerland revealed that weak internal control was the major factor that contributed to the on-going fraud. In addition, Heerden (2011) reported that misappropriation of assets is the most common fraud, and has been exposed by whistleblowing mechanisms. On the other hand, one in seven frauds has been discovered by chance. This puts a question mark on the effectiveness of controls and management review utilized in detecting and preventing fraud (Heerden, 2011). Heerden (2011) suggested that management review and basic internal control mechanism was rated as the most effective means for detection.

Perception

Perception is how people see or interpret the events, objects, and people. People act on the basis of their perceptions and ignoring whether this perception reflects the actual fact (Ikhsan-Ishak 2005). Perception can also be defined as a process which individuals organize and interpret their sensory impressions in order to give meaning to their environment. However, what one receives can basically differ from objective reality. The individual behaviour based on their perception of reality and not the reality itself (Robbins 2008).

In summary of some definitions above, it can be concluded that each individual's perception of an object or event depends on the framework of a different space and time. The difference is caused by two factors, internal factor (cognitive) and the external factors (aspects of visual stimulus). Robins (2008) implicitly saying that an individual's perception of the object is very likely to have differences with the other individual's perception of the same object. The phenomenon is thought to be caused by several factors: a factor in the situation, in the person factors, and factors on target.

The Method of Fraud Early Warning Systems

Prevention of fraud involves two fundamental steps: first, the creation and maintenance of honesty and integrity, the second assessment opportunity of fraud risk and to build a way to minimize risk and eliminate the opportunity of fraud. Fraud mitigation is more effective when reducing opportunities through the system, curb justification and inhibit intention (Hernawan 2010)

The accounting profession must take a responsibility to anticipate and detect fraud in financial reporting preparation. It is necessary for the improvement of auditing standards, especially financial audit standards that emphasize the possible risks of fraud in the financial statements (Verdiana and Utama, 2013).

Auditors will enter a much expanded arena of procedures to detect fraud as they implement SAS no. 99. The new standard aims to have the auditor's consideration of fraud seamlessly blended into the audit process and continually updated until the audit's completion. SAS no. 99 describes a process in which the auditor (1) gathers information needed to identify risks of material misstatement due to fraud, (2) assesses these risks after taking into account an evaluation of the entity's programs and controls and (3) responds to the results.

SAS no. 99 reminds auditors they need to overcome some natural tendencies—such as overreliance on client representations— and biases and approach the audit with a skeptical attitude and questioning mind. Also essential: The auditor must set aside past relationships and not assume that all clients are honest. The new standard provides suggestions on how auditors can learn how to adopt a more critical, skeptical mind-set on their engagements, particularly during audit planning and the evaluation of audit evidence. SAS 99 defines fraud as a deliberate act that results in a material misstatement in financial statements. Fraud can be considered either misstatements that result from fraudulent financial reporting or misstatements that occur from misappropriation of assets. According to SAS 99 the three conditions that must be present for fraud to exist include the incentive to commit fraud, the opportunity to commit fraud and the ability to rationalize the fraud. One method used to measure the effectiveness of fraud-detecting red flags is to use rating scales where auditors report their impression to red flags (Widiyastuti dan Pamudji 2009).

Red flags is a peculiar condition or different from normal circumstances. In other words, the red flags are a signal or indication of something unusual and require further investigation (Sitinjak 2008)

Many studies have examined various methodologies used by auditors to detect fraudulent financial reporting associated with corporations. Moyes (2007) found no differences between external and internal auditors regarding the overall perceived level of fraud detecting effectiveness. However, he found that 17 of the 42 red flags had significant differences regarding the effectiveness of red flags in detecting fraud. For external auditors, the extent of use of red flags was a significant predictor of perceived effectiveness. For internal auditors, perceived fraud detecting effectiveness was a function of total audit experience.

Moser (2012) noted that external auditors who work with internal auditors can create an effective partnership for detecting fraudulent financial reporting. They surveyed 124 internal auditors on the importance of fraud warning signs. Each respondent rated the importance of 43 warning signs in helping indentify possible fraudulent financial reporting. The results show that internal auditors perceive factors related to attitude or rationalization conditions as the most important warning sign of possible fraud. Thus, internal auditors tend to emphasize management characteristics as important fraud detecting factors.

Smith in Moyes, 2007 conducted a study on a selected sample of Malaysian external auditors. The study basically explores the perception of auditors on the existence and usage of fraud risk factors when they audit the financial statements of their clients. Since the concepts of fraud risk factors were newly introduced then, the variables used to measure financial fraud red flags in this article were also very basic. The study found that though fraud risk factors were perceived to be important, their usage (to detect fraud) by these auditors were somewhat limited. There was also no comparison being made to other similar standards as being practiced by other countries. There was also no reference being made to the three fraud triangle dimensions on that study.

The main responsibility of the external auditor is give an opinion on the fairness of financial reporting into their client. In carrying out their responsibilities, the External Auditor profession often rely on someone else for their client's financial statements. Generally, the external auditors rely on the client's internal auditor. Dependence on the results of the internal auditor is in relation to the client cost savings. The external auditors may rely on internal auditors due because internal auditor have a responsibility to ensure the effectiveness of the company's internal controls in order to prevent financial fraud action, where this responsibility is also a function of the External Auditor. Because of these similarities responsibility, the internal auditor and the external auditor are likely to have a same perception regarding the methods and techniques of fraudulent financial reporting detection and prevention.

This various research about the effectiveness of method and technology in fraud detection increased our interest in determining whether there is a different perception among external auditor and internal auditor regarding the effectiveness of method and technology in fraud detection in Indonesia. Thus, the following hypotheses were derived from the literature:

H1: There is no significant difference between the perceptions of internal auditors and external auditors regarding the effectiveness of methods of fraud detection and prevention.

H2: There is a significant difference between the perceptions of internal auditors and external auditors regarding the effectiveness of methods of fraud detection and prevention.

Methodology

Questionnaire Design

In this study, the questionnaireused a five-point Likert scale by which the auditors would indicate their perceptions of how effective each methods was in detecting fraud. To measure perceptions of internal auditors and external auditors regarding the effectiveness of detection and prevention method of fraudulent financial reporting used a seven-point Likert scale by which the auditors (both internal and external) would indicate their perceptions of how effective each method and technology in detecting fraud. The questionnaires using 8 to 9 questions items regarding the profile of respondents, 25 questions about the procedure or technique for detecting fraudulent financial reporting and 9 questions about the software or technology to detect and prevent financial fraud. The instrument used in this study adopted and modified from research Bierstaker, et al. 2006.

Data Collection and Analysis

To gather the data, questionnaires were mailed to 200 internal and external auditors. A total of 71 usable surveys were received which represents 36 percent response rate.The independent sample T-test or different T-test runs to determine how different respondent perception had significant effects on statements related to effectiveness of fraud detecting methodology and technology.

Result

The independent T-test among external auditor and internal auditor's perception regarding method for detecting financial fraud are shown in Table 1 shows that from 26 variables tested, there are 3 variables that had a significant difference ($p < 0.05$) between the perception of auditor internal and external auditors about the effectiveness of the methods or techniques on detection and prevention of financial fraud , there are code of sanctions against suppliers/contractors, increased attention of senior management, and Fraud reporting policy.

Table 1: Independent T-test between external auditor and internal auditor's perception regarding method for detecting financial fraud

Variable		Levene's Test for Equality of Variances		T-test for Equality of Means	
		F	**Sig.**	**t**	**Sig. (2-tailed)**
Method 1	Organizational use of forensic accountants	2.578	.114	.447	.656
Method 2	Bank reconciliations	6.514	.013	-1.705	.093
Method 3	Code of sanctions against suppliers/contractors	2.148	.148	2.737	.008
Method 4	Increased role of audit committee	.794	.377	.961	.341
Method 5	Internal control review and improvement	.399	.530	-.197	.845
Method 6	Fraud prevention and detection training	.226	.636	-.846	.401
Method 7	Increased attention of senior management	5.735	.020	-2.383	.020
Method 8	Performance Audit	1.068	.306	-.986	.328
Method 9	Corporate code of conduct/ethics policy	.502	.481	-.143	.886
Method 10	Cash reviews	.359	.551	-1.003	.320
Method 11	Ethics training	.850	.360	-1.217	.228
Method 12	Reference checks on employees	.149	.701	-1.657	.103
Method 13	Fraud reporting policy	5.316	.025	2.232	.029
Method 14	Fraud auditing	4.622	.036	1.665	.101

Method 15	Inventory observation	.453	.504	-1.529	.132
Method 16	Fraud hotline	2.257	.138	1.628	.109
Method 17	Fraud vulnerability reviews	.745	.392	.609	.545
Method 18	Whistle-blowing policy	1.296	.260	.715	.478
Method 19	Surveillance of electronic correspondence	.000	1.000	.222	.825
Method 20	Security department	1.351	.250	-.239	.812
Method 21	Employment contracts	.003	.958	0.000	1.000
Method 22	Employee counseling programs	.371	.545	-1.513	.136
Method 23	Ethics officer	.286	.595	-.687	.495
Method 24	Staff rotation policy	1.141	.290	-1.282	.205
Method 25	Financial ratios	.424	.518	-1.433	.157
Method 26	SAS 112 reporting for Go Public Company	1.992	.164	-.381	.705
Total		**.033**	**.857**	**-.534**	**.596**

The independent T-test among external auditor and internal auditor's perception regarding technology for detecting financial fraud are shown in Table 2, where there is no significant difference between the perception of the internal auditor and the auditor ekstrenal regarding the effectiveness of software or technology of detection and financial fraud prevention.

Table 2: Independent T-test between external auditor and internal auditor's perception regarding software for detecting financial fraud

Variabel		**Levene's Test for Equality of Variances**		**T-test for Equality of Means**	
		F	**Sig.**	**t**	**Sig. (2-tailed)**
Software 1	Virus protection	2.016	.161	-.274	0.78
Software 2	Firewalls	.314	.577	-.385	0.70
Software 3	Filtering software	.055	.815	-.470	0.64
Software 4	*data mining*	.203	.654	.138	0.89
Software 5	Password protection	.023	.879	-2.037	0.05
Software 6	Continuous auditing	.597	.443	-.737	0.46
Software 7	Digital analysis	2.266	.138	-1.208	0.23
Software 8	Discovery sampling	2.527	.117	-.593	0.56
Software 9	CCTV	.467	.497	0.000	1.00
Software total		**.582**	**.448**	**-.935**	**.353**

The first hypothesis predicts that There is no significant difference between the perceptions of internal auditors and external auditors regarding the effectiveness of methods and technology of fraud detection and prevention. The descriptive statistics in table 1 and 2 below support this hypothesis, whether total value of t for Method is 0.596 and 0.353 for Software where each of these values is more of p = 0.05.

Their similarities and differences in perception between the internal auditor and the external auditor may be due to differences in the education levels of each respondent, but it also influenced by the work experience, and the expectation of audit objective by internal and external auditor.

This is consistent with the theory of perception which states that the factors that influence the perception lies within the perpetrator's perception that attitudes, motives, interests, experience, and hope (Robbins 2008).

In addition, internal auditors and external auditors were asked to rate the effectiveness of anti-fraud procedures and software used in their organization as shown in Table 3.

Table 3 : Percentage of internal auditors (IA) and external auditor (EA) who use fraud prevention method and mean (rank) effectiveness ratings

Method for detecting financial fraud	**EA**	**IA**	**Effectiveness**	**Rank**
Inventory observation	90%	93%	4.27	1
Bank reconciliations	87%	88%	4.23	2
Internal control review and improvement	81%	91%	4.20	3
Fraud vulnerability reviews	82%	92%	4.16	4
Increased role of audit committee	78%	81%	4.09	5
Cash reviews	79%	78%	4.09	6
Staff rotation policy	79%	48%	4.09	7
Fraud prevention and detection training	63%	86%	3.99	8
Whistle-blowing policy	68%	96%	3.97	9
Organizational use of forensic accountants	74%	72%	3.92	10
Increased attention of senior management	56%	68%	3.90	11
Performance Audit	75%	64%	3.90	12
Employment contracts	64%	59%	3.90	13
Corporate code of conduct/ethics policy	57%	72%	3.85	14
Fraud auditing	61%	89%	3.85	15
Financial ratios	61%	68%	3.85	16
Ethics training	43%	70%	3.81	17
Whistle-blowing policy	61%	63%	3.76	18
Fraud hotline	59%	90%	3.74	19
SAS 112 reporting for Go Public Company	59%	48%	3.74	20
Reference checks on employees	51%	43%	3.69	21
Surveillance of electronic correspondence	59%	83%	3.64	22
Employee counseling programs	41%	57%	3.46	23
Security department	37%	42%	3.39	24
Ethics officer	26%	19%	3.29	25
Code of sanctions against suppliers/contractors	39%	82%	3.25	26

According to the perception of internal auditors and external auditors, methods of fraud prevention and detection with the highest level of effectiveness is the Inventory observation , bank reconciliation and Internal control review and improvement. In addition, other methods of combating fraud that involve software or technology show that password protection, continuous audit, and Filtering software are the most effective software to detect and prevent fraud, as shown in Table 4 :

Table 4: Percentage of internal auditors (IA) and external auditor (EA) who use software and mean (rank) effectiveness ratings

***Software* or Teknologi for fraud detection and prevention**	**IA**	**EA**	**Effectiveness**	**Rank**
Password protection	75%	84%	12.09	1
Continuous Audit	78%	79%	12.06	2
Software filtering	81%	74%	11.35	3

Firewalls	64%	71%	11.11	4
Data mining	36%	63%	11.05	5
Digital Analysis	59%	66%	10.78	6
Discovery sampling	59%	53%	10.64	7
CCTV	62%	56%	10.47	8
Virus protection	60%	69%	10.44	9

Conclusions

The finding of this study answer the research questions and objective of the study. First, Does the internal auditor and the external auditor have the same perception of the effectiveness of fraudulent financial detection and prevention method ? The data analysis shows that there isn’t a significant difference between External Auditor and Internal Auditor according to their perception of fraud detection methods. So, we can make a conclusion that the internal auditor and the external auditor have the same perception about financial fraud detection and prevention methods.

If so, which procedure or technique that is believed by Internal Auditor and External Auditor in order to reducing financial fraud action? The methods of fraud prevention and detection with the highest level of effectiveness perceived by the internal auditor and the external auditor are the inventory observation, bank reconciliation, and internal control review and improvement.

And third question is which software or technology that is believed by Internal Auditor and External Auditor for effectively detecting and preventing financial fraud action? Software or technology with the highest level of effectiveness perceived by the internal auditor and the external auditor are password protection, continuous audit and software filtering.

This study has practical implications for accounting practitioners, internal auditors, and fraud examiners. It provides prescriptive information on what fraud detection and prevention methods work best, and suggests that many of the most effective methods are often not being used. Accounting practitioners and management may wish to consider investing in these methods in order to prevent costly frauds in their organizations and respond to the demands of regulatory agencies and legal requirements such as those imposed by the Sarbanes-Oxley Act of 2002. Regulators may also find these results of interest. For example, codes of conduct and whistleblower programs are now required by SOX. The cost/benefit tradeoff in mandating organizational use of forensic accountants may be an issue worthy of consideration by regulators.

Limitation and Suggestions

The sample in this paper uses only an internal auditor at one sector public companies listed in Indonesian Stock Exchange and the external auditor on the Big Four public accounting firm in Jakarta. So, the results of this study can’t be generalized widely for every company and public accounting firm. For further research is expected to broaden the sample and the number of respondents and use different methods to the study. Future research could explore the use of fraud prevention and detection methods by other members of the accounting profession such as tax practitioners. In addition, future research could gather data on practitioners’ suggestions for improving the usefulness of fraud prevention and detection methods, and the reasons why firms are reluctant to invest in anti-fraud technology and forensic accountants. For example, firms may be concerned about the costs of these methods, but may underestimate the potential benefits in terms of cost savings from reduced losses related to fraud.

Implications

The implications of the research findings consist of the theoretical and practical implications. The theoretical implications associated with its contribution to scientific developments relating to auditing, business, and financial and practical implications of the research findings related to its contribution to the preparation audit plan in the audit field.

Theoretical implications

The theoretical implications of this research deals with the theory relating to fraud and internal control, especially in relation to the theory of Internal Control over Financial Reporting (ICOFR). The theoretical implications associated with some methods of financial fraud prevention consistently strengthen the earlier theories, which of the 35 methods of financial fraud detection and prevention , the internal control review is the most effective method for Internal Auditors and the External Auditor to detect and prevent financial fraud.

The practical implications

The practical implications of this research applies to External Auditor and Internal Auditor in Indonesia or other country to making an effective audit plan. In this study, the effective method according to external auditor and internal auditor’s perception are inventory observation, bank reconciliations, and Internal control review and improvement. By using this paper result, the preparation of audit plan and audit program can be focused and more effective to detect and prevent financial fraud.

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