
An Analysis of Pentagon Fraud Theory to Detect Fraudulent Financial Reporting (a Case Study at Sub Sector Transportation That Listed in Indonesian Stock Exchange 2014-2018)

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Abstract

The aim of this study is to examine the element of fraud in fraud pentagon theory against indications of fraudulent financial reporting. The Fraud pentagon model is a further development of classical fraud triangle theory and fraud diamond theory. It includes pressure on financial targets, financial stability, external pressure, institutional ownership, nature of industry, ineffective monitoring, quality of external auditor, change in auditor, change of directors, and duality CEO. The indication of fraudulent financial reporting as dependent variable. Samples were selected using a purposive sampling method from 175 mining companies listed on Indonesia Stock Exchange during the year period 2014 – 2018, resulting in 70 firm-observations. Data analysis was conducted using the logistic regression method. The results of this study show that the change of directors is significant in detecting the occurrence of fraudulent financial reporting.

Keywords: fraud, pentagon fraud, fraudulent financial reporting, transportation sector

1. Introduction

Financial statements are a medium of communication between the company and users of financial information, using a financial report that explains how the company's condition is to users of financial statements, and stakeholders without having to go to the company. The definition of financial statements contained in Statement Standard Financial Accounting No. 1 of 2017 is as follows: Financial statements will be of maximum benefit if they have met the qualitative elements of financial statements comparable, relevant, understandable and reliable, so that the information contained in the financial statements can be used by stakeholders consisting of management, employees, investors, creditors, suppliers, customers, and the government for the collection of fraud. However, management is not always able to make this happen, which is what makes management act to commit fraud in making financial statements.

Fraud or fraud is an action that aims to obtain personal benefits and can be done by anyone, ranging from top-level employees and even lower-level employees of the company. There are many factors that cause this fraud to occur, one of which is weak supervision or the existence of authority abuse until there is a fraudulent practice of financial statements. According to (Wilopo,

2004), fraudulent financial reporting is a form of deliberate misstatement or nominal manipulation of a financial statement. Another definition is to identify the users of these financial statements.

This research was conducted using theories to detect fraud more deeply and specifically about Crowe's fraud pentagon theory's ability to state that this theory is a renewable theory resulting from the development of a basic theory that begins with a fraud triangle theory model by (Cressey, 1953) which states that fraud occurs due to pressure, opportunity, and rationalization on fraud perpetrators. The fraud triangle theory was then developed by (Wolfe & Dena R, 2004) into diamond fraud theory by adding elements of capability that are believed to have a significant influence on fraud actors. The development of the theory of fraud does not stop at the diamond theory, this theory is known as Crowe's fraud pentagon theory developed by (Crowe, 2011) by adding a new element that explains that one of the basics of a person committing fraud is arrogance. These elements in Crowe's pentagon fraud theory cannot simply be researched so they require variable proxy. The first variable financial targets are proxied with a return on asset. The second variable is financial stability which is proxied by the change in total assets. The third variable external pressure is proxied by the amount of debt. The fourth variable is institutional ownership which is proxied by the number of shares owned by other institutions. The fifth variable is the nature of the proxied industry with an unsettled number of receivables. The sixth variable is ineffective monitoring which is proxied by the number of independent commissioners. The seventh variable of quality of external auditors is proxied using Public Accountant Services (KAP). The eighth variable is change in auditors which is proxied with the substitution of independent auditors. The ninth variable of change of director is proxied by a change in directors. The tenth variable of CEO duality is proxied by the large number of positions that the CEO has.

2. Literature Review

Fraud occurs because of a conflict of interest between agents and principals known as agency theory. In this study, the company's management is the agent, and the owner or shareholder (stakeholder) is the principal. Management commits fraud to improve its welfare which is usually given in the form of bonuses when the management is able to achieve the targets set by the owner or shareholders (stakeholders).

Agency Theory

Agency theory is the theory that underlies the company's business practices used so far. This theory explains the relationship between the owner of the company (shareholders) and management. (Jensen & Meckling, 1976) states that agency theory describes shareholders as principals and management as agents. The company as an agent faces various pressures (Pressure) to determine how to keep the company's performance always improving with the expectation that with the improvement of performance, the principal will give an appreciation (Rationalization). The gate to fraud will be more open if management has the opportunity (Opportunity) and ability (Capability) to increase profits. The act of fraudulent financial reporting carried out by management due to conflict of interest and asymmetric information with

the owner is a form of financial statement fraud. Based on this, there is an agency problem between the owner (principal) and management (agent) which is responsible for the occurrence of fraudulent financial statements that are misleading and detrimental.

Fraudulent Financial Reporting

Fraudulent financial reporting is a deliberate misstatement of the company's financial condition that is carried out through misstatements or deliberate misstatements of several disclosures in the financial statements to deceive users of the financial statements. According to the *Statement on Auditing Standards* or SAS for short No. 99 (AICPA, 2002) states that financial statement fraud can be carried out by: (1) Manipulation, falsification, or alteration of accounting records, supporting documents of the compiled financial statements. (2) Intentional errors or omissions in significant information to the financial statements. (3) Commit a deliberate abuse of principles relating to the number, classification, manner of presentation, or disclosure.

Fraud Pentagon

The development of fraud triangle theory by (Cressey, 1953), then fraud diamond theory developed by Wolfe and Hermanson (2004). (Crowe, 2011) developed the theory of fraud triangle and diamond fraud by changing the risk factor of fraud in the form of capability to competence which has the same meaning of the term. In addition, there is an additional risk factor in the form of arrogance (arrogance). Pentagon theory consists of five elements, namely pressure, opportunity, rationalization, capability, and arrogance. Arrogance is an extension of the fraud triangle theory previously proposed by Cressey, in the theory in add two other element fraud, namely competence and arrogance. Competence is the ability of an employee to ignore internal control, develop a concealment strategy, and control the social situation for his personal gain (Crowe, 2011). According to Crowe, arrogance is an attitude of superiority over the rights possessed and feels that internal control or company policies do not apply to him.

3. Data and Methodology

The first factor causing fraud is pressure. In this case, pressure is a form of motivation for someone to commit fraud which generally comes from: (1) financial pressures, such as a luxurious lifestyle and a lot of debt; (2) conundrums of moral weakness, such as gambling and taking illegal drugs; (3) work-related pressures, lack of satisfaction with the salary received may encourage an employee to cheat; (4) other stresses that can feel from the extravagant nature of the couple and the lavish lifestyle (Albrecht, 2011). When management is under pressure, be it pressure derived from financial pressures or financial stability in meeting its needs, management will be encouraged to do all kinds of ways to achieve this, one of which is by committing financial statement fraud.

The population in this study is all transportation sub-sector companies registered in Indonesia Stock Exchange during the period 2014–2018. The research samples used were 70 banks from 35 transportation sector companies that have been listed on the Indonesia Stock Exchange (IDX). The sampling technique is carried out by purposive sampling. The criteria in the selection of samples in this study are as follows:

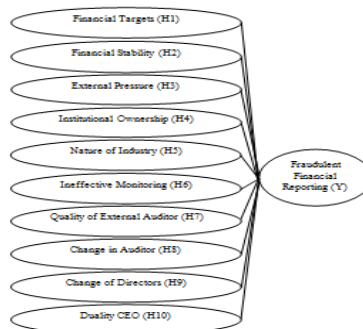
1. Transportation sub-sector companies that have *gone public* or listed on the Indonesia

Stock Exchange (IDX) during the 2014-2018 period.

2. Data on data relating to research variables are available in full (data as a whole are available in publications during the period 2014-2018).

The data source used in this study is a secondary data source in the form of quantitative and using a ratio scale. The data collection method used is documentation, namely by looking at the Financial Statements of transportation sub-sector companies listed on the Indonesia Stock Exchange and can also be seen through the www.idx.co.id, the *Indonesia Capital Market Directory (ICMD)* on the *website of sahamok.com*. The independent variable data studied is data every year from the period 2014 – 2018 after the financial statements are published. This study has two types of variables, namely dependent variables (bound) and independent variables (free). Dependent Variable, namely *fraudulent financial reporting* of transportation companies listed on the IDX, is a bound variable in this study. Free Variables (Independent) Some financial ratios are variables free from research, some of the financial ratios that are variables are financial target, financial stability, external pressure, institutional ownership, nature of industry, ineffective monitoring, quality of external auditors, change in auditors, change of directors, duality CEO.

Table 1. Research Framework



4. Result and Discussion

Descriptive analysis is carried out to describe the variables used, both dependent variables and independent variables. The purpose of the in analysis is to provide a systematic picture of each of the variables used in this study, which includes dividend policy, profitability, liquidity, and solvency. The following are the results of data management using SPSS 25.

The model for Fraudulent Financial Reporting (Y) is:

$$Y = a + b_1X_1 + b_2X_2 + b_3X_3 + b_4 X_4 + b_5 X_5 + b_6 X_6 + b_7 X_7 + b_8 X_8 + b_9 X_9 + b_{10}X_{10} + e \quad (1)$$

Table 2: Data Description of Selected Variables (%)

Variable	N	Minimum	Maximum	Mean	Std. Deviation
ROA	70	-.659419	1.851710	.0193953	.2554922
ACHANGE	70	-.853003	.4972570	-.026576	.1976456
LEV	70	.0631921	1.460658	.4893777	.2421203
OSHIP	70	.0006116	.9999824	.5571151	.2564067
RECEIVABLE	70	-2.81803	1.935136	-.084202	.6787343
BDOUT	70	.1666666	.6666667	.3671598	.1034297
Valid N (list wise)	70				

Table 2 presents the statistical table in this study. There were 70 observations over a five-year period. The study used data from 2014-2018. There is one independent variable, namely fraudulent financial reporting. The mean for ROA is 0.193 with a minimum value of -0.659 and a maximum of 1.851. The mean value for ACHANGE is 0.265 with a minimum value of -0.853 and a maximum of 0.497. The mean value for LEV is 0.489 with a minimum value of 0.063 and a maximum of 1.460. The mean value for OSHIP is 0.557 with a minimum value of 0.000 and a maximum of 0.999. The mean value for RECEIVABLE is -0.084 with a minimum value of -2.818 and a maximum of 1.935. While the mean value for BDOUT is 0.367 with a minimum value of 0.166 and a maximum of 0.666.

Table 3. Data Description of Selected Variables Dummy

Description	Frequency	Percentage (%)
The company uses services BIG 4 (BIG4)	24	34,3
The company performs turnover (CPA)	21	30
Companies that make substitutions (DCHANGE)	11	15,7
CEOs who have more than one position (CEODUA)	12	17,1

Table 3 shows that transportation companies that use the services of BIG 4 public accountants (KAP) are 24 companies or worth 34.3 percent compared to companies that do not use the services of BIG 4 public accountants (KAP), namely 46 companies or 65.7 percent. This shows that more sample company data do not use the services of a BIG 4 public accountant (KAP) than companies that use the services of a BIG 4 public accountant (KAP).

Table 3 shows that the transportation companies that made auditor changes were 21 companies or 30 percent compared to those that did not change auditors, namely 49 companies or 70 percent. This shows that there are more sample company data that do not make auditor changes than companies that do auditor changes.

Table 3 shows that the transportation companies that made the change of directors were 11 companies or worth 15.7 percent compared to the companies that did not make the change of directors, which was 59 companies or worth 84.3 percent. This shows that more sample company data did not make board changes than companies that made board changes.

Table 3 shows that transportation companies that have CEO duality are 12 per business or 17.1 percent compared to companies that do not have CEO duality, which is 58 companies or 82.9 percent. This shows that more sample company data did not make changes to the board of directors than the companies that made the change of directors.

Table 4. Variables, Beta, Significant

		B	Sig.
Step 1	ROA	1.638	.265
	ACHANGE	.999	.530
	LEV	-.447	.748
	OSHIP	.756	.581
	RECEIVABLE	.559	.259
	BDOUT	2.790	.344
	BIG 4	-.503	.419
	CPA	-.584	.342
	DCHANGE	3.055	.011
	CEODUA	-.045	.943
	Constant	-1.042	.606

Financial targets variables do not have a significant influence in predicting fraudulent financial reporting. This is based on Table 4 of the results of the logistic regression analysis test where the significant value of the financial targets is greater, namely $0.265 > 0.05$. This result can be concluded that H_{1} is rejected while H_{0} is accepted, then financial targets cannot detect fraudulent financial reporting.

Financial stability variables do not have a significant influence in predicting fraudulent financial reporting. This is based on Table 4 of the results of the logistic regression analysis test where the significant value of financial stability is greater, namely $0.530 > 0.05$. This result can be concluded that H_{2} is rejected while H_{0} is accepted, then financial stability cannot detect fraudulent financial reporting.

External pressure variables do not have a significant influence in predicting fraudulent financial reporting. This is based on Table 4 of the results of the logistic regression analysis test where the significant value of external pressure is greater, namely $0.748 > 0.05$. This result can be concluded that H_{3} is rejected while H_{0} is accepted, then external pressure cannot detect fraudulent financial reporting.

Institutional ownership variables do not have a significant influence in predicting fraudulent financial reporting. This is based on Table 4 of the results of the logistic regression analysis test where the significant value of institutional ownership is greater, namely $0.581 > 0.05$. This result

can be concluded that H_{4is} is rejected while H_0 is accepted, then institutional ownership cannot detect fraudulent financial reporting.

Variables of industry nature do not have a significant influence in predicting fraudulent financial reporting. This is based on Table 4 of the results of the logistic regression analysis test where the significant value of nature of industry is greater, namely $0.259 > 0.05$. This result can be concluded that H_{5is} is rejected while H_0 is accepted, hence the nature of industry cannot detect fraudulent financial reporting.

Ineffective monitoring variables do not have a significant influence in predicting fraudulent financial reporting. This is based on Table 4 of the results of the logistic regression analysis test where the significant value of ineffective monitoring is greater, namely $0.344 > 0.05$. This result can be concluded that H_{6is} is rejected while H_0 is accepted, so ineffective monitoring cannot detect fraudulent financial reporting.

The variable quality of external auditors does not have a significant influence in predicting fraudulent financial reporting. This is based on table 4 of the results of the logistic regression analysis test where the significant value of the quality of external auditors is greater, namely $0.419 > 0.05$. This result can be concluded that H_{7is} is rejected while H_0 is accepted, hence the quality of external auditors cannot detect fraudulent financial reporting.

The change in auditor variable has no significant influence in predicting fraudulent financial reporting. This is based on Table 4 of the results of the logistic regression analysis test where the significant value of change in auditor is greater, namely $0.342 > 0.05$. This result can be concluded that H_{8is} is rejected while H_0 is accepted, so change in auditors cannot detect fraudulent financial reporting.

The change of director variable has a significant influence in predicting the diction of fraudulent financial reporting. This is based on Table 4 of the results of the logistic regression analysis test where the significant value of change of directors is greater, namely $0.011 < 0.05$. This result can be concluded that H_{9is} is accepted while H_0 is rejected, then change of director can detect fraudulent financial reporting.

The CEO duality variable has no significant influence in predicting fraudulent financial reporting. This is based on Table 4 logistic regression analysis test results where the significant value of CEO duality is greater, namely $0.943 > 0.05$. This result can be concluded that H_{10is} is rejected while H_0 is accepted, hence the duality of the CEO cannot detect fraudulent financial reporting.

The Effect of *Financial Targets* on *Fraudulent Financial Reporting*

The results of the test using logistic regression analysis in table 4 showed that the significant value formed on *the return on assets* was greater than $\alpha = 0.05$, which was 0.265. These results show that the *financial targets* variable proxied with *return on assets* (ROA) has no effect on *fraudulent financial reporting*. This shows that *the Pentagon fraud theory* is not able to detect *fraudulent financial reporting* properly. The reason for the absence of significant *financial targets* against *fraudulent financial reporting* is when the *company's return on assets* increases, meaning that the company is able to generate profits from the company's assets, while to fund the investment of the assets of the source of funds comes from sales. This shows that the company

can still achieve the financial targets that have been set and add to the company's innovation so that what was originally public transportation was less in demand is now a "primadona" as one of the public transportations after being made in the form of technology-based creative businesses. The results of this study are in accordance with research that has been conducted by (Tessa G & Harto, 2016) that financial *targets* have no effect on *fraudulent financial reporting*.

The Effect of Financial Stability on Fraudulent Financial Reporting

The results of the test using logistic regression analysis in table 4 showed that the significant value formed at the change in assets was greater than $\alpha = 0.05$, which is 0.265. The results show that H_2 is rejected, and it can be concluded that *financial stability* proxied by asset change (ACHANGE) has no effect on *fraudulent financial reporting*. This shows that *the Pentagon fraud theory* is not able to detect *fraudulent financial reporting* properly. The fundamental reason why this research is insignificant is that the greater the change in company assets, the smaller the *fraudulent financial reporting* practices. This happened because large changes in assets caused the company to receive the spotlight from the public and information about these changes quickly spread. Companies that have large asset changes will gain the trust of the public, government, investors, and creditors in the hope of obtaining a large rate of return. Therefore, large companies will be more careful in conducting financial reporting, so that it affects companies that report their conditions more accurately. The results of this study are in accordance with research that has been conducted by (Sasongko & Wijyantika, 2019) that *financial stability* does not affect *fraudulent financial reporting*.

The Effect of External Pressure on Fraudulent Financial Reporting

The results of the assessment using logistic regression analysis in table 4 show that the significant value formed on the amount of debt is greater than $\alpha = 0.05$, which is 0.748. The results show that H_3 is rejected and it can be concluded that *external pressure* proxied by the amount of debt (LEVERAGE) has no effect on *fraudulent financial reporting*. This shows that *the Pentagon fraud theory* is not able to detect *fraudulent financial reporting* properly. The fundamental reason this is insignificant is that the amount of debt does not affect the potential for *fraudulent financial reporting*. This is because many companies prefer to reissue shares to obtain additional business capital without having to enter into new debt agreements which causes the company's debt burden to become larger and the company's *leverage* value lower. The results of this study are in accordance with research that has been conducted by (Nurbaiti & Hanafi, 2017) that *external pressure* has no effect on *fraudulent financial reporting*.

The Effect of Institutional Ownership on Fraudulent Financial Reporting

The results of the test using logistic regression analysis in table 4 showed that the significant value formed of shares owned by other institutions with the number of shares outstanding was greater than $\alpha = 0.05$, which was 0.581. The results show that H_4 is rejected and it can be concluded that *institutional ownership* proxied by the number of shares owned by other institutions with the number of shares outstanding (OSHIP) has no effect on *fraudulent financial reporting*. This shows that *the pentagon fraud theory* is not able to detect *fraudulent financial reporting* properly. The fundamental reason this research is insignificant is that companies have

an equally great responsibility to an individual as well as to the institution. The high and low percentage of outstanding shares is controlled by the company in a clean and evenly distributed manner, so that management is unable to carry out *fraudulent financial reporting*. The results of this study are in accordance with research that has been conducted by (Bawekes, Simanjutak, & Daat, 2018) that *institutional ownership* has no effect on *fraudulent financial reporting*.

The Effect of *Nature of Industry* on *Fraudulent Financial Reporting*

The results of the test using logistic regression analysis in table 4 showed that the significant value formed on the number of collectible receivables was greater than $\alpha = 0.05$, which was 0.259. The results show that H_5 is rejected, and it can be concluded that the *nature of industry* proxied by the amount of uncollectible receivables (RECEIVABLE) has no effect on *fraudulent financial reporting*. This shows that *the Pentagon fraud theory* is not able to detect *fraudulent financial reporting* properly. The cause of the absence of a significant influence of *the nature of industry* on *fraudulent financial reporting* due to the large amount of uncollectible receivables does not affect the potential for financial statement fraud itself, this is due to subjective assessment of certain accounts for things that are not k is avoided from the activity of the amount in the company so that it is not considered as a loophole for opportunities to carry out *fraudulent financial reporting*. The results of this study are in accordance with research that has been conducted by (Sasongko & Wijyantika, 2019) that *financial stability* has no effect on *fraudulent financial reporting*.

The Effect of *Ineffective Monitoring* on *Fraudulent Financial Reporting*

The results of the test using logistic regression analysis in table 4 showed that the significant value formed on the independent board of commissioners was greater than $\alpha = 0.05$, which was 0.259. The results show that H_6 is rejected, and it can be concluded that *ineffective monitoring* proxied by an independent board of commissioners (BDOUT) does not affect *fraudulent financial reporting*. This shows that *the Pentagon fraud theory* is not able to detect *fraudulent financial reporting* properly. The reason for the absence of a significant influence of *ineffective monitoring* on *fraudulent financial reporting* is because it is not the independent board of commissioners itself that affects fraud, but the quality of the board of commissioners that affects financial statement fraud. The results of this study are in accordance with research that has been carried out by (Bawekes, Simanjutak, & Daat, 2018) that *institutional ownership* has no effect on *fraudulent financial reporting*.

The Effect of *Quality Of External Auditors* on *Fraudulent Financial Reporting*

The results of the test using logistic regression analysis in table 4 showed that the significant value formed in the use of the services of a BIG 4 public accountant was greater than $\alpha = 0.05$, which was 0.419. The results show that H_7 is rejected and it can be concluded that the *quality of external auditors* proxied by the use of the services of a BIG 4 (BIG4) public accountant has no effect on *fraudulent financial reporting*. This shows that *the Pentagon fraud theory* is not able to detect *fraudulent financial reporting* properly. The cause of the absence of a significant influence of the quality of *external auditors* on *fraudulent financial reporting* is because the quality of auditor services is regulated and controlled by the Indonesian Accounting Association (IAI) with

the Professional Standards of Public Accountants and the Rules of Ethics of the Public Accountant Company. Sanctions can be given in the form of light sanctions with fines to the revocation of permits by IAI, so that the *quality of external auditors* does not affect the possibility of *fraudulent financial reporting*. The results of this study are in accordance with research that has been conducted by (Bayagub, Wafirotin & Mustoffa, 2018) that *institutional ownership* has no effect on *fraudulent financial reporting*.

The Effect of Change in Auditor on Fraudulent Financial Reporting

The results of the test using logistic regression analysis in table 4 showed that the significant value formed at the auditor turnover was greater than $\alpha = 0.05$, which was 0.342. The results suggest that H_8 was rejected and it can be concluded that the change in auditors proxied by the change of auditor (CPA) has no effect on *fraudulent financial reporting*. This shows that *the pentagon fraud theory* is not able to detect *fraudulent financial reporting* properly. The cause of the absence of a significant effect of *change in auditors* on *fraudulent financial reporting* is because the company that replaced its independent auditor is not to cover up the company's fraud that has been detected by the previous auditor, but because of the size of the company and the growth of the company that occurs, when the company expands its business it will be an increase in area and an increase in the volume of activity company. The results of this study are in accordance with research that has been conducted by (Warsidi, Pramuka, & Suhartinah, 2018) that *institutional ownership* has no effect on *fraudulent financial reporting*.

The Effect of Change of Director on Fraudulent Financial Reporting

The results of the tests using logistic regression analysis in table 4 showed that the significant value formed at the change in directors was greater than $\alpha = 0.05$, which was 0.011. The results show that H_9 is accepted and it can be concluded that the change of directors proxied by the change of directors (DCHANGE) affects *fraudulent financial reporting*. This shows that *the pentagon fraud theory* can detect *fraudulent financial reporting* well. The reason underlying the significant research of the change of directors to *fraudulent financial reporting* proxied by the change of directors is when the change is not made with the aim of transferring responsibility to the new EC director *through* the GMS. This change can occur because the board of directors has power within the company and they have a high position, so the board of directors can easily transfer responsibility if the board of directors has committed *fraudulent financial reporting*. The results of this study are in accordance with research conducted by (Siddiq, 2017) that *institutional ownership* has no effect on *fraudulent financial reporting*.

The Effect of Duality CEO on Fraudulent Financial Reporting

The results of the test using logistic regression analysis in table 4 showed that the significant value formed in the number of positions held by the CEO was greater than $\alpha = 0.05$, which was 0.943. The results show that H_{10} is rejected and it can be concluded that the *proxied duality* of CEO with the number of positions held by the CEO (CEODUA) has no effect on *fraudulent financial reporting*. This shows that *pentagon fraud theory* is not able to detect *fraudulent financial reporting* properly. The reason that underlies the significant research of the CEO's *duality* on *fraudulent financial reporting* which is proxied by the change of directors is that the

CEO does have very competent abilities and has excellent performance so that the director is also trusted to lead his work to improve company performance and maintain his performance to stay in his company, *soduality* CEO does not affect the possibility of *fraudulent financial reporting*. The results of this study are in accordance with research that has been conducted by (Sasongko & Wijyantika, 2019) that financial *stability* does not affect *fraudulent financial reporting*.

Research Limitation

This research has limitations, that this study some companies do not display their financial statements, there are also companies that do not display the information of the variables needed clearly so as to reduce some samples.

Based on the conclusions and limitations above, there are suggestions from this study that are expected to be the basis for subsequent researchers as follows:

1. The researchers were further advised to use different samples from this study and increase the number of samples to the test limit to determine whether it produced the same results from the sample under study or different results in the sample studied.
2. Further research is expected to expand the research population and is considered suitable if it is used to see an act of cheating in a Foreign Country.
3. Further research is expected to consider data collection using questionnaire.

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