

**Good Corporate Governance Mechanism and The Possibility of
Fraudulent Financial Reporting**
*(Empirical Study on Manufacturing Company
Listed in IDX period 2016)*



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Proposed as One of the Requirements for Undergraduate Degree in Economics

MINISTRY OF RESEARCH, TECHNOLOGY AND HIGHER EDUCATION
FACULTY OF ECONOMICS
UNIVERSITY OF SRIWIJAYA
2018

COMPREHENSIVE EXAM APPROVAL LETTER

GOOD CORPORATE GOVERNANCE MECHANISM AND THE
POSSIBILITY OF FRAUDULENT FINANCIAL REPORTING
(EMPIRICAL STUDY ON MANUFACTURING COMPANY
LISTED IN IDX PERIOD 2016)

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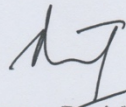
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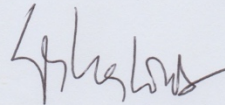
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(EMPIRICAL STUDY ON MANUFACTURING COMPANY
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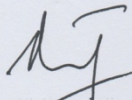
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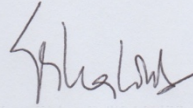
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is truly the result of my work under guidance of supervisors. There is no other people work in this script that I copied without mentioning original sources.

I made this statement in a good faith. If it turns out that my statement is not true in the future then I will be willing to accept my sanctions in accordance with regulations, including cancellation of my degree.

Palembang, February 27th, 2018

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Rizmie Oktariani

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MOTTO

Kindness, Pride, and Confidence

(Liz)

Your life is weight more than yourself, it has the weight of your parents, sisters, brothers, friends, and all of people you know in it. Don't give up, fight, and survive.

(Unknown)

Let yourself be strong, let yourself be independent, let yourself be your strength, because before anyone else, you only have yourself to count on, and after that be the person that can be count on.

(Unknown)

Sesungguhnya kami milik Allah, dan kepada-Nya kita semua kembali.

(Q.S Al-Baqarah: 156)

Allah tidak membebani seseorang melainkan sesuai dengan kesanggupannya.

(Q.S Al-Baqarah: 286)

PREFACE

Praise and thank to Allah SWT for the blessing and mercy that the author can complete the script entitled “**Good Corporate Governance Mechanism and The Possibility of Fraudulent Financial Reporting (Empirical Study on Manufacturing Company Listed In IDX Period 2016)**”. This script is made as one of the requirements to achieve Bachelor Degree of Economics (S-1) in Economic Faculty, Sriwijaya University.

My sincere appreciation to many party who has help me to finish this script. Therefore, author would like to express gratitude to:

1. **Prof. Dr. Ir. H. Anis Saggaff, MSCE** as the Rector of Sriwijaya University.
2. **Prof. Dr. Taufiq Marwah, SE, M.Si** as the Dean of Economic Faculty.
3. **Mr. Arista Hakiki, S.E., M.Acc, Ak, CA** as the Head of Accounting Department.
4. **Mrs. Umi Kalsum S.E., M.Si., Ak., CA** as the secretary of Accounting Department and my academic advisor who always give me her guidance and support.
5. **Mr. Agung Putra Raneo S.E., M.Si.** as the coordinator of International Class.
6. **Mrs. Dra. Hj. Kencana Dewi, M. Sc., Ak, CA**, as the first Script Supervisor and **Mr. Dr. Tertiaro Wahyudi, S.E., MAFIS., Ak, CPA.** as the Second Script Supervisor who have given their time, energy and thought to guide and provide advices in completing this script.
7. All of examiners who have given crtitics and suggestion to fix this script.
8. All of lecturers who have shared knowledge and experience during my college.
9. All of staffs of Economic Faculty who have helped me in preparing administration process.

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20. All of my friends in Accounting departement period 2014 which I can not specify one by one. Thank you for all the things that you have done.

21. All of people related to the accomplishment of this script that author cannot mentions whose name one by one to the all its aid.

Author hopes that this script can be beneficial for many parties. Therefore, criticism and suggestion from all parties can improve this script for perfection will always be welcomed in the future.

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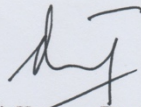
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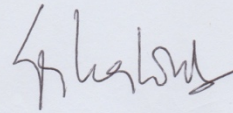
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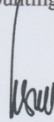


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ABSTRACT

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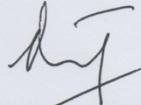
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This study aims to obtain empirical evidence and to analyze the effect of good corporate governance's mechanism such as number of independent commissioners, percentage of financial or accounting literate board commissioners, member of audit committee, and meeting frequency of audit committee on the possibility of fraudulent financial reporting. The population in this study is manufacturing company listed in Indonesia Stock Exchange (IDX) for period 2016. This study uses Beneish model in classifying fraudulent financial reporting and non fraudulent financial reporting. The result of this study indicates that number of independent board commissioners and percentage of financial or accounting literate board commissioner have significant negative effect on the possibility of fraudulent financial reporting, while member of audit committee and meeting frequency of audit committee do not have significant effect on the possibility of fraudulent financial reporting.

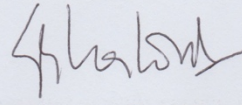
Keywords: *Beneish model, fraudulent financial reporting, good corporate governance.*

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ABSTRAK

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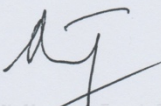
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Penelitian ini bertujuan untuk mendapatkan bukti empiris dan menganalisis pengaruh mekanisme good corporate governance seperti jumlah komisaris independen, persentase komisaris dengan latar belakang keuangan atau akuntansi, anggota komite audit, dan frekuensi rapat komite audit terhadap kemungkinan terjadi kecurangan laporan keuangan. Populasi dalam penelitian ini adalah perusahaan manufaktur yang terdaftar di Bursa Efek Indonesia (BEI) untuk periode 2016. Penelitian ini menggunakan model Beneish dalam mengklasifikasikan laporan keuangan yang melakukan kecurangan dan pelaporan keuangan yang tidak melakukan kecurangan. Hasil penelitian ini menunjukkan bahwa jumlah komisaris independen dan persentase komisaris dengan latar belakang keuangan atau akuntansi mempunyai pengaruh negatif yang signifikan terhadap kemungkinan terjadi kecurangan laporan keuangan, sedangkan anggota komite audit dan frekuensi rapat komite audit tidak berpengaruh signifikan terhadap kemungkinan terjadinya kecurangan laporan keuangan.

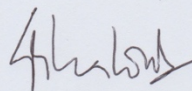
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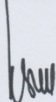
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TABLE OF CONTENTS

TITLE	i
COMPREHENSIVE EXAM APPROVAL LETTER	ii
SCRIPT APPROVAL LETTER	iii
STATEMENT OF RESEARCH INTEGRITY	iv
MOTTO	v
PREFACE	vi
LETTER OF STATEMENT	ix
ABSTRACT	x
ABSTRAK	xi
RESEARCHER RESUME	xii
TABLE OF CONTENTS	xiii
LIST OF APPENDIXS	xvii
LIST OF TABLES	xviii
CHAPTER I INTODUCTION	1
1.1 Research Background	1
1.2. Problem Formulation	11
1.3. Research Objective	12
1.4. Research Usefulness	12
CHAPTER II LITERATURE REVIEW	14
2.1. Agency Theory	14
2.2. Corporate Governance	15
2.3. Good Corporate Governance	17
2.3.1. Board of Commissioner	21
2.3.2. Independent Board of Commissioner	22
2.3.3. Audit Committee	25

2.4. Fraud	27
2.4.1. Fraud Triangle	28
2.4.2. Fraudulent Financial Reporting	29
2.5. Beneish Model (Beneish M-Score)	31
2.6. Previous Research	33
2.7. Research Framework	38
2.8. Reserarch Hypothesis	39
2.8.1 Number of Independent Commissioner and The Possibility of Fraudulent Financial Reporting	39
2.8.2. Percentage of BOC with Accounting or Financial Background and The Possibility of Fraudulent Financial Reporting	40
2.8.3. Size of Audit Committee and The Possibility of Fraudulent Financial Reporting	41
2.8.4. Meetings Frequency of Audit committee and The Possibility of Fraudulent Financial Reporting	42
CHAPTER III RESEARCH METHODOLOGY	44
3.1. Research Varibale	44
3.1.1. Independent Variable	44
3.1.1.1. Number of Independent Commissioner (X1)	44
3.1.1.2. Percentage of Board Commissioner with Accounting of Financial Background (X2)	45
3.1.1.3. Size of Audit Committee (X3)	45
3.1.1.4. Meetings Frequency of Audit Committee (X4)	46
3.1.2. Dependent Variable	46
3.1.2. Fraudulent Financial Reporting	46
3.1.3. Control Variable	48

3.2. Population and Sample.....	49
3.3. Type and Source of Data.....	51
3.4. Method of Collecting Data.....	51
3.5. Analyze Method.....	52
3.5.1. Hypothesis Test.....	52
3.5.2. Descriptive Statistic Analysis.....	53
3.5.3. Goodness of Fit Test	53
3.5.4. Overall Model Fit Test.....	54
3.5.5. Cox and Snell’s R Square and Nagelkerke’s R Square Test	54
3.5.5. Classification Table.....	54
3.5.6. Coefficients’ Significant Test.....	55
CHAPTER IV ANALYSIS RESULT AND DISCUSSION	56
4.1. Research Result.....	56
4.2. Descriptive Static	56
4.3. Logistic Regression Analysis.....	59
4.3.1. Goodness of Fit Test	59
4.3.2. Overall Model Fit Test.....	60
4.3.3. Cox and Snell’s R Square and Nagelkerke’s R Square Test	62
4.3.4. Classification Table.....	63
4.3.5. Coefficients’ Significant Test.....	64
4.4. Hypothesis Testing.....	68
4.4.1. Hypothesis 1: Number of Independent Commissioner and The Possibility of Fraudulent Financial Reporting	68
4.4.2. Hypothesis 2: Percentage of BOC with Accounting or Financial Background and The Possibility of Fraudulent	

Financial Reporting	68
4.4.3. Hypothesis 3: Size of Audit Committee and The Possibility of Fraudulent Financial Reporting	69
4.4.4. Hypothesis 4: Meetings Frequency of Audit committee and The Possibility of Fraudulent Financial Reporting	69
4.5. Discussion	70
4.5.1. Number of Independent Commissioner and The Possibility of Fraudulent Financial Reporting	70
4.5.2. Percentage of BOC with Accounting or Financial Background and The Possibility of Fraudulent Financial Reporting	71
4.5.3. Member of Audit Committee and The Possibility of Fraudulent Financial Reporting	72
4.5.4. Meetings Frequency of Audit committee and The Possibility of Fraudulent Financial Reporting	73
CHAPTER V CONCLUSSION AND SUGGESTION.....	75
5.1. Conclusions	75
5.2. Suggestions	77
REFERENCE	xix

LIST OF APPENDIXS

Appendix 1 Sample Companies.....	78
Appendix 2 Variable Data	81
Appendix 3 SPSS Output.....	86

LIST OF TABLES

Table 3.1. Beneish Model Variable Calculation	47
Table 3.2. Purposive Sampling Elimination	50
Table 4.1. Descriptive Statistic	57
Table 4.2. Hosmer and Lemeshow Test Result	60
Table 4.3. Iteration History Block 0	60
Table 4.4. Iteration History Block 1	61
Table 4.5. Model Summary	62
Table 4.6. Classification Table	63
Table 4.7. Coefficients' Significant Test	65

CHAPTER I

INTRODUCTION

1.1. Research Background

According to the International Accounting Standards (IAS) adopted by International Accounting Standards Board (IASB), the purpose of financial statements is to provide information about the financial position, financial performance, and cash flows of an entity that is useful to a wide range of users in making economic decisions. The financial statement also shows what management has done or management accountability in using the resources that have been entrusted to them. Readers of financial statement want to see what has been done or the accountability of the management so that they can make economic decision. This decision includes, for example, the decision to withhold or sell their investment in the company, the decision to reappoint, or the decision to change the management. The qualitative characteristics of the financial statement that make the information on the financial statement useful to the readers are understandable, relevant, reliability, and comparable. Financial statement is very important tool use by the readers especially investor to make decision, therefore it is make sense if the management will try to alter the financial statement corresponding to its needs. In order to gain trust from investor or external parties, usually company will conduct action that lead to fraudulent financial reporting.

Fraudulent financial reporting is a deliberate doing by the companies to deceive and mislead readers of financial statements, especially investors and creditors, by presenting and manipulating the material value of financial statements (Wicaksono and Anis, 2015). Management attempt to make financial performance appears to be good by managing earnings and thus will mislead the investor. Fraudulent financial reporting is a serious problem and threat to the external party of the company, especially investor, because such act is illegal and violate the financial statement's characteristics, which are relevant and reliability.

The case of fraudulent financial reporting had been prevalent since 1998 by Waste Management Inc. which reported \$1.7 billion fake earning, the company allegedly falsely increased the depreciation time length for their property, plant and equipment on the balance sheets. The next big case of fraudulent financial reporting is a well known Enron scandal (2001) and WorldCom scandal (2002). Enron Corporation's CEO Jeff Skilling developed a staff of executives that by the use of accounting loopholes, special purpose entity, and poor financial reporting were able to hide billions of dollars in debt from failed deals and projects, this causes shareholders lost \$74 billions. While in WorldCom case the company underreported line costs by capitalizing rather than expensing and inflated revenues with fake accounting entries resulting in inflated assets by as much as \$11 billion, leading to \$180 billion in losses for investors (Beasley, M.S. et al, 2000). The case of fraudulent financial reportings keep happening even until now, the most recent case for fraudulent financial reporting

was Valeant Pharmaceuticals that overstated its revenue and Alberta Motor Association case of fake invoice.

The case of fraudulent financial reporting had not only happened in developed countries but also spread to developing countries, and Indonesia is not an exception. In Indonesia there are many cases of fraudulent financial statement, the most booming case of fraudulent financial statement in 2001 done by PT. Kimia Farma Tbk. which reported fake profit Rp 32.6 billion. Fraudulent financial reporting case happen in Indonesia do not stop there, there are many cases that follows such as by PT Great River International (2005) whom reported fake profit of Rp 29.4 billion, PT Kereta Api Indonesia (2005), PT Agis Tbk (2007), and the latest proven case of PT Inovisi Infracom (2015).

Fraudulent financial reporting is a topic which interesting to discussed. In modern era, companies in the world need to implement a system that must be managed properly, which is often called Good Corporate Governance. Good Corporate Governance is a way of ensuring that management acts best for the interest of stakeholders. Implementation of Good Corporate Governance requires strong protection against the rights of minority shareholders. The principles or guidelines for the implementation of Good Corporate Governance indicate the existence of such protection. Good Corporate Governance is definitively a system that regulates and controls the company to create value added for all stakeholders. There are two points emphasized in this concept: first, the importance of stockholder rights to obtain

information accurately and timely and secondly, the company's obligation to disclose accurately, timely and transparently against all the company's performance information and stakeholders.

Good corporate governance system is expected to prevent from the financial and non-financial crisis. Along with the development of corporate governance issues, the system is also expected to improve efficiency in managing the business of a company based on the principles of good corporate governance (Wicaksono and Anis, 2015). Good Corporate Governance (GCG) in a corporate set up leads to maximize the value of the shareholders legally, ethically and on a sustainable basis, while ensuring equity and transparency to every stakeholder – the company's customers, employees, investors, vendor-partners, the government of the land and the community (Shil, 2015).

The issue of corporate governance in Indonesia was first started in 1998. In that year there was a global monetary crisis that caused Indonesia to experience a prolonged economic crisis. A study conducted by the Asian Development Bank (ADB) in 1999 concluded that there were several factors that cause the financial crisis in Asia, including Indonesia, such as (1) ineffective board of commissioners and boards of directors, (2) leakage in the company's internal control, (3) does not present adequate disclosures in the financial statements of the company, (4) the company's financial statements are presented unfairly and less compliance with the policies of the organization. Weak corporate governance system in Indonesia at the time, caused some companies to commit fraud in financial reporting. In order of economic recovery, the

Government of Indonesia and the International Monetary Fund (IMF) introduced the concept of Good Corporate Governance as a healthy corporate governance (Khairandy and Malik, 2007).

The Forum for Corporate Governance in Indonesia (FCGI) defines corporate governance as a set of rules governing relationships between shareholders, managers of companies, creditor parties, governments, employees and other internal and external interests relating to their rights and duties, or in other words a system that regulates and controls the company (FCGI, 2003). According to Khairandy and Malik (2007), corporate governance refers to a procedure created within a company that provides the material facts of the state of the investor and other stakeholders and makes efficient and accurate decisions within the company. In other words, corporate governance here describes a set of legal rules that govern the authority and obligations of directors, officers, and shareholders.

Effendi (2009) defines good corporate governance as an internal corporate control system that has the primary goal of managing significant risks to meet its business objectives through securing corporate assets and increasing shareholder value in the long term. Good corporate governance deals with how investors are confident that managers will benefit investors, managers will not steal and embezzle or invest in unprofitable projects with funds or capital invested by investors, and how investors controlling managers (El-Gammal and Showeiry, 2012). Based on the definition of corporate governance, the role of corporate governance is needed to prevent and deter

managers from issuing fraudulent financial reporting. Bad corporate governance can lead to fraud as happened in some companies in Indonesia. Therefore, the quality of corporate governance needs to be improved so that managers do not deviate from the stakeholders.

The growing incidences of corporate fraud is an indication to ineffective emphasis on fraud prevention and deterrence mechanisms are being prioritized by organizations. In many recent corporate misconducts, failure of corporate governance structure as an effective monitoring tool has been highlighted to be one of the reasons to prevent fraudulent financial reporting financial. This infers that effective corporate governance structure has a positive impact in reducing such incidences (Razali and Roshayani, 2014). Corporate governance encompasses the controls and procedures that exist to ensure that management acts in the interest of shareholders. In addition to reducing the likelihood that management, acting in its self-interest, taking actions that deviate from maximizing the value of the firm, corporate governance mechanisms also affect the information disclosed by the firm to its shareholders. These mechanisms make it less likely that management, acting in its self interest, does not fully disclose relevant information to shareholders or discloses information that is less than credible (Kanagaretnam *et al.*, 2007).

One of the mechanism of good corporate governance is Independent Commissioner. According to Indonesia's Code of Good Corporate Governance by National Committee on Governance, Independent Commissioner is a member of the

Board of Commissioner who is not originated from an affiliated party. According to Chtourou (2001) Independent board of commissioners generally have better supervision of management, thus affecting the possibility of fraud in presenting the financial statements made by managers, this statement is supported by Wicaksono and Anis (2015), Hermawan (2011), and Beasley (1996), according to them the more independent the board of commissioners, the further it will reduce the possibility of fraudulent financial reporting.

According to Forum for Corporate Governance in Indonesia (2003), the board of commissioners is responsible for ensuring the implementation of corporate strategy, overseeing management in managing the company and requiring accountability. Indonesia's Code of Good Corporate Governance indicated that the members of the Board of Commissioners must be a professional that possess the integrity and capability to enable them to carry out their function properly. Cadbury (1992) state that board of commissioner's adequate educational background would determine quality and expertise. According to Metawee (2013) the board of directors that is financially literate can understand and address financial statement issues better, therefore it is important for member of boards of commissioners to have financial or accounting background.

According to Indonesia's Code of Good Corporate Governance that in carrying out its duty, the Board of Commissioners may form committees. One of the committees that help board of commissioners is the audit committee. The Audit Committee

functions to assist the Board of Commissioners to ensure that: (i) financial reports are presented appropriately in accordance with the generally accepted accounting principles; (ii) internal control structure is adequate and effective; (iii) internal and external audits are conducted in accordance with applicable audit standards; and (iv) audit findings are followed up by the management.

The Audit Committee plays an important role in the quality and credibility of financial statements. An effective audit committee is expected to focus on the optimization of shareholders' wealth and prevent the maximization of personal interests by the top management (Wathne and Heide, 2000). The number of audit committee members are indicator of resources available to this committee. The audit committee size is one of the significant characteristic that contribute to its effectiveness. According to Indonesia's Code of Good Corporate Governance, the composition of the Audit Committee shall be such that it can accommodate with complexity of the company by taking into account the effectiveness in decision making. If the audit committee size is too small then an insufficient number of directors to serve the committee in occurring and thus decrease its monitoring effectiveness (Metawee., 2013).

Abbott (2000) examine the role of the audit committee in reducing the likelihood of fraud, the result of the research concluded that firms with audit committees which are composed of independent director and which meet at least twice per year are less likely to be sanctioned for fraudulent or misleading reporting. Razali (2014) indicates

that effective corporate governance structure is paramount in enhancing the credibility of financial reporting. Wicaksono and Anis (2015) indicate that audit committee negatively effects on likelihood of fraudulent financial reporting.

The Association of Certified Fraud Examiners notes that frequency of financial statement fraud by the manufacturing industry is higher than in other industries, which amounted to 13.8% follows by is oil and gas industry 12.2%, construction sector 11.6%, transportation and warehousing by 10.4%, banks and finance by 10.2%, and education by 10%. Industry with case frequency below 10%, that is health sector equal to 8%, social service equal to 7,5%, service 6,7%, retail 6,5%, public administration and public 5%, and insurance 3,2%.

Beside good corporate governance there are other factor that can also affect the occurrence of fraud. According to Handoko (2017) company size is also assessed to affect the occurrence of fraud from a financial report. There are two views about the size of a company against fraud from a financial statement. The first small company size is considered more to practice earnings management in this case that is fraudulent financial statements, rather than large companies. This is because small companies tend to want to show the condition of companies that always perform well for investors to invest in the company. Large companies are more concerned with the community so it will be more careful in doing financial reporting so that the impact of the company reported the condition more accurate (Nasution & Setiawan, 2007). Watts and Jerold (1990) found that large firms and high-growth firms attempted to manipulate their

profits in the current period. Prasetyo (2014) found in his research that firm's characteristic which is size has a positive influence on financial reporting fraud.

Another factor that may influence the occurrence of fraud is the leverage. According to fraud triangle theory one of the reason or factors in doing fraud is external pressure. External pressure is an excessive pressure for management to meet the requirements or expectations of third parties. According to AU-C section 240, when excessive pressure from external parties occurs, there is a risk of fraud to the financial statements. This is supported by the opinion of Skousen et al. (2008) stating that one of the pressures often experienced by company management is the need to obtain additional debt or external financing sources to remain competitive, including research and development or capital expenditure financing. Therefore many research use leverage as proxy for external pressure and one of factors that influence fraudulent financial reporting. Skousen (2008) found in his research that leverage has positively relation to the likelihood of fraud. Tiffani and Marfuah (2015) also concluded in their study that external pressure which proxy by leverage has positive influence against financial statement fraud. Indarti, Inova and Nurhayani (2016) also concluded the same in their research that Leverage significantly affect the financial statement fraud.

Based on the background that had been mention, the researcher interested to examine **“Good Corporate Governance’s Mechanism and The Possibility of Fraudulent Financial Reporting”**. Researcher will use manufacturing sector of period 2016. Since there are other factors that can also affect the occurrence of fraud,

the size of the company and leverage will be used as control variable in this study, so that the relationship of independent variables to the dependent variable is not influenced outside factors that are not examined.

1.2. Problem Formulation

Based on the background that have been explained before and the results of previous studies that vary, the author is interested in conducting research on corporate governance mechanisms and fraud in financial reporting. This study examines the effect of corporate governance mechanisms comprising the number of independent board of commissioners, the percentage of board of commissioners with accounting or financial background, the size of audit committee, and the meeting frequency of audit committee on the possibility of fraud in financial reporting. This research will have the following problem formulation:

- 1) How does the number of independent board of commissioners influence the possibility of fraudulent financial reporting?
- 2) How the percentage of board of commissioners with accounting or financial background influence the possibility of fraudulent financial reporting?
- 3) How does the size of audit committee influence the possibility of fraudulent financial reporting?
- 4) How does the meeting frequency of audit committee influence the possibility of fraudulent financial reporting?

1.3. Research Objective

From the problem formulation that have been described earlier, then the purpose in this research are as follows:

- 1) To analyze the influence of the number of independent board of commissioners on the possibility of fraudulent financial reporting
- 2) To analyze the influence of the percentage of independent board of commissioners with accounting or financial background on the possibility of fraudulent financial reporting
- 3) To analyze the influence of the size of audit committee on the possibility of fraudulent financial reporting
- 4) To analyze the influence of the meetings frequency of audit committee on the possibility of fraudulent financial reporting

1.4. Research Usefulness

Based on the research objectives, we can conclude that this research usefulness's are:

1.4.1. Theoretically:

Researcher hopes that by reading this study, any other university students, especially accounting students may be able to have clearer view about good corporate mechanism and the possibility of fraudulent financial reporting. Researcher also hopes

that any other researchers could use this study as their reference or supporting research regarding good corporate mechanism and the possibility of fraudulent financial reporting.

1.4.2. Practically:

Researcher hopes that investors and management of business entities could use this study to give them a better view about good corporate mechanism and the possibility of fraudulent financial reporting.

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