



THE SCIENTIA JOURNAL OF ECONOMICS ISSUES

ISSN
E-ISSN
VOLUME 1 NO 1 2022
PP: 7-11

The Urgency of Agency Theory in Minimizing Financial Fraud: A Case Study in the Construction Industry

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Abstract

Fraud that still occurs in certain corporations, including in specific construction industries, is a problem that must be addressed in the current era of good corporate governance (GCG). Based on secondary data and with a qualitative approach, it is concluded that the weakness of corporations in applying agency theory has led to fraud in the form of motives, incentives, opportunities, and rationalizations carried out by agents. In comparison, one of the implementations of agency theory in tackling fraud in financial statements is to apply accountability through contractual relationships that are strictly binding on agents and principals.

Keywords: Agency Theory, Fraud, Financial Statement

A. Background.

The rise of fraud that occurs through construction companies' misuse is an essential issue in the contemporary good corporate governance (GCG) era. This issue becomes urgent and urgent to resolve when it involves a company that is required to organize books objectively and be audited by a public accounting firm. However, the expectation of the implementation of GCG still needs to be fully implemented by all these companies, as revealed by several cases of fraudulent financial statements of several companies, including the construction industry, in several countries. Of course, financial statement fraud and all errors in financial reporting are a very significant threat to the existence and efficiency of stakeholders, including capital markets in related countries (Amiram et al., 2018).

Krishnan (2009) asserts that fraud, such as corruption and bribery, in the construction sector is so massive in many countries that it causes enormous casualties, such as loss of life, financial losses, and diversion and destruction of resources, to name a few facts. In the Netherlands in 2002, the Cabinet, the Ministry of Justice, and the Dutch Competition

Authority undertook extensive investigative efforts to uncover malpractice in public sector procurement in light of documentary evidence showing collusive behavior, bid rigging, and corrupt practices among construction companies and civil servants (Doree, 2004). In South Africa, the spread of corruption through construction companies is massive, with Bowen et al. (2012) describing 4 (four) causes of rampant corruption by construction companies, i.e., involvement in corruption, forms of corruption, factors likely to increase corrupt activity, and the means used to combat corruption.

The involvement of certain corporations in economic crimes, such as collusion and corruption, cannot be separated from the active role of their public officials through bribery and tender manipulation. Forms of corruption in construction companies center on the weakness of rules in terms of appointments and tenders and the lack of rules and administration related to contracts / agreements, which is one of the important characteristics of agency theory. Thus, it is necessary to conduct a literature review related to the urgency of agency theory in minimizing inevitable corporate fraud, with case studies in the construction industry sector.

B. Research Methods

This study, which uses secondary data, uses a qualitative approach. Studies with this qualitative approach emphasize the analysis of the deductive inference process and the use of scientific logic (Saifuddin, 2010). Furthermore, Sekaran (2013) argues that a qualitative study is a type of conclusive research that primarily describes something, usually an explanation of market characteristics or functions.

C. Analysis and Discussion

a. Financial Statements and Their Potential for Misuse

Rezaee (2005) asserts that financial statement fraud that can lead to a decline in stock market reputation shows how vital the quality of financial statements is because the occurrence of fraud has raised serious concerns about the effectiveness of corporate governance, the integrity and ethical behavior of top executives, the adequacy and effectiveness of internal controls, the reliability of financial statements, and the quality of financial statement audit results. Thus, the occurrence of fraud, according to Rezaee (2005), cannot be separated from the lack of supervisory functions (board of directors, audit committee), arrogant and greedy management, inappropriate business behavior by top executives, lax regulations, inadequate and less transparent financial disclosures; and negligence of the board of commissioners and shareholders. Later, Lennox and Pittman (2010) revealed that the Big Five of public accounting firm clients' sharp increase in accounting fraud is merely an artifact of firm size. Controlling well for firm size and other determinants, such as firm age, percentage of independent directors, percentage of the independent audit committee, and the number of audit committee meetings, shows that the incidence of financial reporting fraud is consistently lower for Big Five clients.

Of course, the fraudulent financial statements show a deliberate effort by the company involving actors who are experts and have sufficient authority in the company

to deceive or mislead users. Users of the published financial statements, especially investors and creditors. The fraud is carried out through the preparation and disclosure of materially misstated financial statements, which according to Rezaee (2005), involves 6 (six) well-planned and neat schemes, including:

1. falsification, alteration, or manipulation of material financial records, supporting documents, or business transactions;
2. Intentional material misstatements, omissions, or misrepresentations of events, transactions, accounts, or other significant information that differ from the supporting documents from which the financial statements were prepared;
3. Intentional misapplication, intentional misinterpretation, and incorrect implementation of accounting standards, principles, policies, and methods used to measure, recognize, and report economic events and business transactions;
4. omissions and intentional disclosure or presentation of inadequate disclosures regarding accounting standards, principles, practices, and related financial information;
5. Use of aggressive accounting techniques through unauthorized earnings management; and
6. Manipulation of accounting practices based on existing regulatory-based accounting standards that turn out to be too detailed and too easy to circumvent and contain loopholes that allow companies to hide the economic substance of their financial performance.

The description of the financial reporting fraud scheme as described above still shows that financial statement fraud has a typical fraud that is different from other fields considering that financial statement fraud is usually carried out by management by exploiting improper accounting and recording that is not following its nature due to ambiguity and the availability of choices to present financial statements that meet the financial targets imposed on management (Brennan & McGrath, 2007).

b. Agency theory in company practice

The existence of a principal-agent relationship in every action of company management further emphasizes the use of agency theory in minimizing fraud in construction companies, especially those listed on the IDX. By definition, Black's Law Dictionary (Garner, 2009) emphasizes agency as a "fiduciary relationship created by express or implied contract or by law, in which one party (the agent) may act on behalf of another party (the principal) and bind that other party by words or actions." The same thing was also stated by Ross (1973), stating that the agency relationship is a relationship between the parties (two or more parties), where one party is called an agent (agent) who acts against, on behalf of, or behalf of another party called the principal, as "one who authorizes another to act on his or her behalf as an agent" (Garner, 2009).

The existence of agency theory as a fiduciary relationship between the agent and the principal shows that in a company, there is a contractual relationship where the principal is the party who mandates the agent to carry out all activities on behalf of the

principal. Agency theory, according to Eisenhardt (1989), is instrumental in solving agency problems that arise when (a) the desires or goals of the principal and agent conflict and (b) it is difficult or expensive for the principal to verify what the agent has done (information asymmetry). The problem that arises is that the principal needs to check whether the agent has behaved appropriately so that in Good Corporate Governance, it is necessary for the professional accountability of the parties involved in a company's governance. Clarkson, Miller, and Cross (2012) suggest that violating the law in professional behavior is a reflection of a violation of "honesty or trustworthiness, or propriety as a professional worker," where a professional worker is considered to have failed to exercise reasonable care, professional judgment, and violate the duty of care which causes harm to the company itself, or investors, or to third parties (suppliers, customers, creditors), or the government, so that liability in the form of malpractice or professional negligence can be imposed.

D. Conclusion

Based on the background, methods, analysis, and discussion, it can be concluded that the occurrence of fraudulent financial statements in certain corporations cannot be separated from the weak application of agency theory, resulting in motives, incentives, opportunities, and rationalizations made by the agent against the principal. One way to minimize financial statement fraud is to apply strict liability and contractual binding strictly to the agent and principal.

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