

# **THE EFFECT OF RED FLAGS AND INTERNAL BANK AUDITOR PROFESSIONAL SKEPTICISM ON FRAUD DETECTION IN DENPASAR**

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## **ABSTRACT**

**Aims:**This study was conducted to examine the effect of red flags and auditor's professional skepticism on the ability of internal auditors to detect fraud.

**Study design:**Quantitative method with survey method.

**Place and Duration of Study:**Internal Auditors who work at Rural Credit Banks throughout the City of Denpasar, between October 2022 to December 2022.

**Methodology:**This study uses a survey method by adopting the previous research variable measurement scale, namely red flags, professional skepticism and fraud detection. The red flags construct is measured by 4 items, professional skepticism is measured by 3 items and the fraud detection construct is measured by 3 items. A five-point Likert scale was used to measure all study constructs, where "5=strongly agree" and "1=strongly disagree". Data collection was carried out through a questionnaire survey using the saturated sampling method, with 42 respondents to the BPR Bank internal auditor research throughout Denpasar City where all respondents were able to participate well. 65% of respondents are male, and 35% are female. More than 55% of respondents have an undergraduate degree or more

**Results:**The ability of internal auditors in BPR offices throughout Denpasar City can be improved by optimizing the detection signal (red flag) and expecting the auditor to always be critical through professional skepticism towards the audit evidence presented.

**Conclusion:**This study has limitations that the sample in this study is still relatively small and only limited to internal auditors who work at Rural Banks throughout the city of Denpasar, so this research suggests for further research by adding and expanding the area, number of samples and using the variable characteristics of internal auditors. others such as personality, work experience, motivation and knowledge of the auditor as any factors that can influence fraud detection.

*Keywords: Red Flag, Professional Skepticism, Fraud Detection.*

## **1. INTRODUCTION**

The business world has a very important goal, which is to get the maximum profit with the smallest effort. This goal actually traps entrepreneurs in actions that are not in accordance with accounting rules, so that fraud occurs to get the maximum possible profit(1). Fraud that occurs in the corporate environment still occurs frequently and is sometimes difficult to overcome, because fraud is a hidden behavior.(2). Fraud is very influential for society in general, especially users of information. International Standard on Auditing (ISA) section 240 states that fraud is defined as an intentional act by a member of the company's management, a party that plays a role in corporate governance, an employee or a third party who commits deception or fraud to gain unfair or illegal advantages. To avoid fraud, the company makes efforts to prevent it through early detection. Because early detection is one of the duties of an internal auditor in a company, the ability of internal auditors to detect fraud against financial statements is absolutely necessary and very necessary.(3).

Cases of accounting scandals in recent years provide further evidence of misstatements in a company's financial statements. The following is a phenomenon of the auditor's role in preventing fraud through detecting fraudulent fraud in the financial statements of well-known companies in Indonesia. There are several Rural Banks (BPR) that have had their business licenses revoked from the Financial Services Authority because of unscrupulous BPR individuals. Such as the case of criminal acts caused by the Main Director as well as the controlling shareholder of PT BPR Legian, Titian Wilaras. Titian Wilaras' modus operandi deliberately asked the directors and bank employees to carry out an action which resulted in the bank not operating according to the sequence required to ensure compliance with the bank's rules in accordance with the law and other statutory provisions. Titian Wilaras also asked bank employees and their directors to use cell phones or short messages via WhatsApp and the committee that had been formed, to make payments and transfer sums of money or PT BPR Legian funds for their personal needs. So that this action has violated the banking law Titian Wilaras also asked bank employees and their directors to use cell phones or short messages via WhatsApp and the committee that had been formed, to make payments and transfer sums of money or PT BPR Legian funds for their personal needs. So that this action has violated the banking law(4).

In this case it can be judged that it is very important for a company to detect fraud as early as possible. Fraud detection is an effort to obtain an adequate initial indication regarding fraudulent actions, which simultaneously narrows the space for an actor who commits fraud. In terms of detecting fraud, it is expected that internal auditors can detect fraud symptoms, irregularities and early indications which can be called Red Flags or early warning of fraud. Therefore, auditors are required to be able to detect various fraud cases with high integrity and maintain professional objectivity.

The act of fraud occurs in secret so that it cannot be predicted with certainty whether the fraud is true. For this reason, an auditor cannot immediately fully trust an auditee, so that an auditor is not deceived by the auditees. An auditor must have professional skepticism in carrying out his duties because professional skepticism will make an auditor not easily believe in existing evidence and make himself more critical of management's statements, besides that professional skepticism creates an attitude of curiosity in the influential auditor. in a wider scope of examinations so as to make it easier for the auditor to find fraud.(5). The auditor will certainly increase the ability to detect fraud if he has a high character of professional skepticism by expanding the search for additional information if faced with symptoms that lead to acts of fraud.(6). An auditor who has a good attitude of professional skepticism will not easily believe evidence from audits that are incomplete and inadequate during the audit process.(7).

The task of fraud detection is not an easy one. The Internal Auditor Work Unit (SKAI) requires indicators or red flags that can assist in focusing performance when examining financial reports. Red flags are potential symptoms indicating a higher risk of intentional misstatement in the financial statements. Red Flags do not immediately provide information whether someone has made a mistake or not, but is a sign or warning that there is an act of fraud(8). Even though red flags are considered as early warning signals that can reduce the risk of fraud not being detected, further in-depth investigations are still needed to obtain accurate audit results. Based on the concept of The Fraud Triangle, IIA standard 2120.A2(for internal audit) states that the auditor must evaluate the potential/risk of fraud and how the organization manages the risk of fraud. Therefore, every auditor (internal and external) must have sufficient knowledge to be able to identify indications/existence of fraud (fraud red flags). Several previous studies have been conducted to identify the effectiveness of using red flags based on The Fraud Triangle in detecting fraud(9–11).

The purpose of this study was to determine the role of professional skepticism and identify the effectiveness of red flags in detecting fraudulent banking financial statements as a form of fraud prevention, especially in rural credit banks (BPR). BPR SKAI is also asked to identify fraud prevention measures that are believed to be appropriate to be implemented at BPRs. These two things are important and interesting to study considering that fraud that occurs in the banking sector is systemic in nature, that is, the impact can spread to other similar banks or even to the banking system as a whole. Fraud that has occurred in several BPRs has certainly had a negative impact on the BPR industry, and if it is not addressed immediately it can reduce public trust in this bank. Proactive steps are required from SKAI to determine indicators as well as efforts to prevent and detect accounting fraud. Thus this research is important and interesting to be conducted in order to be able to formulate indicators of professional skepticism and red flags as fraud detectors and steps needed to prevent fraud.

## **2. LITERATURE REVIEW**

### **2.1 Cognitive Dissonance Theory**

Cognitive dissonance social psychology theory talks about the uncomfortable feelings of an individual because of conflicting behaviors, thoughts, and attitudes and encourages an individual to take definite steps to minimize the level of

uncomfortable feelings. Cognitive dissonance can occur if an internal auditor has a great deal of faith in the auditee (staff), but over time the auditor sees indications of fraud committed by the staff but he has not been able to prove it, this then gives rise to cognitive dissonance in the auditor. Red flags will be able to overcome the cognitive dissonance experienced by internal auditors. With red flags, internal auditors will be increasingly alert to staff who are indicated to be committing the fraud. So that the internal auditor will try to improve it so that he can get out of this cognitive dissonance(2,12).

## **2.2 Fraud Detection**

Fraud is a form of deviation that violates the law which is deliberately committed by an individual or group for the sake of personal enjoyment and can be detrimental to other parties. Association of Certified Fraud Examiners (ACFE) in DiNapoli(13) defines "fraud as an act of fraud or a mistake made by a person or entity who knows that the mistake may result in some unfavorable benefit to the individual or entity or other party". Fraud detection is an attempt to obtain an adequate initial indication regarding fraudulent actions, which simultaneously narrows the space for an actor who commits fraud.(14).

## **2.3 Red Flags**

In terms of detecting fraud, it is expected that internal auditors can detect fraud symptoms, irregularities and early indications which can be called Red Flags or early warning of fraud. So that Red Flags are a condition that is different or odd from the usual situation, or it can be said that Red Flags are an indication or clue about something that needs ongoing investigation and the presence of something unusual. Red Flags do not immediately provide information whether someone has made a mistake or not, but is a sign or warning that there is an act of fraud(8). Yanti(15) emphasizing red flags as being different from normal activity. In contrast to Pramuki et.al(6) which emphasizes red flags as a sign that something is not right. Ayu et.al(16) explained that red flags are very important for the success of detecting and preventing fraud. Red flags point to effective detection methods and processes.

## **2.4 Professional Skepticism**

The act of fraud occurs in secret so that it cannot be predicted with certainty whether the fraud is true. For this reason, an auditor cannot immediately fully trust an auditee, so that an auditor is not deceived by the auditees. This attitude of disbelief is usually referred to as Skepticism. An attitude of skepticism is an attitude that always performs and provides questions or critically evaluates audit evidence(5). An auditor who has an attitude of professional skepticism is assumed to be able to find a fraud very well if he is aligned with an auditor who does not have an attitude of skepticism.(6). An auditor who has a good attitude of professional skepticism will not easily believe in audit evidence that is incomplete and inadequate during the audit process.(7). The application of professional skepticism will be able to overcome the cognitive dissonance experienced by internal auditors(12). So that the internal auditor will try to increase his professional skepticism so that he can get out of this cognitive dissonance.

## **2.5 The Effect of Red Flags on the Internal Auditor's Ability to Detect Fraud**

Red flags are signs or signals that must be detected by the auditor in auditing financial statements. In detecting red flags, the auditor must have expertise in detecting and assessing existing risks. The use of red flags in fraud detection when something is suspected and designated as one of the signs, this sign can help auditors to focus more on their performance in assessing the risk of fraud. Detecting fraud does not always get a bright spot, this is due to the various kinds of underlying motivations, as well as the many methods used in committing 13 forms of fraud. The occurrence of various frauds certainly needs serious attention from various parties, one of which is the internal auditor who hopes to be able to reveal the fraud that has occurred(17). To support the auditor's ability to detect fraud that may occur during the audit, the auditor needs to understand and understand fraud, its types, characteristics, and ways to detect it. Methods that can be used to detect fraud include looking for signs, signals, or red flags of an action that is suspected of causing or having the potential to cause fraud. Red flags are conditions that are odd or different from normal conditions. Dinapoli and Magro(13,18) found that there is a positive and significant relationship between red flags and fraud detection. These findings have been confirmed and are in line with research conducted by Pramuki et.al(6) which reveals that red flags have a significant effect on the auditor's ability to detect fraud

H1. Red Flags has a positive effect on the Internal Auditor's Ability to Detect Fraud.

## **2.6 The influence of professional skepticism on the auditor's ability to detect fraud**

An auditor must be skeptical but within professional limits. The process of examining the client's financial statements is carried out by evaluating audit evidence, making a critical assessment of the validity of audit evidence, questioning and critically evaluating audit evidence so that the information obtained can be useful in detecting fraud. Amlayasa and Riasning, Pramuki et.al and Noviyanti(5,6)as well as(12)found evidence that professional skepticism has a significant impact on fraud detection. Several explanations put forward show the inconsistency of the relationship between professional skepticism and fraud detection. To detect fraud and material misstatement, the use of a skeptical mindset will direct more conservative actions and develop a search for additional information regarding the symptoms of fraud that have occurred. Therefore, an auditor's professional skepticism is expected to assist the auditor in detecting fraud.

H2. Professional skepticism has a positive effect on the Internal Auditor's Ability to Detect Fraud

### 3. RESEARCH METHOD

This study uses a survey method by adopting the previous research variable measurement scale, namely red flags, professional skepticism and fraud detection. The red flags construct is measured by 4 items, professional skepticism is measured by 3 items and the fraud detection construct is measured by 3 items, where all items are adopted from Arsendy's study.(8). A five-point Likert scale was used to measure all study constructs, where "5=strongly agree" and "1=strongly disagree". The hypothesized research structural model is shown in the following figure

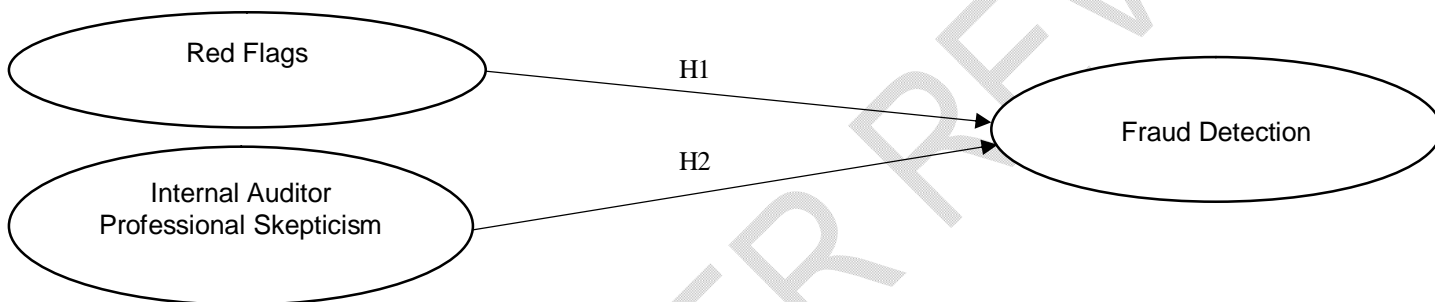


Figure 1. Research Concept Framework

Data collection was carried out through a questionnaire survey using the saturated sampling method, with 42 respondents to the BPR Bank internal auditor research throughout Denpasar City where all respondents were able to participate well. 65% of respondents are male, and 35% are female. More than 55% of respondents have an undergraduate degree or more.

This study uses data analysis methods using SmartPLS version 3.2.9 software. with the PLS-SEM approach. PLS (Partial Least Square) is a variant-based structural equation analysis (SEM) that can simultaneously test the measurement model as well as test the structural model. The measurement model is used to test validity and reliability, while the structural model is used to test causality (testing hypotheses with predictive models).

### 4. RESULTS AND DISCUSSION

#### 4.1 Results

Data collection in this research was by distributing 42 questionnaires via Google form to respondents, namely internal auditors at BPRs in Denpasar, and 42 questionnaires had been returned and could be processed further. The descriptive statistics from this study used a survey method on 42 respondents who were BPR internal auditors throughout the city of Denpasar.

Table 1 Descriptive Statistical Analysis

	N	Minimum	Maximum	Means	Standar Deviation
Red Flags	42	3.00	5.00	4.08	0.59
Professional Skepticism	42	3.00	5.00	4.05	0.66
Fraud detection	42	3.00	5.00	3.99	0.64

Data analysis used the PLS-SEM method with SmartPLS.3.0 software consisting of testing the outer model and inner model. The outer model is related to the specific relationship between latent variables and their indicators. Based on the test results several times, it shows that the results of all research indicators are valid. each latent construct is greater than the correlation between latent constructs so that the test results can be said to have met the requirements of discriminant validity. In addition, the results of reliability measurements show that the composite reliability and conbach's alpha values meet the measurement criteria. The role of growing outer model refers to(19,20).

Inner model testing is done by R-squared analysis on each dependent variable as the predictive power of the structural model. R-squares values 0.75, 0.50 and 0.25 it can be concluded that the model is strong, moderate and weak. The greater the R-square value indicates that the model predictor is better at explaining the variance. However, the maximum limit for the R-square value is only up to 0.70 in the PLS context. If the R-square value exceeds 0.70, it is possible that the model has a colinearity problem. The results of the test show that the R-square on the millennial generation consumptive behavior variable is 0.457. These results indicate that the consumptive behavior variable is included in the moderate category, which means that it is a moderate predictor in explaining variance.

The expected hypothesis testing is that Ho is rejected or a significance value  $< 0.05$  (or a statistical t value  $> 1.645$  with a significant level of 0.05 one-sided test. Hypothesis testing is evaluated in detail based on the results of testing and research shown in the following table.

**Table 2. Path Analysis and Statistical Testing**

	Original Sample (O)	TStatistics ( O/STDEV )	P Values	Information
Red flags -> fraud detection	0.171	1,829	0.068	Significant
Auditor skepticism -> fraud detection	0.775	10,496	0.000	Significant

Based on table 2, it was found that the p-value of the red flags variable for the detection of fraud was worth 0.068 when compared to the significance of 0.05. Due to the statistical t value of  $1.829 > 1.645$  and the p-value of  $0.000 < 0.10$  with a positive beta value of 0.171 it can be concluded that hypothesis 1 is supported. The same results were also obtained in Hypothesis 2. That the positive beta coefficient was 0.775 with a t statistic  $> 1.645$  and a p-value of  $0.000 < 0.10$

#### 4.2 The effect of Red Flags on the detection of fraud in BPRs throughout the city of Denpasar

The test results on the first hypothesis (H1) are supported. The results of this study support the results of previous findings which state that Red Flags has a positive and significant effect on the auditor's ability to detect fraud(6,8,10,18,21). The results of this study illustrate that having an understanding and knowledge of the existence of red flags will make it easier for the auditor to regulate the steps to be carried out in carrying out inspections in detecting fraud and can immediately take preventive action(6). Suspicion arising from the presence of signs of fraud is one of the indications that will make it easier for the auditor to focus more on his performance to obtain accurate and relevant information on the fraud that has occurred. Increased awareness of the emergence of red flags will make the auditor conduct a more in-depth search or investigation of audit evidence, this can make the auditor's ability to detect fraud even higher(10)

#### 4.3 The Influence of Internal Auditor Skepticism on the Detection of Fraud in BPRs throughout the city of Denpasar

The results of testing the second hypothesis stated (H2) was accepted. These results state that the auditor's professional skepticism has a positive and significant effect on fraud detection. The higher the auditor's professional skepticism, the better the fraud detection will be. The results of this study illustrate the implications that in the process of auditing financial statements the financial statements presented by clients have not been supported by assertions in the form of adequate reports and documents, and recording and reporting of assets that are not in accordance with financial accounting standards are still found. This condition certainly has an impact on the existence of a critical attitude in which the auditor in assessing audit evidence, who is critical of the validity of audit evidence, and tends to be wary of audit evidence. The skepticism of internal auditors who work at Rural Banks throughout Denpasar City is very high, internal auditors always question and critically evaluate the audit evidence they obtain so that the information they obtain is useful in detecting fraud. An auditor who has a good attitude of professional skepticism will not easily believe evidence from audits that are

incomplete and inadequate during the audit process.(7). The results of this study support Amlayasa and Riasning's research(5), Pramuki et.al(6)and Noviyanti(12)who found that professional skepticism had a positive and significant effect on the ability to detect fraud.

#### 4. CONCLUSION

The results of this study found evidence that the results of testing the red flags variable, and the internal auditor's professional skepticism had a positive and significant effect on fraud detection. This study has limitations that the sample in this study is still relatively small and only limited to internal auditors who work at Rural Banks throughout the city of Denpasar, so this research suggests for further research by adding and expanding the area, number of samples and using the variable characteristics of internal auditors. others such as personality, work experience, motivation and knowledge of the auditor as any factors that can influence fraud detection.

#### CONSENT

We certify that there are no competing interests in this research.

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