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# AGENCY EFFECTS: RELATED-PARTY TRANSACTIONS, CORPORATE GOVERNANCE, AND FINANCIAL STATEMENT FRAUD IN INDONESIA

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This study investigates the impact of related-party transactions on financial statement fraud in the Indonesian publicly listed firms grounded in agency theory. The research study is aimed at examining the need for good corporate governance in order to uphold reporting integrity. This research applies a quantitative approach and a sample of 500-unit data from the companies listed on the Indonesian Stock Exchange in the period from 2017 to 2019 is analyzed using logistic regression models. This study also utilizes moderating regression analysis so as to investigate the moderating roles of institutional ownership and independent commissioners in the research model. The study results have revealed that related-party transactions and institutional ownership significantly affect the likelihood of the financial statement fraud occurrence in Indonesia and that institutional ownership can moderate the impact of related-party transactions on the likelihood of the financial statement fraud occurrence. This study provides the empirical evidence on the role of related-party transactions and corporate governance in shaping the quality of financial statements in emerging economies.

**Keywords:** financial statement fraud, related-party transactions, institutional ownership, independent commissioners, agency theory

JEL Classification: M40, M41, M42, M48

## INTRODUCTION

Recent academic discourse has emphasized the factors and mechanisms contributing to financial statement fraud in light of its increased prevalence.

Financial statement fraud (FSF) has posed significant threats to business stakeholders. The ACFE reports (ACFE, 2022) concluded that the estimated average of a \$593,000 loss had been caused by fraud in financial statements as the most costly fraud scheme. The size of the economic loss resulting from FSFs makes investors extremely cautious when placing their investments, which may affect capital market development. FSF implies dishonest and unethical

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acts that may cause the stakeholders' loss of trust and may harm the company's sustainability efforts. When FSF occurs, the company is not the victim but rather an instrument of fraud. Company executives can easily override the company's internal control and conduct FSF. PricewaterhouseCoopers (2020) reported that an increase in fraud cases from 16% in 2016 to 24% in 2018 was due to the increased fraud committed by senior executives.

Several phenomenal FSF cases on a global scale, such as Enron, Adelphia, and Parmalat, have shown bad management practices under the company's executive authority which involves related-party transactions (RPTs) (Gordon, Henry, Louwers & Reed, 2007; Marchini, Mazza & Mediolini, 2018). In Indonesia, the cases of RPT-related fraud have been done by Adaro Energy, Sun Prima Nusantara Finance, Hanson International, and the latest case was in 2023, Wijaya Karya, done to manipulate the company's operational performance for the benefit of the company's controlling parties. Those cases of RPT-related FSF have adversely affected stakeholders and snatched investors' confidence in the quality of financial reporting in Indonesia. Furthermore, it is estimated that 68.18% of the companies operating in the manufacturing industry have related-party transactions, which means that 105 out of 154 companies are involved in related-party transactions (Naibaho & Kusuma, 2019). Another prior research also mentioned that 90% of Indonesian-listed companies conduct many forms of RPT (Habib, Muhammadi & Jiang, 2017). Those cases and facts portray the interesting phenomena that urgently call for further investigation so as to understand the magnitude of how RPTs can cause FSF cases in the context of public companies in Indonesia.

As a significant concept within corporate governance, agency theory focuses on the relationship between a company's principals (shareholders) and its agents (managers or executives). According to that theory, modern corporations where ownership and management are separated from each other allow agents not to always act in the best interests of the principals, which results in agency issues. The framework is particularly relevant when examining aspects such as RPT, the role of institutional

ownership, and independent commissioners may affect FSFs.

Previous research has indicated the fact that corporate governance effectively reduces managerial opportunism and improves the quality of corporate reporting (Chen, Firth, Gao & Rui, 2006; Nasir & Hashim, 2020). As a part of the Asian Roundtable on Corporate Governance (ARCG), a white paper on corporate governance in Asia was published in 2003 (Nasir & Hashim, 2020), including included a series of standard policies, objectives, and recommendations intended to improve governance controls in order to improve the quality of financial reporting and protect minority shareholders. Furthermore, A. R. H. Pratista (2019) emphasized the importance of good corporate governance in supervising RPT, which became the main priority in the corporate governance reform in Indonesia. Implementing corporate governance will maximize the managerial functions and increase investors' confidence in the company, thus ensuring efficient and effective management (Firmansyah, Pamungkas & Zainuddin, 2021).

Institutional ownership is a critical factor in corporate governance. Frauds, however, are attributed to institutional ownership, prompting companies to focus more on displaying profitable financial performance (Chen *et al*, 2006). Indonesia is an emerging country with concentrated stock ownership, low investor protection, and strong private control. Hence, in regard to the minority and majority interests of the company, the ownership structure has become a critical element of corporate governance in Indonesia from the point of view of agency theory.

Apart from institutional ownership, an independent commissioner is also considered to be the key element of corporate governance that may reduce the possibility of FSF occurrence (Dechow, Sloan & Sweeney, 1996; Nasir, Ali & Ahmed, 2019; Nasir & Hashim, 2020). Indonesia applies a two-tier board system in the company's corporate governance which separates the Board of Directors from the Board of Commissioners. The Indonesian Financial Services Authority regulation no. IX.1.5 stipulates that independent commissioners are the members of Board of Commissioners that are not shareholders,

do not have any affiliations with the company and its management, and are not involved in any external activities which may create a conflict of interest. Previous research stated that weak corporate governance was characterized by fewer independent directors in the company (Beasley, 1996; Persons, 2005), whilst N. A. B. M. Nasir *et al* (2019) found that companies without fraud had stronger independent commissioners.

Although several previous studies consistently demonstrate the fact that RPTs are more prevalent in companies with weak governance, only few have examined whether RPTs relate to FSFs within the corporate governance framework, specifically when institutional ownership and independent commissioners are considered. Therefore, this study was conducted so as to address this research gap. The relationship between RPT, institutional ownership, and the presence of independent commissioners is crucial to the understanding and prevention of FSFs. The presence of institutional ownership and independent commissioners may provide a more practical setting for testing these competing views of RPT, as their impact may be more significant. This study aims to examine the impact of RPT and corporate governance on FSF in Indonesia as an emerging country. This study also examines how institutional ownership and independent commissioners can moderate the occurrence of the FSF caused by RPT. This study investigates the companies that are publicly listed on the Indonesian Stock Exchange in the period from 2017 to 2021. The study contributes to understanding the red flag of FSF and nuanced insights into agency theory, allowing for the structured examination of the relationships among stakeholders and the RPT characteristics that affect the likelihood of FSF.

The remainder of the paper is structured as follows: Section 2 reviews the relevant literature and develops the hypotheses, Section 3 describes the research design issues, and Section 4 describes the sample selection and the descriptive statistics. Furthermore, Section 5 provides the main test results, and Section 6 concludes the paper.

## LITERATURE REVIEW

M. C. Jensen and W. H. Meckling (1976) define agency relations as a cooperation contract between principals and agents in order to carry out the company's activities. The conflicts of interest between the owner of the company and the management are sometimes encountered due to differences in goals between the parties. Company owners are interested in high return on their investment, whereas company management are looking for maximum bonuses for their efforts in managing the company. Management may be under pressure to conduct the company's activities according to the owner's expectations, which may lead to fraud, which is more likely to occur in the companies characterized by weak governance, as management have broad access to control and can override control to commit fraud (Cressey, 1953; Wolfe & Hermanson, 2004).

The ACFE (2022) defined FSF as the intentional misstatement of the company's financial condition, specifically the omission of the financial statement elements intended to deceive users in the form of misstatements, both over- and understatements. Z. Rezaee (2005) states that FSF was characterized by 1) false representation/misleading information, 2) inaccurate information, and 3) the involvement of directors and top management. FSF can also take the form of fictitious revenue, distinctive time differences, the concealment of liabilities and debts, an illicit disclosure, and undisclosed information (Rezaee, 2005; Hogan, Rezaee, Riley & Velury, 2008; Reposisis, 2016; Habib & Hasan, 2017).

The Statement of the Financial Accounting Standard (PSAK) Number 7 that regulates RPT in Indonesia stated that RPT was closely related to a person or entity, which includes majority shareholders, an affiliation of majority shareholders, and another affiliated company (Jian, Wong & Jian, 2004). RPT enables the activity of channeling the assets of the company's majority shareholders, for example by supplementing cash compensation for CEOs and directors (Kohlbeck & Mayhew, 2017).

Based upon agency theory, J. Dahya, O. Dimitrov and J. J. McConnell (2008) argued that the conflict of interest between majority and minority shareholders with management may lead to opportunistic earnings manipulation in the form of RPT. The opportunistic motives of management may drive management to use their decision for their personal gain (Benedict, 2021). Managers can manipulate earnings by structuring transactions such as RPT in order to alter the company's financial statement (Hwang, Chiou & Wang, 2013). Furthermore, M. J. Kohlbeck and B. W. Mayhew (2017) stated that RPT problems occurred when management prioritized a profit. Y. L. Cheung, L. Jing, T. Lu, P. R. Rau and A. Stouraitis (2009) noted that controlling shareholders could use RPT as the tunnelling tool to expropriate funds for themselves (Siregar & Utama, 2008; Habib *et al*, 2017). The controlling shareholder may use RPT to exercise earnings management (Cheung *et al*, 2009; Jian & Wong, 2010).

M. J. Kohlbeck and B. W. Mayhew (2010) emphasized the fact that RPT affected the reliability of the financial statement in a way that reduced the effectiveness of contracts, reducing agency conflict. Thus, RPT may contribute to a more significant agency problem through higher equity and monitoring costs. Moreover, M. J. Kohlbeck and B. W. Mayhew (2010) stated that RPT could push a company to engage itself in accounting manipulations because they can be used to conceal the company's bad financial performance (Cheung *et al*, 2009) and as a potential method for achieving earnings targets (Habib *et al*, 2017). RPT is perceived as a high-risk factor that requires auditors to implement additional audit procedures to identify and document fraud risk (Gordon *et al*, 2007). RPTs are complex transactions that can increase the indication of FSF (Lou & Wang, 2009; Henry, Gordon, Reed & Louwers, 2012) and are one of the high-risk factors that may cause FSF in developing countries (Beasley, Carcello, Hermanson & Lapides, 2000). Since RPT must only be disclosed in the footnote, not in the Income Statement, opportunistic behavior can be concealed within a company. C. K. Lau and K. W. Ooi (2016) report that, between 1988 and 2012, public companies in Malaysia committed FSF by not disclosing RPT. Therefore, RPT is considered to be

a red flag indicating fraud in financial statements. Therefore, the first hypothesis of this study reads as follows:

H1: RPT positively affects the FSF occurrence.

P. M. Dechow *et al* (1996) found that companies with weak governance have a higher fraud rate. In addition, J. T. Wells (2017) states that management and those in charge of governance are highly responsible for detecting and preventing fraud. Z. Rezaee (2005) points out the fact that good corporate governance must be applied for the company's financial reports to be reliable and credible.

From the point of view of agency theory, the ownership structure can cause the agency conflict type 2 in terms of the conflict between majority shareholders and minority shareholders. Institutional owners have a significant influence in the supervisory function in the company and set high expectations of management's financial performance, simultaneously applying external control of how management should operate so as to improve their performance (Shayan-Nia, Sinnadurai, Mohd-Sanusi & Hermawan, 2017).

M. A. Gulzar, J. Cherian, J. Hwang, Y. Jiang and M. S. Sial (2019) stated that institutional investors had a significant positive effect on profit manipulation. Institutional ownership encourages companies to increase their short-term profits, which may sacrifice their long-term profits. However, institutional owners are rational investors interested in long-term profit orientation (Shayan-Nia *et al*, 2017). The external supervision functions held by institutional owners may affect the opportunity for management to commit themselves to FSF (Lin, Wu, Fang & Wun, 2014; Ramos Montesdeoca, Sánchez Medina & Blázquez Santana, 2019). Therefore, these following hypotheses will be tested, namely:

H2a: Institutional ownership negatively affects the FSF occurrence.

H2b: Institutional ownership lowers the impact of RPT on the FSF occurrence.

The independent commissioners' role is crucial for aligning the interests of management with those

of shareholders, thus reducing agency conflicts. M. S. Beasley *et al* (2000) demonstrate the fact that the lower proportion of independent boards are seen in the companies that experience FSF, which impacts the effectiveness of management supervision in reducing the opportunistic behavior of management because, unlike internal supervisors, independent commissioners are not subject to the control and pressure of the company (Ramos Montesdeoca *et al*, 2019; Rostami & Rezaei, 2022). Consequently, the following hypotheses are proposed:

H3a: Independent commissioners negatively affect the FSF occurrence.

H3b: Independent commissioners lower the impact of RPT on the FSF occurrence.

## RESEARCH METHOD AND DATA

FSF is calculated using the F-Score model by P. M. Dechow, W. Ge, C. R. Larson and R. G. Sloan (2011). The F-Score Dechow model is a model for assessing the level of risk or likelihood of fraud in financial statements by applying a methodology similar to M. D. Beneish's (Beneish, 1997, Beneish, 1999). However, the F-Score model is claimed to be a more comprehensive model compared to the Beneish M-Score model since it is formulated based on the examination of all the accounting and auditing enforcement releases issued by the Security Exchange Commission (SEC) between the years 1982 and 2005 (Aghghaleh, Mohamed & Rahmat, 2016). This model is also considered to be better to use in the context of developing countries, such as Indonesia (Aghghaleh *et al*, 2016; Nurcahyono, Hanum, Kristiana & Pamungkas, 2021). The F-Score model is built with the five dimensions: accrual quality, financial performance, non-financial measures, off-balance sheet activities, and market-related variables to detect misstatements in financial statements.

The F Score model is explained as follows:

$$\text{Predicted Value} = -7.893 + 0.790 * \text{RSST} + 2.518 * \Delta \text{REC} + 1.191 * \Delta \text{INV} + 1.979 * \Delta \text{SOFTASSETS} + 0.171 * \Delta \text{CASHSALES} - 0.932 * \Delta \text{ROA} + 1.029 * \text{ISSUE}$$

$$\text{probability} = \frac{e^{(\text{predicted value})}}{(1 + e^{(\text{predicted value})})}$$

$$\text{Unconditional probability} = 0.0037$$

$$\text{F Score} = \frac{\text{probability}}{\text{unconditional probability}} \quad (1)$$

If the F-Score value exceeds 1.00, it indicates a higher probability of misstatement than the unconditional expectation.

Below is the formula for each dimension calculation in the model:

$$\text{RSST} = \frac{(\Delta \text{WC} + \Delta \text{NCO} + \Delta \text{FIN})}{\text{Average Total Assets}}$$

$$\text{WC} = [\text{Current Assets-Cash and Short-term Investment}] - [\text{Current Liabilities-Debt in Current Liabilities}]$$

$$\text{NCO} = [[\text{Total Assets-Current Assets-Investment and Advances}] - [\text{Total Liabilities-Current Liabilities-Long-term Debt}]]$$

$$\text{Fin} = [\text{Short-term Investment} + \text{Long-term Investment}] - [\text{Long-term Debt} + \text{Debt in Current Liabilities} + \text{Preferred Stock}]$$

$$\Delta \text{REC} = \Delta \text{Account Receivables} / \text{Average Total Assets}$$

$$\Delta \text{INV} = \Delta \text{Inventory} / \text{Average Total Assets}$$

$$\text{SOFTASSETS} = [\text{Total Assets-PPE-Cash and Cash Equivalents}] / \text{Total Asset}$$

$$\Delta \text{CASHSALES} = \text{Percentage change in cash sales} [\text{Sales} - \Delta \text{Account Receivables}]$$

$$\Delta \text{ROA} = [\text{Earnings } t / \text{Average Total Assets } t] - [\text{Earnings } t-1 / \text{Average Total Assets } t-1]$$

$$\text{ISSUE} = 1 \text{ if securities are issued during the year } t \quad (2)$$

Furthermore, this research uses abnormal sales RPT to measure the manipulation level of RPT per total net sales. The regression model is used in the calculation of the abnormal sales RPT.

$$\text{Sales RPT ratio} = \alpha_0 + \alpha_1 (\text{Size}) + \alpha_2 (\text{Lev}) + \alpha_3 (\text{growth}) + e \quad (3)$$

Abnormal Sales RPT = the value difference between the actual value with the prediction value of the regression model.

Institutional ownership (IO) is calculated by comparing the number of the shares institutional owners have with the total number of the outstanding shares. The independent commissioner (IND) is calculated as the percentage of the independent commissioners on the Board of Commissioners. The company size (SizeComp) and leverage (LEV) are the control variables in this research model, considering various characteristics of the companies included in the research sample. SizeComp is a logarithm natural of the company's total assets and LEV is the percentage of the total debt to the total assets.

The research sample is selected purposively following certain criteria, including the companies listed on the Indonesia Stock Exchange during the period from 2017 to 2021 in the sectors such as information technology, materials, real estate, industrials, communication services, consumer discretionary, and healthcare, the companies with the relevant data on the RPT, IO, IND and the complete data required for this study. Based on these criteria, a total of 100 companies were obtained as the research samples, resulting in 500 data units in the five years for further analysis. The data were obtained from Eikon Reuters, the Indonesian Stock Exchange Database, and the companies' websites.

Logistic regression analysis was used to analyze the data of this research that used the dummy variable measurement for its dependent variable (Ghozali, 2016). T-tests demonstrate how each independent variable affects the dependent variable individually. The t-test was also employed so as to determine how big an influence the independent variable has on the dependent variable individually, which was achieved by comparing the p-value in the Sig column of each independent variable based on the probability values with  $\alpha = 0.05$ .

## RESULTS AND DISCUSSION

FSF is operationalized by using the dummy variables 0 and 1, where 0 indicates that no FSF has been detected, whereas 1 indicates that an FSF has been detected. The results show that 139 out of the 500 companies (27.8%) are classified as "1", and 361 of the 500 companies (72.2%) are classified as "0" (see Table 1). Thus, 139 companies are indicated as the companies committing to FSF. As shown in Table 2, the maximum value of the abnormal RPT is 4.112, which is held by a consumer discretionary company in 2020. Whilst the minimum value of -0.316 belongs to a communication service company in 2021. The maximum IO in the study was 100.00, and the smallest IO was 0.025. Averaging 75.453 points, this study illustrates that the firms are primarily owned by certain institutions and that they are relatively concentrated in ownership. Furthermore, the sample companies have an average IND proportion of 37%, meaning that they have met the minimum requirement of Article 6 POJK 55/2015, requiring at least 30% of IND in public companies.

**Table 1** Frequency distribution – FSF

	Frequency	Percent	Valid Percent	Cumulative Percent
Valid 0	361	72.2	72.2	72.2
Valid 1	139	27.8	27.8	100.0
Total	500	100.0	100.0	

Source: Authors

**Table 2** Descriptive statistics

	N	Min	Max	Mean	Std. Deviation
FSF	500	0	1	0.28	0.448
RPT	500	-0.316	4.112	0.000	0.394
IO	500	0.025	100.000	75.453	27.855
IND	500	0.167	0.800	0.396	0.101

SIZE	500	11.324	22.024	17.677	1.728
LEV	500	-27.560	76.353	0.959	4.282
IO*RPT	500	0.000	6.966	0.268	0.752
IND*RPT	500	0.000	6.470	0.242	0.590

Source: Authors

Table 3 shows that all the variables used have met the multicollinearity assumption since the correlation value is  $< 0.8$  for each pair of correlations between variables.

Furthermore, a feasibility test of the logistic regression model was done using the Hosmer and Lemeshow Goodness of Fit, resulting in the statistical value of Chi-Square 14.38, and the Sig value 0.072. The Omnibus test is the test done for the fitness of the logistic regression model. Based on Table 5, the value of Sig. is  $0.000 < 0.05$  significance level, so it can be concluded that the research model is fit. Moreover, in Table 6, the prediction accuracy 89% is considered

as very good because it is in the 81% – 100% range. Moreover, Nagelkerke's R Square is 0.099. Based on these findings, the RPT, INDs, IOs, assets, and LEV explain almost 9.9% of the FSF, the remainder being explained by the other variables.

**Table 4** The Hosmer and Lemeshow Test

Step	Chi-square	Df	Sig.
1	14.38	8	0.072

Source: Authors

**Table 5** The Omnibus Tests of Model Coefficients

		Chi-square	Df	Sig.
Step 1	Step	86.66	7	0.00
	Block	86.66	7	0.00
	Model	86.66	7	0.00

Source: Authors

**Table 3** The correlation matrix

		RPT	SIZE	LEV	IO	IND	IO*RPT	IND*RPT
RPT	Pearson Corr	1	0.005	0.057	-0.223**	-0.086	0.755**	0.535**
	Sig. (2-tailed)		0.919	0.260	0.000	0.090	0.000	0.000
	N	392	392	392	392	392	392	392
IO	Pearson Corr	-0.223**	0.115*	0.019	1	0.105*	-0.326**	-0.104*
	Sig. (2-tailed)	0.000	0.022	0.702		0.038	0.000	0.040
	N	392	392	392	392	392	392	392
IND	Pearson Corr	-0.086	0.106*	-0.011	0.105*	1	-0.076	0.313**
	Sig. (2-tailed)	0.090	0.036	0.825	0.038		0.132	0.000
	N	392	392	392	392	392	392	392
SIZE	Pearson Corr	0.005	1	0.101*	0.115*	0.106*	0.193**	0.335**
	Sig. (2-tailed)	0.919		0.045	0.022	0.036	0.000	0.000
	N	392	392	392	392	392	392	392
LEV	Pearson Corr	0.057	0.101*	1	0.019	-0.011	0.053	0.036
	Sig. (2-tailed)	0.260	0.045		0.702	0.825	0.296	0.474
	N	392	392	392	392	392	392	392
IO*RPT	Pearson Corr	0.755**	0.193**	0.053	-0.326**	-0.076	1	0.668**
	Sig. (2-tailed)	0.000	0.000	0.296	0.000	0.132		0.000
	N	392	392	392	392	392	392	392
IND*RPT	Pearson Corr	0.535**	0.335**	0.036	-0.104*	0.313**	0.668**	1
	Sig. (2-tailed)	0.000	0.000	0.474	0.040	0.000	0.000	
	N	392	392	392	392	392	392	392

Note: \*\* Correlation is significant at the 0.01 level (2-tailed); \* Correlation is significant at the 0.05 level (2-tailed).

Source: Authors

**Table 6** Classification Table<sup>a</sup>

Observed			Predicted		
			FSF		Percentage Correct
			0	1	
Step 1	FSF	0	350	1	99.7
		1	41	0	0.0
Overall Percentage			89.3		

a. The cut value is 0.500

Source: Authors

**Table 7** The Nagelkerke R Square

Step	-2 Log likelihood	Cox & Snell R Square	Nagelkerke R Square
1	243.489 <sup>a</sup>	0.048	0.099

Source: Authors

The statistical value of the Wald test is chi-squared distributed, as is presented in Table 8 below. The RPT significance level is  $0.049 < 0.05$  and the coefficient 3.593, which means that RPT significantly affects the likelihood of FSF. As a result, H1 is accepted. This result is crucial as it emphasizes the potential risks associated with these transactions in environments with weaker regulatory frameworks. The statistical significance of this finding with the p-value less than 0.05 highlights the robustness of the model and the reliability of the data.

Statistically, IO influences FSF significantly, with the significance level  $0.025 < 0.05$  and the coefficient -0.16. Therefore, H2a is accepted. The negative relationship between IO and the occurrence of FSF means that more significant institutional ownership reduces the likelihood of FSF significantly. The findings suggest that institutional ownership plays a significant role in mitigating FSF. This result supports the hypothesis and provides the empirical evidence that institutional investors contribute to stronger governance practices. Moreover, the interaction between RPT and IO is statistically significant at  $0.024\% < 0.05$ . with the coefficient -3.799. Therefore, H2b is accepted. The interaction between IO and RPT showed a significant moderating effect on the occurrence of FSF. This

finding is crucial as it illustrates the fact that IO can buffer the adverse effects of related-party transactions. This interaction was statistically significant with the coefficient -3.799 and the p-value 0.024, indicating a strong moderating role of IO in corporate governance.

Furthermore, IND has a significant level of  $0.807 > 0.05$ , indicating that IND does not influence the occurrence of FSF. Therefore, H3a cannot be accepted. The interaction between RPT and IND shows a significance level of 0.233, suggesting that independent commissioners do not moderate the impact of RPT on the occurrence of FSFs. Thus, H3b is also rejected. This finding challenges the traditional view that independent commissioners are effective in mitigating fraud, suggesting that other factors might influence their effectiveness in the Indonesian context. The lack of significant results for IND in moderating the relationship between RPT and fraud further suggests that merely appointing IND is insufficient without ensuring their active involvement and empowerment in governance processes.

Based on the result shown below, the research model reads as follows:

$$\begin{aligned} \ln \frac{FSF}{1-FSF} = & -5.773 + 3.593RPT - 0.016IO + \\ & 0.513IND + 0.312SIZE + 0.25LEV - \\ & 3.799IO * RPT - 5773IND * RPT + \epsilon \end{aligned} \tag{4}$$

This study provides a significant theoretical contribution to the agency theory domain, particularly in the context of the relationships explored – RPT, IO, IND, and FSF. The unexpected results regarding the influence of IND challenge the conventional agency theory assumptions, highlighting the nuanced dynamics at play within Indonesian corporate governance. This research result reveals that 27.8% of the sample is likely to commit FSF.

The results obtained in this study demonstrate the fact that RPT significantly affects the occurrence of FSF. Thus, a more significant amount of RPT increases the likelihood of the occurrence of FSF, which confirms the previous research stating that RPT is a high-risk area for causing FSF, as was demonstrated in several cases such as Enron, Satyam, and WorldCom (Hogan



**Table 8** The variables in the equation

		B	S.E.	Wald	df	Sig.	Exp(B)
Step 1 <sup>a</sup>	RPT	3.593	1.823	3.885	1	0.049	36.329
	IO	-0.016	0.007	5.042	1	0.025	0.984
	IND	0.513	2.104	0.060	1	0.807	1.671
	SIZE	0.312	0.126	6.097	1	0.014	1.367
	LEV	0.025	0.025	0.964	1	0.326	1.025
	IO*RPT	-3.799	1.681	5.109	1	0.024	0.022
	IND*RPT	-1.699	1.425	1.421	1	0.233	0.183
	Constant	-5.773	2.382	5.870	1	0.015	0.003

<sup>a</sup>The variable(s) entered in step 1: RPT, TA, LEV, IO, IND, IO\*RPT, IND\*RPT.

Source: Authors

*et al*, 2008; Lou & Wang, 2009; Lau & Ooi, 2016). RPT is positively correlated with restatement, which works as financial statement red flags (Kohlbeck & Mayhew, 2017). M. Jian and T. J. Wong (2004) point out the fact that capital is the cause of internal markets arising within a group of companies in an emerging market, such as Indonesia, which is characterized by unfavorable external financial market conditions and a high cost of capital. According to agency theory, however, managers may take actions and make decisions in their interest due to the power of delegation, a conflict of interest, and moral hazard, which may result in opportunistic earnings manipulation. Managers can manipulate earnings through structuring transactions such as RPT so as to alter the company's financial statement (Hwang *et al*, 2013), which happens when management place a high priority on the profit, leading the company to engage itself in accounting manipulations (Kohlbeck & Mayhew, 2010). Backing up with a bigger research sample, this study proposes a different perspective from A. Hudayati, T. K. Nisa and Z. M. Sanusi (2022) that states that RPTs negatively affect FSFs in the manufacturing sector in Indonesia. This study results in different findings, accounting for the fact that RPTs positively affect the occurrence of FSFs, which is consistent with A. Habib *et al* (2017) and J. L. Cheung *et al* (2009), who conclude that RPT is useful in achieving earnings targets and hiding companies' poor financial performances. The results of this

study support J. L. Cheung *et al* (2009) and M. Jian and T. J. Wong (2010), who also conclude that RPT can be utilized as a tool for tunnelling and earning management. Paying attention to the scale, quantity, as well as category of the total number RPT will help detect financial fraud (Mao, Sun, Zhu & Li, 2022).

The research results indicate that IO negatively affects the likelihood of the FSF occurrence. The results confirm the previous studies (Lo, Wong & Firth, 2016; Shayan-Nia *et al*, 2017), also highlighting the role of IO as a mitigating factor. Agency theory posits that, with their more significant stakes, institutional investors act as monitors to align managerial actions with the shareholder's interests. IO represents the majority shareholders with a significant influence on the company's supervisory functions. IO expects management to deliver strong financial results for each investment they make in the company. As a result, they serve as an external control for how management should operate in order to improve the company's performance (Shayan-Nia *et al*, 2017). Additionally, IO are rational investors interested in long-term profit objectives and, with their external supervision functions, they can reduce the opportunity for management to commit to FSF (Shayan-Nia *et al*, 2017; Ramos Montesdeoca *et al*, 2019).

Furthermore, the research results confirmed that IO can lower the effect of RPT on the likelihood of

the FSF occurrence. The nature of RPT is closely associated with management opportunism; therefore, with its external supervision functions, IO can lower the opportunity for management to commit to FSF (Shayan-Nia *et al*, 2017). The ownership structure inversely affects the aggressive behavior on the part of the company's management (Osemene, Adeyele & Adinnu, 2018). Along with that, Lo *et al* (2016) also state that corporate governance is vital in deterring manipulated transfer prices in related-party sales transactions.

M. C. Jensen and W. H. Meckling (1976) stated that monitoring mechanisms could play a substantial role in disciplining RPT and even reduce potential agency costs. Therefore, there is a high incentive for institutional stakeholders to monitor the RPT occurrence and structures (Kohlbeck & Mayhew, 2011). Therefore, together with the RPT disclosure arrangements in Indonesia stipulated in PSAK No. 7 released on February 19, 2010, IO can effectively control management through its monitoring authority by affecting the mandatory disclosure level (Izzaty & Kurniawan, 2018).

However, the study also shows that IND does not affect the likelihood of the FSF occurrence and does not moderate the effect of RPT on the likelihood of the FSF occurrence. Several previous studies led to similar results (Kusumawati, 2007; Sihombing & Rahardjo, 2014). IND could not perform their supervision duty objectively due to the company's policy intervention power held by the concentrated family ownership, which is broadly found in most Indonesian public companies. Indonesia needs stronger regulatory frameworks and effective corporate governance practices to enhance the role of IND in preventing FSF. The recruitment of commissioners is limited to meeting the requirements of the Financial Services Authority. In this regard, the role and functions of the independent Board of Commissioners in supervising the company become less than optimal in practice. As has been found in this study, even though the companies included in the sample have an average of 37% IND in their Boards of Commissioners, it is only to fulfil the regulations of the minimum 30% of IND on the company's Board of Commissioners.

In agency theory, the role of IND is often viewed as a crucial mechanism to align the interests of the company's management with those of the company's shareholders, simultaneously mitigating agency conflicts. The insignificant effect of independent commissioners on FSF prompts the re-evaluation of the presumed effectiveness of IND in mitigating FSF, especially in the presence of RPT, which challenges the traditional agency theory perspective, suggesting that the impact of independent commissioners might be contingent upon contextual factors and the complexity introduced by RPT.

The findings provide insightful implications for various entities, including companies, regulators, and associations, particularly in managing and disclosing RPT and their impact on FSF. Considering the association between RPT and an increased risk of FSF, companies must closely monitor RPT. To ensure proper disclosure of RPT in financial statements, robust internal control systems must be established, and adherence to the PSAK No. 7 should be ensured. In addition to maintaining investor confidence, such transparency can minimize potential agency conflicts. Furthermore, companies should enhance their corporate governance practices so as to minimize the risks associated with RPT, which includes the optimization of the role of independent audit committees and the implementation of stringent review processes for all RPTs.

Regulators should consider enacting more comprehensive regulations on RPT under the PSAK No. 7 in order to ensure their full disclosure and fair dealing in these transactions, which includes thorough audits and potential penalties for noncompliance to deter fraudulent activities and enhance corporate accountability. Only 31.83% of the total companies listed on the IDX sequentially in the period from 2017 to 2021 can be examined due to the absence of RPT and IO data in their financial statements, which fact must be addressed so that all auditors are more skeptical and thorough to ensure audited companies truly disclose their RPT in their financial statements.

IOs are generally equipped with the resources and expertise so as to monitor corporate activities,

including RPT, thus reducing the likelihood of the FSF occurrence. Therefore, regulators should establish a regulatory framework promoting transparency and accountability, such as imposing stricter requirements on the disclosure of companies' relationships and involvement with their institutional investors in order to assess the potential impact of IOs involvement on the company's corporate governance and its financial reporting practices.

Moreover, financial and accounting professional associations should educate their members on the risks associated with RPT and the importance of complying with standards such as the PSAK No. 7. The best practices can be published through workshops, seminars, and publications. As a result of their efforts, these associations can play a crucial role in advocating ethical business practices and financial transparency. Their expert advice and recommendations can influence policymaking.

## CONCLUSION

This research study provides important insights into how financial statements are manipulated through RPT inside the Indonesian market, simultaneously underscoring its implications for scholarly work and practical applications. Our findings reveal a significant link between RPT and FSF, thus enriching previous studies by detailing the specific mechanisms through which RPT is employed for earnings manipulation in less developed economies. This study deepens the practical application of agency theory in the emerging markets characterized by weaker regulatory infrastructures. It highlights the critical role of IO in fostering transparency and maintaining the integrity of financial reports. The outcomes suggest that regulators and corporate entities might benefit from strengthening audit practices and enhancing RPT disclosure protocols, which could substantially diminish agency issues while reducing related costs over the long term. The analysis supports the hypothesis that institutional ownership is vital in curtailing the risks linked to RPT, reinforcing the argument for robust corporate

governance as an effective barrier against FSF. This support provides the empirical backing to the debate on corporate governance, affirming the importance of institutional investors in deterring fraud.

The limitation of the study reflects in the fact that it solely focuses on the Indonesian publicly listed companies, which may restrict the extent and manner to which the findings are applicable to companies in the other parts of the world or within different economic frameworks. Moreover, the emphasis on the manufacturing sector might limit the breadth of the applicability of said findings across various industrial landscapes. Future research could broaden its scope so as to include firms from various emerging and developed economies and examine how RPT influences FSF under different regulatory and economic conditions. Additionally, covering data from 2017 to 2019, the study may not account for how shifting economic conditions, regulatory changes, or market dynamics could impact the findings during this particular period. Therefore, future studies should consider employing a time-series analysis inclusive of a broader span of years, which would enable researchers to observe how changes in economic conditions, regulatory frameworks, and market dynamics over an extended period may influence the relationship between RPT, IO, IND, and FSF. Lastly, further investigations could explore additional corporate governance elements, such as board diversity, executive remuneration, the CEO duality, and the audit committee effectiveness so as to gain a fuller picture of what influences FSF.

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