Hexagon Fraud Assessment in Detecting Fraudulent Financial Reporting of Village Credit Institutions (LPD)

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Abstract. Village Credit Institutions (LPD) are village-owned financial institutions whose characteristics only exist in the province of Bali. The existence of LPDs refers to the Bali Governor's regulation number 44 of 2017. In its development, which was first established in 1984 until May 2023, there were 1,439 in the entire province of Bali. Along with the journey of LPD management, acts of fraud were discovered in the LPD's financial reports, which is detrimental to the community and undermines trust in the LPD. These can have an impact either directly or indirectly on other LPDs. The trigger for the emergence of *fraud* can start from opportunities, pressure, rationalization, capability, arrogance, and collusion, which is called *fraud hexagons*. This research aims to analyze *fraud hexagons* as an indicator of fraudulent financial reports of LPD. Data analysis was conducted using an interactive analysis model involving sources from academics, public accounting firms, and the regulatory agency that empowers village precredit institutions (LPPLD). The results of this research identify the practices carried out in fraudulent LPD financial reports, which refer to the elaboration of the fraud hexagon theory. *Fraud hexagon* can be used as an indicator to detect fraudulent financial reports of LPD. Pressure, capability, opportunity, rationalization, arrogance, and collusion can detect the potential for LPD fraud. Fraudulent acts on LPD financial reports tend to occur due to weak internal control, ineffective supervision, lack of clarity regarding the implementation of SOPs for all policies in LPD, and different interpretations of the implementation of LPD bookkeeping guidelines.

Keywords: Audit, Fraud Hexagon, LPD

1 Introduction

The Village Credit Institution, hereinafter referred to as LPD, is a financial institution belonging to Pakraman Village that is domiciled under the authority of Pakraman Village (Bali Provincial Government, 2017). LPD aims to maintain the economic resilience of Krama Desa Pakraman through regular, targeted savings and productive capital distribution, eradicating debt bondage, illegal pawning, and other things that can be equated with it; encouraging equality and business opportunities for every Pakraman Village Community; and increasing purchasing power, smooth payment traffic, and

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money circulation. LPDs, in their operations, are different from Microfinance Institutions, which are specifically established to provide business development and community empowerment services, either through loans or financing in micro-scale businesses to members and the community, managing savings, or providing business development consulting services that are not solely for profit. , this is under article 39 of Law of the Republic of Indonesia Number 1 of 2013 concerning Microfinance Institutions. Village Credit Institutions are recognized for their existence based on customary law. They are not subject to Law Number 1 of 2013 (State Gazette of the Republic of Indonesia, 2013), one of which is that they are not subject to tax.

In its development, LPD, first established in 1984 until May 2023, numbered 1,439 in the entire province of Bali. The Covid-19 storm had a tremendous impact on the development of their business. Several LPDs were unable to survive, and quite a few LPDs could survive and even contribute to the residents of Pekraman village during Covid 19. Research results (Junaedi *et al*., 2021) found three LPD roles for members during the Covid-19 pandemic, namely productive roles: financial solutions for members based on family principles, macro social responsibility role: source of funding for members' collective needs, and the role of micro social responsibility: a source of funding for members' individual needs.

The LPD's financial report refers to the Bali Governor's regulation number 44 of 2017, which is differentiated into a report on loan activities and developments, a profit (loss) calculation report, and a balance sheet report. The current operational and financial reporting of LPDs is closer to banking (BPR) practices, which are not to the initial objectives of forming LPDs themselves. However, this does not mean that LPDs are the same as banking (Suartana, 2020). LPD is very different from BPR, especially from the LPD's equity structure, which comes from traditional village capital, including *due* (belongs to) traditional villages, both tangible and intangible assets (*taksu*). LPD in preparing financial reports refers more closely to the financial accounting standards of entities without public accountability whose presentation can be developed in a non-profit orientation (Putrayasa et al., 2023). The Village Credit Institution Empowerment Institution (LPPLD) will empower LPD through mentoring.

Along with the journey of LPD management, there are a small number of fraudulent acts (*fraud)* in the LPD's financial report, which is detrimental to Krama Desa Pakraman and undermines trust in the LPD. The fraud cases that occurred have even entered the realm of law (Darmayasa, 2023). Detecting and preventing financial statement fraud is necessary with the spread of fraud cases. One way to detect manipulation in financial reports is to use the *fraud hexagon* (Vousinas, 2019). Six factors form the basis of why someone commits fraud and are more complex than the previous theory of *fraud*: Pressure, Opportunity, Capability, Arrogance, Rationalization, and Collusion. Based on the fraud phenomenon that occurs in LPDs, the research that will be proposed is *Assessment Fraud Hexagon* in Detecting Fraudulent Financial Reports of Village Credit Institutions (LPD). Hopefully, this research will benefit the development of LPD internal controls for overcoming fraud in financial reports.

2 Methodology

This research uses a qualitative descriptive method with data collection techniques in unstructured interviews with parties competent with LPD, namely auditors, academics, and village credit institution empowerment institutions (LPPLD). The data analysis technique in this research was carried out using the interactive analysis model proposed by Miles et al. (2014). The interactive analysis model includes stages of collecting data or research facts, stages of data reduction, stages of presenting data for the selection or specification process on the focus of the research problem, and the final stage of concluding.

3 Result and Discussion

3.1 Result

Village Credit Institutions (LPD) must implement an administration system that produces transparent and auditable financial reports. All transactions are recorded based on transaction type, then transactions are grouped and presented in the form of financial reports, and all documents are archived in an orderly manner. Presentation of LPD financial reports includes balance reports, profit and loss reports, activity reports, and loan progress. LPD does not directly refer to the provisions of financial accounting standards applicable in Indonesia, but its operations more closely refer to financial accounting standards for entities without public accountability (SAK ETAP). Recording, recognition, and measurement of transactions at LPDs refer to the LPD bookkeeping administration guidelines and are by the policies that apply to each LPD. Low knowledge in the accounting field tends to impact the process of presenting financial reports and the occurrence of irresponsible accounting practices. The rapid development of LPD capital has prompted LPDs to make improvements, especially in internal control. Internal control is important for an organization to safeguard the organization's assets.

Weak internal control impacts LPD fund management, which makes it vulnerable to fraud cases. The potential for fraud is very large. This has been found in several LPDs, which have resulted in legal problems. Some LPD administrators carry out practices that are not appropriate, namely, carrying out creative accounting processes with a financial reporting system that is not loyal to actual financial conditions created deliberately to achieve a certain goal. LPD operational activities collect funds from village communities and distribute them back to village communities through loans. Potential fraud can occur in several LPD activities, such as collecting public funds, distributing public funds, and abuse of authority held by LPD administrators. Fraud can be caused by errors in the interpretation of the accounting policies used and for personal interests, which lead to acts of corruption.

The Indonesian Financial Audit Agency (BPK) states that fraud is an unlawful act intentionally to obtain something by deceiving. As time goes by, many Village Credit Institutions (LPD) in Bali are found to be unhealthy and congested. This is usually caused by internal LPD parties abusing their authority to commit fraudulent acts (fraud), which can harm other parties. Apart from that, embezzlement of funds is also a factor that causes LPD to enter a state of traffic jams and unhealthy conditions. Embezzlement of funds is caused by poor governance of the Village Credit Institution (LPD) and non-transparent management of funds by the LPD, so several misappropriations occur, such as acts of fraud.

Fraud in the context of an audit is a fraudulent act carried out intentionally to obtain illegitimate benefits or harm other parties. Audit standards guide how auditors should handle, detect, and report fraud that may be detected during the financial statement audit process (IAPI, 2021). Auditor responsibilities include risk assessment, testing, communication of findings, and providing recommendations for improvements to the internal control system. Fraud can involve the manipulation of financial reports and the misuse of assets. Financial reports are manipulated by changing financial information to provide an incorrect picture of financial conditions. Misappropriation of assets included using or taking company assets without permission or illegally. Fraud hexagon theory detects anything that influences someone to commit fraudulent acts (fraud). The fraud hexagon has six elements: pressure, capability, opportunity, rationalization, arrogance, and collusion. Pressure (stimulus) is when a person is under pressure and in difficult conditions, so they are encouraged to commit acts of fraud. Capability is an employee's ability to develop their organization and control social situations that can benefit them. Opportunities cause perpetrators to freely carry out their actions due to weak internal control, indiscipline, weakness in accessing information, and apathy. Poor internal control will provide opportunities for people to commit fraud. Rationalization is seeking the truth about fraudulent acts committed by the perpetrator. A person who commits fraud will rationalize his unlawful behavior to maintain his identity as a trusted person. Arrogance is a behavior of superiority, entitlement, or greed towards criminals who believe that company policies and procedures are not applied to them. Collusion refers to a fraudulent agreement that occurs between two or more parties in which they commit a crime in the form of deception against another party by harming the rights of the other party to gain profit. Indirect collusion can lead to fraudulent acts occurring in an organization.

Based on interviews with Public Accountants who have conducted investigative audits on LPD fraud, they stated that several conditions cause fraud, namely pressure. The initiative to commit fraud is triggered by conditions in the economic sector and financial problems. Capability: the ability of administrators or employees to manage the organization for personal interests. Chance: There are opportunities to commit fraud caused by weak internal controls. Rationalization: justify the fraudulent acts committed. Arrogance: Company policies and procedures are not applied to parties who commit fraud. Collusion: Fraud is committed by a conspiracy of more than one employee. Fraudulent acts on LPD financial reports tend to occur as a result of weak internal control, supervision carried out is not yet effective, there is no clarity regarding the implementation of SOPs for all policies in LPD, different interpretations of the application of LPD bookkeeping guidelines, this is following interviews conducted with academics as well as from LPD regulators.

3.2 Discussion

Fraud or cheating is a problem that occurs in all lines of modern business regardless of size, industrial sector, or nature of operations (Asmah et al., 2020). Fraud hexagon research in LPD can provide a reference for LPD to detect fraudulent practices due to pressure, capability, opportunity, rationalization, arrogance, and collusion. This fraud hexagon indicator provides early steps to prevent possible acts of fraud. Fraud or fraud at LPD is a serious problem that can harm many parties. The types of fraud used include document falsification, embezzlement of funds, credit manipulation, and internal fraud. In their research, Anggraeni dan Yuniarta (2023) stated that the fraud hexagon theory influences acts of fraud in LPDs. Fraud in village credit institutions (LPD) can arise from various forms of pressure that influence individual and system behaviour. This pressure is often related to economic, social situations, or internal system weaknesses. Suryandari et al. (2019) state that Pressure positively affects acts of fraud. The pressure that can trigger or increase the risk of fraud in LPDs is that individuals experiencing financial difficulties may feel forced to commit fraud to obtain funds illegally. Economic instability that causes a decrease in income or assets at the LPD can cause additional pressure on employees to commit fraudulent acts so that targets or performance are maintained. Weaknesses in the internal control system can increase the risk of fraud. Pressure to meet deadlines or lack of supervision can create opportunities for individuals to commit fraud without detection.

Capability in the context of fraud in village credit institutions (LPD) refers to an individual or group's ability or opportunity to commit fraud. These capabilities are often related to access, knowledge, and power that enable them to abuse their position or information. LPD employees or administrators with access to financial systems and transaction data can easily manipulate data or embezzle funds. Saputra et al. (2019) stated in their research that managerial competence and internal supervisory bodies influence the potential bankruptcy of LPDs. Chance refers to situations or conditions that allow individuals to commit fraudulent acts without being detected. Opportunities often arise due to weaknesses in internal controls, inadequate oversight, or deficiencies in existing systems. Fraud opportunities in LPD can be triggered by weaknesses in internal control, inadequate procedures, ineffective supervision, manual record keeping, and inconsistent LPD policies and procedures. Rationalization refers to the psychological process in which individuals who commit fraud justify their actions, often to overcome feelings of guilt or moral conflict. Rationalization helps them feel more comfortable with the unethical actions they commit. Rationalizations used in Fraud, for example, employees who face personal financial difficulties may use the situation to justify fraudulent actions. They may feel forced to do it to meet basic needs.

Arrogance in the context of fraud in village credit institutions (LPD) refers to attitudes or self-views that can encourage someone to commit fraudulent acts. A person involved in fraud may have a sense of entitlement or superiority that makes them feel above rules or ethics. An employee with arrogance, the big ones, may feel that they deserve more than what they receive, be it money, bonuses, or recognition. They may see fraud as a way to balance the injustice they feel. Collusion in the context of fraud in village credit institutions (LPD) occurs when two or more people work together to commit fraud or misappropriation in a mutually beneficial way. Collusion often involves cooperation between employees, managers, or outside parties with sufficient access and power. LPD employees colluded with loan applicants to obtain unauthorized loan approvals. Employees may process loans with falsified documents or use false information, while applicants obtain funds without fulfilling valid requirements.

Overcoming fraud in village credit institutions (LPD) requires a comprehensive approach involving various strategies to prevent, detect, and handle fraud. Develop clear and firm policies regarding integrity and ethics and establish consequences for violations. This policy should define fraud, reporting procedures, and disciplinary measures. A comprehensive and integrated approach can reduce the risk of LPD fraud, increase the trust of members and the public, and ensure safer and more transparent operations.

4 Conclusion

Fraud hexagon can be used as an indicator to detect fraudulent financial reports of village credit institutions (LPD). Pressure, capability, opportunity, rationalization, arrogance, and collusion can detect the potential for LPD fraud. The fraud hexagon can be used to detect financial statement fraud that occurs in companies (Setyono et al., 2023). Fraudulent acts on LPD financial reports tend to occur due to weak internal control, supervision not yet effective, lack of clarity regarding the implementation of SOPs for all policies in LPD, and different interpretations of the implementation of LPD bookkeeping guidelines.

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