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Detecting Financial Statement Fraud in Public Sector Institutions: Insights from Internal Auditors in Law Enforcement Organizations

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Abstract: This study aims to explore the role of auditors in detecting *fraudulent financial statements* within police agencies, particularly at the Regional Police (POLDA) level. Using a qualitative approach with an interpretive paradigm and phenomenological methods, this study examines the experiences of internal auditors from the Regional Supervisory Inspectorate (Itwasda) in dealing with the dynamics of public sector financial oversight. Data were collected through semi-structured interviews and audit document analysis. The results indicate that the role of auditors is not limited to detection functions but also encompasses fraud prevention and response through a risk-based approach and cross-institutional collaboration. Key challenges include limited access to information, bureaucratic complexity, and potential conflicts of interest within the organizational structure. This study enriches the forensic accounting literature by presenting a contextual perspective from the public sector and reaffirms the relevance of Responsive Regulation theory in audit practice.

Keywords: financial statement fraud, internal auditor, public sector, law enforcement, responsive regulation.

INTRODUCTION

Financial statements are a key tool for assessing the performance, transparency, and accountability of an entity, whether in the private or public sector (Mardiasmo, 2018). The information contained in financial statements serves as a crucial foundation for stakeholders in economic decision-making processes, organizational performance evaluations, and oversight of the use of resources managed by the entity (Jatmiko, B., Prawoto, N., & Putri, 2020). In the public sector context, financial statements not only represent an organization's financial condition but also reflect the level of accountability of the government or public institutions to the public regarding the management of public funds (Mardiasmo, 2018). Therefore, the quality of financial statements serves as a key indicator of an organization's integrity and the effectiveness of its governance practices (Chen, L., Srinidhi, B., Tsang, A., & Yu, 2019).

The quality of financial statements is often threatened by fraudulent practices, particularly *fraudulent financial statements* (Albrecht, W. S., Albrecht, C. O., Albrecht, C. C., Zimbelman, 2012). This type of fraud involves the deliberate manipulation or presentation of financial information to mislead users of financial statements for specific purposes. Such practices can include asset inflation, revenue manipulation, concealment of liabilities, and fabrication of financial transactions (Rezaee, 2005). Compared to other types of fraud, *fraudulent financial statements* have the greatest financial impact because they can cause significant economic losses, undermine an organization's credibility, and damage public trust in the institution in question (ACFE, 2024).

The *2024 Occupational Fraud Report: Report to the Nations*, published by the Association of Certified Fraud Examiners, indicates that although cases of financial statement fraud occur less frequently than *asset misappropriation* or corruption, this type of fraud results in the highest median loss (ACFE, 2024). These findings indicate that financial statement manipulation poses a serious threat to organizational sustainability and the stability of financial management systems (Wells, 2014). In addition to causing financial losses, financial statement fraud can also lead to legal consequences, undermine institutional legitimacy, and create a crisis of public trust in organizational oversight and governance systems (Rezaee, 2005).

The phenomenon of financial statement fraud does not occur only in the corporate sector but has also spread to the public sector, including government agencies and law enforcement institutions (Tuanakotta, 2010). Various cases of budget irregularities, manipulation of accountability reports, and abuse of authority in financial management indicate that the public sector still faces serious issues regarding the integrity and effectiveness of internal controls (BPK RI, 2023). Within police institutions, the complexity of the organization's hierarchical structure, a strong bureaucratic culture, and a high concentration of authority can create opportunities for fraud if not balanced by an effective oversight system (Regulation of the National Police Chief No. 2 of 2022). These conditions indicate gaps in the internal control system that are not yet optimal, as well as weak early detection mechanisms for signs of fraud (KPMG., 2020).

In such situations, auditors play a highly strategic role in detecting, preventing, and uncovering financial statement fraud (Skousen, C. J., Smith, K. R., & Wright, 2009). Auditors are not only tasked with examining the fairness of financial statement presentation, but are also expected to identify indications of material misstatements caused by fraud (Rezaee, 2005). Through audit procedures, risk analysis, and evaluation of internal control systems, auditors serve as a monitoring mechanism that helps maintain organizational transparency and accountability (Dechow, P. M., Ge, W., Larson, C. R., & Sloan, 2011). Developments in modern auditing practices have also encouraged auditors to use *risk-based auditing* approaches, investigative audit techniques, and digital data analysis to improve the effectiveness of fraud detection (Ngai, E. W. T., Hu, Y., Wong, Y. H., Chen, Y., & Sun, 2011).

In practice, auditors often face various challenges in detecting fraud, particularly in public sector institutions with complex bureaucratic structures such as the police (KPMG, 2020). These challenges include limited access to information, potential interference from within the organization, a hierarchical culture that can affect auditor independence, and conflicts of interest in the audit process (Braithwaite, 2002). Furthermore, fraud involving management or senior officials is generally more difficult to detect because perpetrators have the ability to manipulate documents, influence internal control systems, and conceal the traces of financial transactions (Wolfe, D. T., & Hermanson, 2004). These conditions indicate that an auditor's success in detecting fraud is influenced not only by technical competence but also by structural factors, organizational culture, and institutional support (Ayes, I., & Braithwaite, 1992).

Based on this phenomenon, this study aims to explore the role of auditors in detecting *fraudulent financial statements* within the Regional Police (POLDA) and to identify the factors that influence the effectiveness of that role. This study employs an interpretive qualitative approach to understand the experiences, interpretations, and practices of auditors in the context of public sector financial oversight. This approach was chosen because it provides a deeper understanding of the social realities and dynamics of oversight in the field, which often cannot be comprehensively explained through quantitative approaches (Merriam, S. B., & Tisdell, 2016).

Theoretically, this study is expected to enrich the literature on forensic accounting and public sector auditing, particularly regarding fraud detection practices in law enforcement agencies. Additionally, this study contributes to the development of an interpretive perspective in fraud studies, a field that has long been dominated by positivistic and quantitative approaches. Practically, the findings of this study are expected to serve as input for police agencies and internal oversight bodies in strengthening internal control systems, enhancing audit effectiveness, and developing fraud detection strategies that are more adaptable to the dynamics of public sector organizations.

Literature Review and Theoretical Framework

Fraud and Fraudulent Financial Statements

Fraud is an intentional act of deception aimed at obtaining personal gain through the presentation of misleading information (Albrecht, W. S., Albrecht, C. O., Albrecht, C. C., Zimbelman, 2012). One of the most complex forms is *fraudulent financial statements*, which involve the material manipulation of financial reports to influence decision-making.

The phenomenon of fraud is explained through several major theories, such as the fraud triangle, which encompasses pressure, opportunity, and rationalization. This theory later evolved into the fraud diamond with the addition of the capability element (Wolfe, D. T., & Hermanson, 2004), as well as the fraud pentagon, which adds the factor of arrogance as a key determinant.

The Role of Auditors in Fraud Detection

Auditors are responsible for detecting material misstatements in financial statements through systematic audit procedures (Skousen, C. J., Smith, K. R., & Wright, 2009). In modern practice, auditors use a *risk-based auditing* approach as well as technologies such as data analytics to identify indications of fraud (Ngai, E. W. T., Hu, Y., Wong, Y. H., Chen, Y., & Sun, 2011).

However, auditors are not an absolute guarantee of fraud-free operations, especially when fraud involves top management who have control over internal systems (Dechow, P. M., Ge, W., Larson, C. R., & Sloan, 2011).

Responsive Regulation Theory

The Responsive Regulation theory emphasizes an adaptive and tiered oversight approach, ranging from persuasion to law enforcement (Braithwaite, 2002). In the context of public sector auditing, this approach allows auditors to adjust their strategies based on the severity of violations and the auditee's response.

This approach is relevant in a police environment characterized by a hierarchical structure and a strong organizational culture, necessitating a balance between oversight and guidance.

METHOD

This study employs a qualitative approach using an interpretive paradigm and phenomenological methods to understand the subjective experiences of auditors in detecting *fraudulent financial statements* within the police institution (Merriam, S. B., & Tisdell, 2016). A qualitative approach was chosen because this study focuses on a deep understanding of the experiences, meanings, and social dynamics encountered by auditors in the practice of public sector financial oversight. Meanwhile, an interpretive paradigm is used to understand how auditors interpret their roles, face organizational challenges, and interpret the phenomenon of fraud within the context of a complex and hierarchical police bureaucracy (Chariri, 2009).

The phenomenological method was used to explore auditors' *lived experiences* regarding the fraud detection process, including their experiences in dealing with limited access to information, organizational pressure, and efforts to maintain audit independence. Research data were obtained through semi-structured interviews and analysis of audit documents to gain a comprehensive understanding of fraud detection practices within the South Sumatra Regional Police. Data analysis was conducted thematically through a process of data reduction, categorization, and interpretation of the informants' experiences to identify patterns in the roles of auditors and the factors influencing the effectiveness of fraud detection (Bhattacharjee, 2012).

Location and Informants

The research was conducted at one of the Provincial Police Headquarters in Indonesia, with the primary informants being internal auditors from the Provincial Police Audit Division (Itwasda) who have direct experience in financial and investigative audits.

Data Collection Techniques

Data was collected through:

1. Semi-structured interviews
2. Analysis of audit documents such as audit reports and investigation reports

Data Analysis Techniques

Analysis was conducted thematically through a process of data reduction, categorization, and interpretation of the informants' experiences (Bhattacharjee, 2012).

RESULTS AND DISCUSSION

The Role of Auditors in Fraud Detection

The results of the study indicate that auditors play a significant role in detecting *fraudulent financial statements* within police institutions. This role is realized through the identification of fraud risks using a *risk-based auditing* approach, which is an audit process focused on areas or activities with a higher risk of fraud. Auditors map risks based on transaction patterns, weaknesses in internal control systems, and potential irregularities in financial management. This approach enables auditors to more effectively determine audit priorities and allocate audit resources to areas most vulnerable to fraud. One of the sources stated that:

“We usually start by identifying the most vulnerable areas, such as the use of specific budgets or activities where irregularities might occur. So the audit is focused more on those areas.” (R1)

This statement indicates that the auditors have adopted a risk-based approach in the oversight process to enhance the effectiveness of fraud detection.

Auditors also play a role in analyzing *red flags* or early indicators of fraud through forensic audit techniques and analytical procedures. Such indicators may include document discrepancies, unusual transactions, budget manipulation, and inconsistent financial reporting patterns. In practice, auditors do not rely solely on administrative reviews but also employ professional judgment and audit skepticism to assess the likelihood of financial statement manipulation. Research findings indicate that an auditor’s ability to identify patterns of anomalies is a critical factor in the fraud detection process, particularly within organizations featuring complex bureaucratic structures. This is further supported by the following statement from an expert:

“There are usually certain signs, such as inconsistent reports, recurring transactions with the same pattern, or documents that differ from one another. That’s where we begin our in-depth investigation.” (R2)

This quote indicates that auditors use analysis of transaction patterns and data discrepancies as an initial step in identifying indications of fraud.

In addition, auditors also play a crucial role in evaluating the effectiveness of an organization’s internal control system as a means of preventing fraud. This evaluation is conducted to assess whether oversight mechanisms, administrative procedures, and authorization systems are functioning effectively to minimize the likelihood of fraud. Through this evaluation, auditors can provide recommendations for system improvements to strengthen the organization’s transparency and accountability. One informant stated that:

“If internal controls are weak, the likelihood of irregularities is certainly greater. That is why we do not just look for errors, but also provide recommendations to improve the system.” (R3)

These findings indicate that the role of auditors is not merely reactive in identifying fraud that has already occurred, but also proactive in preventing potential fraud through the strengthening of internal control systems and risk-based oversight.

Challenges in Fraud Disclosure

The research findings indicate that auditors face various challenges in the process of detecting *fraudulent financial statements* within police institutions. One of the main challenges is limited access to information, particularly to documents, financial data, or certain sensitive information that falls under the authority of specific units. This situation hinders auditors from obtaining sufficient audit evidence to support the examination process. Furthermore, limited information transparency also has the potential to reduce auditors’ effectiveness in comprehensively identifying indications of fraud. One interviewee stated that:

“We cannot access all data immediately. Some documents require specific authorization, so the audit process sometimes takes longer.” (R1)

This statement indicates that limited access to information poses a barrier to the optimal collection of audit evidence and the detection of fraud.

Another challenge is the presence of structural interventions within the organization that can affect the auditor’s independence during the audit process. The hierarchical nature of the police organizational structure allows for the emergence of pressure—both direct and indirect—that can limit the auditor’s ability to conduct inspections. In some cases, auditors face situations that require caution in disclosing certain findings because they involve officials or parties holding strategic positions within the organization. One informant explained that:

“Sometimes there are situations that require auditors to exercise caution, especially when the audit involves officials or specific units that hold key positions.” (R2)

These conditions indicate that factors such as power and organizational culture influence the effectiveness of the oversight process and the detection of fraud.

In addition, the complexity of bureaucracy poses a significant challenge to auditing practices in the public sector. Lengthy administrative procedures, complicated coordination mechanisms between units, and overlapping authorities often slow down the audit process and the follow-up on audit findings. This complexity means that the process of detecting fraud depends not only on the auditors' technical capabilities but also on the effectiveness of the organizational system in supporting internal oversight processes. This was highlighted by the following interviewee:

“The bureaucratic process is quite lengthy, so when coordination between departments is required, the audit often takes longer.” (R3)

On the other hand, potential conflicts of interest also pose a challenge to maintaining audit objectivity, particularly when auditors have close structural or professional ties to the audited entity. This situation can compromise the auditor's independence and potentially introduce bias in both the evaluation process and the reporting of audit results. One auditor stated that:

“Another challenge is maintaining objectivity. Because within an organization, there are inevitably work relationships or certain close ties that sometimes make the auditor's position difficult.” (R4)

The findings of this study reveal a gap between ideal audit standards and the reality of practice in the field. Although auditors are normatively required to work independently, objectively, and professionally, organizational conditions and bureaucratic dynamics often affect the effectiveness of audit tasks. Therefore, strengthening internal control systems, improving access to information, and protecting auditor independence are critical factors in enhancing the effectiveness of fraud detection in the public sector.

Implementation of Responsive Regulation

The research findings indicate that auditors employ a phased oversight approach in detecting and addressing *fraudulent financial statements* within police institutions. This approach reflects the application of the *Responsive Regulation* theory, which is an oversight model conducted adaptively and in stages according to the severity of the violation and the response from the audited party. In practice, auditors do not immediately resort to a repressive approach but prioritize guidance and prevention before proceeding to more serious enforcement measures. This approach is considered more effective in maintaining organizational stability while enhancing compliance with accountable financial management.

1. Initial Stage: Guidance and Clarification

In the initial stage, auditors prioritize a persuasive approach through guidance, clarification, and the provision of improvement recommendations to the audited party. Auditors communicate directly to understand the causes of errors or discrepancies in the financial statements. In this stage, audit findings that are still administrative in nature or early indications of fraud are generally resolved through system improvements, enhanced procedural compliance, and strengthened internal controls. This approach demonstrates that auditors serve not only as supervisors but also as mentors to the organization in improving the quality of financial governance.

2. Advanced Stage: Investigative Audit

If more serious indications of fraud are found or there are discrepancies that cannot be adequately explained, the auditor will proceed to the investigative audit phase. At this stage, the auditor conducts a more in-depth examination of documents, transactions, and

budget usage flows to obtain stronger evidence regarding the alleged fraud. An investigative audit is conducted using a more systematic and focused approach, including tracing transaction patterns, identifying the parties involved, and analyzing the potential financial losses to the organization. This stage reflects an increased intensity of oversight in response to a higher level of fraud risk.

3. Final Stage: Reporting to the Legal Authorities

In the final stage, if the results of the investigative audit reveal strong evidence of fraud or legal violations, the auditor will report these findings to the appropriate authorities for follow-up through legal proceedings. This stage reflects the auditor's role as part of the organization's accountability and integrity enforcement mechanisms. Reporting to law enforcement agencies is carried out as a response to violations that cannot be resolved through the organization's internal mechanisms. In addition to serving as a deterrent, this action also aims to maintain public trust in the oversight and governance systems of public sector institutions.

The implementation of this phased approach demonstrates that audit practices within the police force are not only focused on identifying errors, but also on efforts to provide guidance, prevent issues, and improve the organizational system. The *Responsive Regulation* approach allows auditors to tailor their oversight strategies based on the severity of violations and the organization's circumstances, thereby making the audit process more adaptive, proportionate, and effective in supporting the establishment of transparent and accountable financial governance.

CONCLUSION

This study concludes that the role of auditors in detecting *fraudulent financial statements* within police agencies is multidimensional, encompassing detection, prevention, and response functions. The effectiveness of this role is influenced by structural factors, organizational culture, and auditor capacity.

The implementation of the Responsive Regulation approach has proven effective in enhancing the effectiveness of oversight in the public sector. However, it is necessary to strengthen internal control systems and enhance auditor independence to minimize the risk of fraud.

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