

# Risk of Material Misstatement, Supply Chain Management and Audit Liability in Economy Development

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**Abstract**— In today's complex connected world, supply chain is more and more recognised as a key source of competitive advantage and differentiation. Companies strive to build powerful supply chains that will enable them to get their products to market faster, more efficiently and more economically than their competition. The auditor should provide judgment with professionals, but empirical findings indicate the auditor is influenced by supply chain managements that can the determination of risk of material misstatement. With the fraud found in several large companies in Indonesia that have received reasonable opinions without exceptions, the auditor is accused of not professionally determining risk of material misstatement. The purpose of this study is to investigate the auditor's views on the allegations of failure of audit judgment when the client receives a reasonable opinion without exception but later it is proven that the client is cheating financial statements. This research also aims to explore supply chain managements that have the potential to influence the determination of the auditor's risk of material misstatement in the auditor's legal obligations related to fraud detection. The novelty of this research is in the search for factors that influence auditor judgment in the form of risk of material misstatement. Previous research in behavioral aspects in the context of the audit examined the auditor's judgment in terms of audit opinion as well as fraud risk assessment. Risk of material misstatement is relevant in explaining the various phenomena that accuse auditors when fraud is found in companies that have been given a fair opinion without exception. The study design was employed Qualitative methods using interview techniques with several key informants. Resource persons who act as informants are CPA firm partners who are partners in the big ten in Indonesia. The results showed that the supply chain managements that caused the auditor not to determine professional judgment in the form of risk of material misstatement were auditor's lack of skepticism, individual bias, lack of training and lack of supervision from the audit manager during fieldwork. The results of this research can be used by the Indonesian Institute of Certified Public Accountants in

**conducting training that is able to improve the quality and capability of auditors to improve the ability to formulate risk of material misstatement.**

**Keywords**— *Audit Liability, Business, Supply chain management, Economy Development*

## 1. INTRODUCTION

Any chain is only as strong as its weakest link – and it's the same with a supply chain, except that within a supply chain ecosystem the linkages are not consecutive and not linear; there are numerous multi-dimensional connections with profound interdependencies. The fraud scheme carried out by an entity is an effort made by management to portray the good condition of the company in stakeholders view [1]. This behavior then impacts the bias of the information contained in the financial statements and imposes sanctions on those who commit it. In [2, 3] states that there are three main factors underlying various parties to commit fraud (namely fraud triangle); (a) the presence of pressure, (b) opportunity and (c) rationalization. In [4] noted that although pressure, opportunity and rationalization exist side by side, cheating will not occur sufficiently with these three factors, but requires a fourth factor, namely capability.

Fraud in organization has an impact on litigation cases faced by auditors. In [5] fraud risk factor theory is based largely on a series of interviews conducted with people who had been convicted of embezzlement. He concludes that frauds generally share three common traits. In [6] explains that the cases that occurred resulted in criticism directed at the auditor in providing judgment. In Indonesia in 2018 the Financial Services Authority (FSA) imposed administrative sanctions on two public accountants (AP) and one public accounting firm (KAP) related to the case of PT Sunprima Nusantara Financing (SNP Finance). The problem is that AP Marlinna and AP Merliyana Syamsul and KAP Satrio, Bing, Eny (SBE) and Partners are deemed not to give opinions in accordance with the actual conditions in the annual audit financial statements of the SNP. Sanctions given to KAP Satrio, Bing, Eny (SBE) by Otoritas Jasa

Keuangan (OJK)/Financial Service Authority (FSA) are in the form of a ban on the addition of new clients.

Auditors are expected to have a high attitude of independence and skepticism so that the results of the audit given can be declared. The case was considered tarnishing the attitude of independence that public accountants (PA) should uphold only for the sake of expanding market share and impacting on the decline in audit quality. The case that was also highlighted was the Enron Case, this case proves that in manipulating profits there is stakeholder involvement in an organization, including the Enron Finance Director of the Andersen Public Accountant Office, the Board of Directors and Former Head of Enron's Internal Audit. The impact on quality control that necessity for preparers and auditors to exercise professional judgment is, if anything, even more important in light of these conditions. Despite the rumors, professional judgments remain the most essential element of the preparation and auditing of financial statements. Professional institutions that regulate the work of accountants and auditors make overarching decisions and judgments on the appropriate disclosure and presentation of financial information [7].

The purpose of this study is to investigate the auditor's views on the allegations of failure of audit judgment when the client receives a reasonable opinion without exception but later it is proven that the client is cheating financial statements. This research also aims to explore supply chain managements that have the potential to influence the determination of the auditor's risk of material misstatement in the auditor's legal obligations related to fraud detection. The results of this research can be used by the Indonesian Institute of Certified Public Accountants in conducting training that is able to improve the quality and capability of auditors to improve the ability to formulate risk of material misstatement.

## 2. LITERATURE REVIEW

### 2.1 Audit Liability In Fraud Detection

Lindgren & Lundgren (2016) explained that in 1985 the auditor was responsible for compensating for damage caused by the company due to negligence in the audit. After the Kruger accident, in 1944, the auditor's role underwent a major change. The auditor's responsibilities are further extended to include responsibility for damage to third parties. In [8] also write that auditors have both internal and external responsibilities, internal responsibilities are corporate responsibilities and external responsibilities are the responsibilities of third parties. Samsonova-Taddei & Humphrey (2014) conceptualizes responsibility as a source of risk. Characterizes risk not as a static fact, independent of interpretation, but as an entity

whose contextual meaning varies and is inherently unstable. The difference in how we conceptualize risk comes from the way risk defines objects and identifies them by establishing causal relationships between objects and alleged damage.

### 2.2 Supply Chain Managements

Supply chain managements that influence auditor judgment are experience and gender. The first supply chain management that influences audit judgment is experience. Experience is knowledge, skills, or practice that comes from direct observation in a particular event or activity. The auditor's experience is important for competency development for the achievement of reasonable judgments. The experience factor is usually measured by the length of the auditor working in the audit field. The experience itself is divided into three categories, namely general experience, special assignment experience, and special industry experience [9]. Knowledge considered as one of the supply chain managements because knowledge can affect auditor judgment. Auditors acquire knowledge through education, training, and experience [10].

Position Level Studies on ethical behaviour found that individuals of higher rank have a stronger sense of obligation to their profession than those in a lower rank. This means the attention to ethical principles increases as the level of responsibilities increases. In earlier study, [11] investigate possible relationship between moral reasoning and position and found that auditors' position level in the firm influence ethical reasoning and judgment. This is because, according to the study, higher position means auditors pays more attention to external forces such as firm's profit. Moreover, auditors who hold a higher position such managers and partners display greater management skills than auditors of lower position. However, [12] find no significant relationship between position level and ethical judgment.

### 2.3 Audit Judgement

Irawati & Solikhah (2018) examines the variables of gender, audit fees, task complexity and framing influence on audit judgement. In addition, two new variables have been included namely the variables of audit situation and the professional due diligence. Audit situation refers to various situations faced by the auditor in his or her audit assignment. In situations which have risks can certainly affect judgement produced by the auditor, so that the researcher tries to examine the audit situation variable as an independent variable to audit judgment.

In [13] examine the factors influencing professional judgment of Malaysian auditors. Using questionnaire to measure the level of professional judgment and factors influencing the judgment such as gender, knowledge, position level, experience and also firm size. The multiple regression results showed that the position level and experience to be statistically

significant in determining the level of professional judgment of auditors. Gender, knowledge and firm size have no significant relationship with professional judgment.

In [14] states that the relationship between experience, tasks and information used by auditors uses long-term memory. This is what dominates the topic of decision-making research in the context of auditing. Auditors use their judgments when they make major decisions such as: "(1) the assessment of the risks of material misstatements of financial statements, including the potential effects of fraud, bias and business risk; (2) the identification, performance and assessment of audit procedures to address those risks; (3) the evaluation of audit evidence to determine the quality and meaning of that evidence and to assess the need for additional evidence based on the process; and (4) the formation of an opinion on the financial statements and the decision whether or not to express that opinion" [15].

Brainstorming makes new standards to require group linked to make decision making [16] or discussions at meetings for planning fraud detection programs [17]. In [18] makes provides to insight the evaluation of evidence, and especially in relation to the attributes of several types of evidence that management might manipulate. Auditor is a negotiator in interpersonal interactions [19]. Research on client-auditor negotiations uses a model developed by [20].

#### **2.4 Supply Chain Managements And Auditor Judgement**

Supply chain management that influences audit judgment is experience. Experience is knowledge, skills, or practice that comes from direct observation in a particular event or activity. The auditor's experience is important for competency development for the achievement of reasonable judgments and identification fraud risk factor. The identification of efficient fraud risk factors can be influenced by the auditor's professional skepticism [21]. Professionalism has becomes very important for an auditor to remember that the level of auditor professionalism is indispensable while undertaking an audit. In [22] suggest auditor with professional skepticism will seek additional evidence from the client's company if the auditor feels that the evidence he has obtained has not been convincing enough. In [23] explains the auditor's decision making in determining the Risks of Material Misstatement (RMM) that is influenced by supply chain managements. The auditor's decision with Regulatory Focus Theory (RFT) explains the auditor's motivation in making decisions influenced by two choices, namely promotion or prevention.

The second supply chain management that

influences audit judgment is gender. Gender is a personal characteristic or indicator that is thought to influence affective and ongoing commitment [24]. In other words, the effect of some organizational practices might be different for men and women. For example, [25] found that male and female auditor ratings were indeed different. [26] showed that female auditors are more sensitive to business situations involving earnings management and management auditors. In a study involving 166 participants from business classes. [27] examined students' ethical judgments about 24 business-related scenarios. Their results showed a significant difference in the participants' ethical judgments by sex, with male students assessing all the actions described in the scenario as less ethical than female students.

In [28] examined factors influencing professional judgment of auditors in Malaysia. A questionnaire was used to measure the level of professional judgment and factors influencing the judgment. Not only the gender, this study also examined the other supply chain managements like knowledge, position level, and experience. A considerable amount of research associated with auditor judgment has produced several concerns about how knowledge might affect the approach to audit judgment and to help auditors in better decision making [19]. Auditors acquire knowledge through education, training, and experience [10].

Audit judgment is a consideration of perceptions in responding to financial statements obtained, coupled with the existence of factors from within a person auditor itself, thus generating an evaluation base of the auditor [12]. According to ISA 200 professional judgment is the application of relevant knowledge and experience, in the context of accounting auditing and ethical standards, to reach appropriate decisions in situations or circumstances during an audit engagement. Besides knowledge and position level, experience has also been identified as possible factors that may influence an auditor's performance. [8] suggest effects procedural knowledge needed for ratio analysis, as well as the effects of procedural knowledge and ability on ratio analysis performance of auditor's. In addition, [6] find that experienced auditors have a more complete understanding of the errors in the financial statement and are able to explain them. They conclude that experienced auditors can reach a proper conclusion more quickly than their less experienced colleagues.

### **3. RESEARCH METHOD**

This study uses a qualitative design using primary and secondary data sources. The qualitative research design uses interviews as a technique for obtaining data. The results of the interviews between the informants with other informants were compared as a form of validity and reliability. Validity is important to ensure and accuracy of a measuring instrument in

carrying out its size function [9]. Reliability is an index that shows which measuring instrument can be trusted or reliable [11]. This research explains the cause of auditors in Indonesia to be the first party to be blamed when material misstatement occurs in the audited financial statements.

This research uses an interpretive paradigm because the phenomenon in the audit field is a systematic examination practice to evaluate financial statements and assess their compliance with generally accepted accounting principles. Research on the responsibilities of auditors in Indonesia, when viewed from the impact of individual, government and cultural factors on the risk of material misstatement has been carried out using a quantitative approach (survey and experiment). By looking at the need for in-depth exploration of individual, cultural and governmental factors in determining RMM by auditors, this research will use a qualitative approach. Audit developments have changed from time to time with strong social influences, including the influence of regulators (government and professional associations). The right paradigm to explain audit practices in Indonesia, especially in RMM decision making, is the interpretive paradigm. [5] support this argument, that the interpretive paradigm is able to support the freedom of future accounting research. In [7] also stated that interpretive studies can pave the way to facilitate more humane social movements by breaking communication barriers in the mainstream perspective.

## 4. RESULTS AND DISCUSSIONS

### 4.1 Why do auditors in Indonesia become the party to blame when material misstatement occurs in the audited financial statements?

Interview was conducted with Big Four partners in Indonesia to gauge the auditor's views on the allegation that the auditor's role was not functioning in determining material misstatement. The Big Four partners that have been interviewed are Pricewaterhouse coopers (PwC), Ernest and Young (EY), KPMG, Doli Bambang Sulistyanto Dadang & Ali (DSBD & A). Interviews were also conducted with speakers from the regulator, namely the Indonesian Institute of Certified Public Accountants (IAPI) and the Financial Services Authority (OJK).

The first interview was conducted with Mr. S as auditor and partner at the Public Accounting Firm (KAP) Doli, Bambang, Sulistyanto, Dadang & Ali during 2000-2012. Then since 2012 until now, he moved to the Public Accounting Firm (KAP) Bambang and Sudarmadji. The interview was held on July 31, 2019. Information obtained from him as an accountant, especially in this case the auditor is:

"The socialization needs to be improved so that

public accountants have knowledge about responsibility as accountants. Public accountants must be aware of the risks of fraud, so that knowledge related to business audits must be mastered by public accountants so that they are more aware of the possibility of fraud and must be careful "

The same thing was also conveyed by Managing Partner of Public Accountant Firm (KAP) Doli, Bambang, Sulistyanto, Dadang and Ali namely Mr. B when asked to do an interview on July 31, 2019 which revealed that:

"There is also a perception that those who make financial reports and everything are accountants, even though in fact they are opinions and all of them state that financial statements are the responsibility of management, but still sir, public perception cannot be erased." But actually, legally it is not accountant's responsibility, still it's the responsibility of management sir, but the community is that ... the perception is that the accountant is everything there. " The results of the interviews of the two partners showed that public accountants who served as auditors must be aware of the knowledge of their duties and responsibilities. In addition, more aware of the possibility of fraud and to know that the accountant's job is to provide an opinion on the financial statements that have been made by management. The same thing was explained by Managing Partner Ernest and Young (EY) namely Mr. AG when asked to conduct an interview on September 17, 2019 in his office, which revealed that:

"There are several stages that are carried out when there are new clients, first they must get an internal financial report. Second, for clients that we see in high profile or hear publications such as committees, that committee is determined to go. If we go, we will do an independent control check to all EY people throughout Indonesia to avoid if the company has used EY in other services such as tax. Then, if for Tbk, check the database by checking whether this name appears elsewhere, another division, tag or consultant. Third, consider the risk of the client because there is a low or moderate or high or close monetaring".

The statement submitted by Mr. A was supported by the managing partner of the Public Accountant Office (KAP), PricewaterhouseCoopers (PwC) namely Mr. J and Mr. T as managing partners of the Deloitte Public Accountant Office (KAP) and Mr. the managing partner of the KPMG Public Accountant Office (KAP) . When requested to conduct an interview in his office, World Trade Center (WTC) 3 on December 17, 2019, Mr. J who had assumed his duties and responsibilities as an accountant in the Big Four Public Accountant Firm explained that:

"The audit work involves testing millions of transactions if the auditor is careful, then risk assessment can be done carefully, this is also supported if through an understanding of culture and government and determining the risks where. For more in-depth audit areas the risk of error sampling

cannot be avoided so the thing to remember is that every audit there is no 100% confidence that the material misstatement was caught. Especially if in the company of fraud, collusion, vouching evidence, making authentic but fake evidence with extraordinary technology through collaboration with partners. When this happens, top management should be the center of authorization in every transaction, not the initiator and even endorse such behavior."

The statement delivered from the public accountant who served as an auditor revealed that to reduce the risk of material misstatement, there needs to be an increase in competence for the auditor, especially in understanding the sampling risk in handling each transaction. This is supported through the results of interviews conducted with the regulator namely Mr. TA as Chairman of the Indonesian Institute of Public Accountants (IAPI) for the period 2017 to 2021 which states:

"Because they are not diligent in writing, it is difficult to document it, right here, and sometimes there is a miss in documenting it, there is also a second what, because of the time pressure due to deadline targets, for example, also makes procedures that may be missed and so on, so in terms of internal office oversight there is which needs to be improved, such as improving internal review competence and quality control system review, then for the external side of p2pk and IAPI, they can conduct an audit at the accountant's office".

The statement was also supported by Mr. S as regulator and Director of Accounting and Governance Standards, at the Financial Services Authority (OJK) who added:

"If there is an opportunity to speak, just say that financial statements are the responsibility of management and your job as an auditor is to provide insurance, yes at SPAP, yes at SAK. Even though the presence of the majority within, it still assumes that if an error occurs in the financial statements is the accountant's fault. I am just straightening out, if the financial statements are wrong, the management is wrong first, the management is wrong first, then the accountant can do it or just the management. The accountant only acknowledges his opinion, always so. This is difficult when placing a case, fraud, that what position it is. Because it could be the majority of legal and management backgrounds. like that we have to voice".

Then Mr. A, who also has a role in the administration, added:

"So if it is good or bad depends first on the auditor's understanding of risk assessment or the auditor's expertise in conducting risk assessment. The second is very dependent on the internal control of the company being audited, so if that's the question. with a variety of assumptions it makes

things misstatement disappear, but it also depends on the quality of internal control and integrity of the client. If the auditor is integrity, but the client will not have many risks. with a variety of assumptions it makes things misstatement disappear, but it also depends on the quality of internal control and integrity of the client. If the auditor is integrity, but the client will not have many risks".

Based on interviews with public accountants serving as auditors, it was found that the auditor must understand his duties and responsibilities specifically within the scope of determining material misstatement. The interview results from the regulator also revealed that public accountants who served as auditors must enhance the auditor's function in determining material misstatements with internal and external oversight of the office and assisted through monitoring conducted by IAPI, especially in terms of increasing journal reviews, engagement quality control reviews and the need for training to improve the performance of auditors in carrying out their duties and responsibilities to avoid material misstatements. Then the auditor must also understand the duties and responsibilities, namely in providing opinions on financial statements provided by clients, and what needs to be underlined is the difference between the management responsible for the financial statements while the auditor is the party responsible for providing opinions on financial statements.

4.2 How do supply chain managements influence the auditor's RMM determination?

To find out some supply chain managements that influence the determination of the RMM auditor, interviews with several Big Four partners in Indonesia. The Big Four partners interviewed were Pricewaterhouse Coopers (PwC), Ernst and Young (EY), KPMG, Doli Bambang Sulistyanto Dadang & Ali (DSBD & A). Interviews were also conducted with speakers from regulators, namely the Indonesian Institute of Certified Public Accountants (IAPI) and the Financial Services Authority (OJK).

The first interview was conducted with Mr. JW as a public accountant who served as an auditor as well as a partner at the Public Accounting Firm (KAP) PricewaterhouseCoopers (PwC). Information obtained from him as an accountant especially in this case the auditor is:

"Determination of the RMM conducted by the auditor is influenced by several factors, namely an understanding of culture and government and risk determination. Audit work involves testing millions of transactions if the auditor is careful then risk assessment can be carried out carefully. Then keep in mind that for more audit areas, the risk of sampling error cannot provide 100% confidence that the material misstatement was caught. Especially if in the company of fraud, collusion, vouching evidence, making authentic but fake evidence with extraordinary technology through collaboration with partners. When this happens, top management should be the center of

authorization in every transaction, not the initiator and even endorse such behavior.”

The same thing was also conveyed by Managing Partner Ernest and Young (EY) namely Mr. AG who revealed that:

“At the client acceptance stage so if for example there is a new client, we always do the name like a survey client and there are problems, for example, we have to meet with management first, then after that the first is to get this financial report and the financial statements must be we get at least a balance sheet and income statement. This is a factor that can assist the auditor in determining the RMM or material misstatement in the client's financial statements ”.

The interview results from the two partners also showed that public accountants who served as auditors must know and have an understanding of culture, government and risk determination in conducting audits, especially when accepting new clients, an examination of the company's background is needed. When meeting with client management, the auditor must request the client's financial statements such as balance sheets and income statements. This is important to avoid the risk of material misstatement for the auditor. When conducting an audit there will be a risk of sampling errors that can not be avoided, so the auditor can not give 100% confidence. Although this is natural, in practice, in order to avoid material misstatements in the financial statements and when determining the sampling risk, the auditor also needs to be equipped with adequate competence, such as through socialization and training. The same thing was conveyed by Mr. SD who served as an auditor and partner at the Public Accountant Office (KAP) Bambang and Sudarmadji who stated:

"... in determining the RMM, a lot of socialization must be carried out for accountants starting from the most basic ones such as" what are accountants' responsibilities "so that accountants can carry out their duties and responsibilities to the maximum, especially when determining material misstatements in financial statements".

Mr. T as Deloitte's Managing Partner also added that:

"... HR is the key to accounting firm practice, so HR is weak, the accounting firm is also ..."

The statement delivered from the public accountant who served as an auditor revealed that the factors affecting the auditor in determining the RMM were culture, government, risk determination as well as the potential and HR owned by the auditor. This was then supported through the results of interviews conducted with several regulators namely Mr. Ahsin as a government representative stating that:

"Supposedly with a variety of assessment, it will make things misstatement disappear, but it also

depends on the quality of internal control and integrity of the client. If the auditor has integrity but the client is not, there will still be a lot of risk.”

The statement was also supported by Mr. S as regulator and Director of Accounting and Governance Standards, at the Financial Services Authority (OJK) who added:

("... increasing capacity through competence by following PPL needs to be done but the issues discussed in class must be related to new issues in the accounting world. Especially in the use of the latest accounting standards such as the existing ETAP Sharia now. Don't forget the details because the regulations are actually remains the same, because accounting is back to basic principles, like checking related checks just like financial accounting has reached advanced finance, don't keep forgetting the previous ...")

The same thing was said by Mr. TA as one of the regulators of the Indonesian Institute of Certified Public Accountants (IAPI) who added:

("..pada saat menentukan ada area signifikan skeptisme profesionalnya ya bisa jadi karena tekanan waktu, kemudian juga di lapangan, terus melihat data di lapangan tidak menunjukkan hal yang perlu, hal ini menunjukkan bahwa justifikasi menjadi mudah untuk dibuat, sehingga kemudian ternyata itu menjadi tidak efektif, karena begitu dibuat semacam justifikasi sehingga risk assesmentnya rendah, maka prosedurnya tidak berubah disitu, sehingga perlu juga kompetensi yang memadai dari pihak auditor dalam memberikan opini atas laporan keuangan terutama saat mengecek data yang ada dilapangan)

Based on the results of interviews with public accountants who served as auditors, it was found that several supply chain managements that influence the determination of the Auditor's RMM are: 1) understanding of culture and government, 2) determination of risk, 3) potential and human resources owned by the auditor. The interview results from the regulator also revealed that public accountants who served as auditors must have adequate competence through training or outreach, especially in the use of financial accountant standards, then the next thing was to increase professional skepticism in carrying out tasks, especially in the case of determining RMM.

## 5. CONCLUSIONS

This research aims to explore supply chain managements that have the potential to influence the determination of the auditor's risk of material misstatement in the auditor's legal obligations related to fraud detection. The results showed that the supply chain managements that caused the auditor not to determine professional judgment in the form of risk of material misstatement were auditor's lack of skepticism, individual bias, lack of training and lack of supervision from the audit manager during fieldwork.

This research has limitations in terms of CPA Firm Indonesia's data access from OJK. Data that cannot be obtained is CPA Firm's routine activity data in providing training to mitigate individual bias and increase auditor capabilities. The impact is the absence of information about the strategy of the CPA Firm to overcome supply chain managements that influence the determination of risk of material misstatement.

This research can be used by IAPI as a public accountant organization in Indonesia in designing various trainings that can improve audit quality. The implication for auditors is the need to use professional skepticism to improve the ability to formulate risk of material misstatement.

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