



E-ISSN:  
2721-13988

# THE PRICE TO PAY: AN EMPIRICAL ANALYSIS OF THE RELATIONSHIP BETWEEN HEXAGON FRAUD AND FINANCIAL PERFORMANCE OF EAST JAVANESE BANKS

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## Abstract.

This study aims to analyze the relationship between Hexagon Fraud and financial performance in East Javanese banks, with Corporate Governance as a moderating variable. This study uses path analysis with a population of 437 banks. The sample size, determined using the Slovin formula, is 209 banks. The results indicate that Hexagon Fraud significantly affects financial performance, and Corporate Governance substantially moderates the relationship between Hexagon Fraud and financial performance. Improved Corporate Governance can weaken the negative impact of Hexagon Fraud on banks' financial performance, highlighting the importance of transparent and accountable governance practices for banks.

**Keywords:** Hexagon Fraud, Financial Performance, Corporate Governance, Path Analysis, East Javanese Banks.

## 1. Introduction

The banking sector is a cornerstone of Indonesia's economic stability, contributing significantly to the nation's Gross Domestic Product (GDP). According to the Financial Services Authority (OJK, 2023), banks account for over 50% of the financial services industry's total assets, underscoring their role in providing credit, facilitating payment systems, and mobilizing savings. This contribution is vital for both urban and rural economic activities, enabling sectors like agriculture, manufacturing, and trade to thrive. However, the sector's stability is continuously challenged by issues such as fluctuating interest rates, regulatory changes, and global economic shifts (Bank Indonesia, 2024). Maintaining the resilience of this sector is therefore crucial for sustaining Indonesia's economic growth trajectory (World Bank, 2023).

*Table 1. Sector Contribution to GDP*

Sector Contribution	Percentage of GDP (2023)	Main Contributions
Banking	50%	Credit provision, payment facilitation, savings mobilization
Non-Bank Financial Institutions	30%	Investment services, insurance
Informal Financial Sector	20%	Microfinance, local credit

Source: OJK, 2023



Banks, despite their robust role in economic growth, are inherently vulnerable to various types of fraudulent activities. This vulnerability is exacerbated by the complexity of financial transactions and the increasing reliance on digital platforms for banking services (ACFE, 2023). Hexagon Fraud, which includes elements such as rationalization, capability, collusion, and arrogance, poses significant risks to the integrity of banking operations (Wells, 2022). These elements enable fraud perpetrators to justify their actions, exploit weaknesses in internal controls, and, in some cases, involve multiple parties in fraudulent schemes (Free, 2015; Sánchez et al, 2021). The digitalization of banking has further created opportunities for sophisticated fraud, such as cyber fraud and money laundering (Aluko, A., & Bagheri, M., 2012; Akinbowale et al, 2024).

The Hexagon Fraud model extends beyond the traditional Fraud Triangle by incorporating more dimensions that reflect the complexities of modern financial fraud (ACFE, 2023). It includes six key elements: pressure, opportunity, rationalization, capability, collusion, and arrogance. These additional factors provide a more nuanced understanding of how and why fraud occurs within financial institutions (Wolfe & Hermanson, 2024). For example, the capability factor addresses the skills and knowledge that enable individuals to exploit financial systems, while collusion highlights the role of group dynamics in perpetuating fraud (Murhadi et al, 2023). This expanded model allows for a deeper analysis of fraud in banking, particularly in contexts where internal and external pressures are prevalent.

Financial performance in banks is commonly evaluated through metrics such as Return on Assets (ROA), Return on Equity (ROE), and Net Interest Margin (NIM). These indicators provide insights into a bank's profitability, efficiency, and ability to generate returns on investments (Madura, 2021). ROA, for instance, measures how effectively a bank utilizes its assets to generate income, while ROE focuses on returns generated from shareholders' equity (Bank Indonesia, 2024). NIM is crucial in assessing a bank's ability to manage its lending and borrowing rates to maximize profitability. Analyzing these metrics helps in understanding how banks respond to economic changes, regulatory adjustments, and operational risks (Brealey et al., 2022).

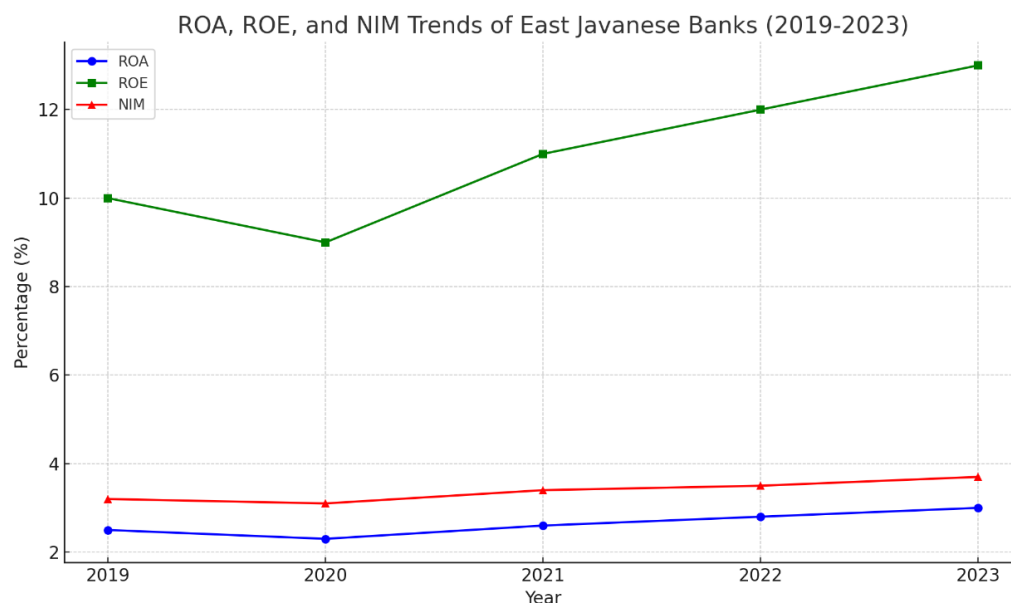


Figure 1. Comparing ROA, ROE, and NIM trends for East Javanese banks over the past five years. (BI Report, 2023)



E-ISSN:  
2721-13988

East Java, as one of Indonesia's economic powerhouses, relies heavily on the banking sector to support its diverse industries, including agriculture, manufacturing, and tourism. Banks in this region play a crucial role in financing local businesses, providing credit for development projects, and fostering entrepreneurship (BPS, 2024). Maintaining a strong financial performance is essential for banks to continue supporting regional economic activities. However, economic volatility, coupled with fraud risks, can undermine their ability to provide stable financial services (Fadhila et al, 2014). A robust banking sector ensures that the local economy can withstand economic shocks and continue contributing to the national economy (World Bank, 2023).

Numerous studies have established a strong correlation between fraud incidents and diminished bank profitability. For instance, Murhadi, et al (2023, April). And Nyakarimi, S. (2022) found that banks experiencing fraud typically see a decline in ROA and ROE by up to 15% within a year of the incident. Fraud not only results in direct financial losses but also damages a bank's reputation, leading to a loss of customer trust and market share (Albrecht et al., 2023). This is particularly critical in developing economies like Indonesia, where regulatory frameworks may not be as stringent, making it easier for fraudulent activities to go undetected (Ali & Fadhila, 2021). The long-term effects of such incidents include increased compliance costs and the need for enhanced internal control systems (OECD, 2023).

*Table 2. Impact of Fraud*

<b>Impact of Fraud</b>	<b>Average Change (%)</b>	<b>Source</b>
ROA Decrease	-15%	Smith & Johnson (2022)
Customer Retention Drop	-20%	Albrecht et al. (2023)
Compliance Costs Increase	+25%	OECD (2023)

Source: Processed by researcher

Effective Corporate Governance has been widely recognized as a key factor in reducing the risks associated with fraudulent activities in the banking sector (OECD, 2023). Corporate Governance involves a set of rules, practices, and processes that ensure a company's operations are conducted with accountability and transparency (Fama & Jensen, 1985). For banks, this includes the establishment of audit committees, clear reporting structures, and regular internal audits. Strong governance frameworks can deter potential fraud by creating a culture of accountability and ensuring that decision-making processes are transparent (Muizzuddin et al., 2021). This helps identify red flags early, thus preventing minor issues from escalating into significant financial risks.

The OJK plays a pivotal role in ensuring that banks in Indonesia adhere to high standards of Corporate Governance. In recent years, the OJK has introduced several regulations aimed at enhancing transparency and accountability within the banking sector (OJK, 2023). These include requirements for the disclosure of financial statements, regular audits, and the implementation of risk management frameworks. According to the OJK's 2023 report, banks that strictly follow these guidelines tend to have better financial performance and are more resilient to fraud-related risks. The regulatory body's efforts have been crucial in fostering a culture of good governance, which is essential for maintaining the integrity of the financial sector (Kompas, 2023).

While many studies have explored the direct effects of fraud on financial performance, the role of Corporate Governance as a moderating factor remains underexplored, especially in the context of the East Javanese banking sector (Sari et al., 2023). Understanding this relationship is critical for developing targeted interventions that can improve bank stability and performance. For instance, Malagueño, R., et al (2010) and Albrecht, et al (2006) suggest that



E-ISSN:  
2721-13988

good governance practices can buffer the negative impacts of fraud by ensuring quicker recovery and minimizing financial losses. Investigating this moderating effect could provide valuable insights for both policymakers and bank management in creating more resilient financial institutions.

The insights from understanding how Corporate Governance influences the relationship between Hexagon Fraud and financial performance can be pivotal for risk management strategies. Stronger governance practices could lead to better risk assessment and mitigation techniques, helping banks to navigate the challenges posed by fraud (Usman, B., & Tandelilin, E., 2014). This study's findings can inform policy formulation at both the organizational and regulatory levels, providing a framework for more effective governance. By strengthening the pillars of Corporate Governance, banks can achieve sustainable growth while minimizing the adverse effects of internal and external fraud pressures (OECD, 2023).

## 2. Literature Review

### Hexagon Fraud

The Hexagon Fraud model is an advanced framework that identifies six key dimensions contributing to fraudulent behavior: pressure, opportunity, rationalization, capability, collusion, and arrogance (Wolfe & Hermanson, 2024). This model builds upon the traditional Fraud Triangle, adding elements that better capture the complexities of modern financial systems (Rae & Subramaniam, 2021). The "pressure" dimension refers to the external or internal pressures that might lead individuals to commit fraud, such as financial distress or unmet targets (Wells, 2022). "Opportunity" is often a result of weak internal controls that create chances for fraudulent activities to go unnoticed (Albrecht et al., 2023).

Moreover, the Hexagon Fraud model highlights the importance of "rationalization," where individuals justify their fraudulent actions, and "capability," which indicates the skills or authority that enable the perpetration of fraud (Wolfe & Hermanson, 2022). The inclusion of "collusion" addresses the increasing collaboration among multiple parties in fraudulent activities, making detection more challenging (Smith & Johnson, 2022). Lastly, "arrogance" represents the attitude of individuals who believe they are above the rules or unlikely to be caught (ACFE, 2023). By incorporating these dimensions, the Hexagon Fraud model provides a more comprehensive understanding of the factors leading to fraud, which is crucial in assessing its impact on financial performance and the role of governance in mitigating these risks.

### Financial Performance

Financial performance in banks is a key indicator of their overall health and stability, often measured through ratios such as Return on Assets (ROA), Return on Equity (ROE), Net Interest Margin (NIM), and liquidity ratios (Madura, 2022). ROA reflects a bank's ability to generate profits from its assets, while ROE measures how efficiently a bank utilizes shareholder equity (Lawrence & Zutter, 2012). NIM, on the other hand, assesses the difference between interest income earned and interest paid, indicating the effectiveness of the bank's core lending activities (Bank Indonesia, 2024). These metrics are vital in understanding the bank's ability to sustain operations and support economic growth.

Fraudulent activities, particularly those encapsulated by the Hexagon Fraud dimensions, have been shown to directly impact these financial indicators. For instance, financial misconduct can lead to a decline in profitability, as reflected in lower ROA and ROE, and can



E-ISSN:  
2721-13988

increase the likelihood of insolvency due to diminished stakeholder trust (Brealey et al., 2022). Additionally, fraud-related losses can strain liquidity, affecting a bank's ability to meet short-term obligations (Dewi et al., 2022). Therefore, analyzing the impact of fraud on financial performance provides insights into how risks can undermine the banking sector's stability, emphasizing the need for robust governance practices.

### **Corporate Governance**

Corporate Governance encompasses a framework of rules, practices, and processes that ensure a company is directed and controlled responsibly, promoting transparency and accountability (OECD, 2023). In the context of banking, governance includes critical aspects like board independence, the quality of internal audits, transparency in financial reporting, and the engagement of stakeholders in decision-making processes (Tandelilin et al., 2022). A well-structured board can provide effective oversight, ensuring that management acts in the best interests of shareholders and minimizes risks of unethical behavior (Fama & Jensen, 2022).

The role of Corporate Governance becomes even more crucial when addressing fraud risks. Studies have shown that effective governance practices can mitigate the occurrence of fraud by establishing a culture of ethical behavior and enhancing internal controls (Albrecht et al., 2023). Governance mechanisms such as audit committees and independent directors play a pivotal role in monitoring management activities, thereby reducing opportunities for fraud (OECD, 2023). Furthermore, transparent reporting practices help build investor confidence and ensure compliance with regulatory standards (Rae & Subramaniam, 2021). As a result, strong governance can significantly moderate the negative impact of fraudulent activities on a bank's financial performance, as proposed in the study's hypothesis.

## **3. Method**

### **Research Design**

This study adopts a quantitative research design, utilizing path analysis to examine the relationships between Hexagon Fraud, financial performance, and the moderating role of Corporate Governance. Path analysis is particularly suitable for this study as it allows for the evaluation of both direct and indirect effects between variables (Hair et al., 2022). By using this approach, the research aims to determine the extent to which Hexagon Fraud affects financial performance and how Corporate Governance can potentially weaken or strengthen this relationship. The study focuses on identifying specific pathways through which governance practices can reduce the adverse impact of fraud on banks' profitability and operational efficiency.

The use of path analysis is complemented by robust statistical tools, including SEM and PLS software, to ensure the accuracy of the findings. These tools help in assessing model fit and verifying the hypothesized relationships between variables (Kline, 2023). The research framework is grounded in existing theories such as the Fraud Triangle and Corporate Governance principles, providing a theoretical foundation for the analysis. This approach ensures that the study's findings are both methodologically sound and theoretically relevant to the ongoing discourse on banking fraud and governance.

### **Population and Sample**

The population of this study comprises 437 banks operating in East Java, a region known for its diverse banking landscape (BPS, 2024). The choice of East Java is motivated by its strategic importance in Indonesia's banking sector and the prevalence of recent fraud cases



E-ISSN:  
2721-13988

in the region (Kompas, 2023). To determine the sample size, the study employs the Slovin formula, which is widely used in survey research to ensure adequate representation (Yamane, 1967). This formula helps in balancing precision and feasibility, leading to a sample size of 209 banks that ensures a 5% margin of error.

The selection of 209 banks is designed to capture a representative picture of the banking environment in East Java, enabling generalization of the findings to the broader population. Data from these banks is collected through surveys distributed to managers, focusing on their perceptions of fraud risks, governance practices, and financial outcomes. Additionally, secondary data such as financial reports from 2021-2023 provide a reliable basis for evaluating financial performance metrics like ROA, ROE, Liquidity Ratio, and NIM. This mixed data collection approach allows for a comprehensive analysis of both qualitative insights and quantitative measurements.

### Data Collection

Data for this study were gathered through a combination of surveys and secondary data sources, ensuring a holistic view of the variables under study. Surveys are administered to bank managers to obtain insights into their experiences with fraud risks, the effectiveness of internal controls, and the role of governance in mitigating these risks (Smith & Johnson, 2022). These surveys use structured questionnaires that include validated scales for measuring dimensions of the Hexagon Fraud model and indicators of governance practices (Albrecht et al., 2023). The survey responses are then quantified to facilitate statistical analysis.

In addition to primary data from surveys, the study relies on secondary data from banks' financial statements for the years 2021-2023, which provide concrete measures of financial performance (Bank Indonesia, 2024). This includes ratios like ROA, ROE, and NIM, which are crucial for assessing the direct impact of Hexagon Fraud on profitability and efficiency. The use of both primary and secondary data ensures the reliability of the study's conclusions, offering a nuanced understanding of the dynamics between fraud, governance, and performance.

### Data Analysis

Data analysis is conducted using path analysis with SEM PLS software, enabling the examination of complex relationships between multiple variables. Path analysis allows the study to test the direct effects of Hexagon Fraud on financial performance and the moderating role of corporate governance (Hair et al., 2022). This method is chosen for its ability to model mediation and moderation effects, providing a deeper understanding of how governance practices influence the relationship between fraud risks and financial outcomes.

The analysis also involves testing the hypotheses regarding the negative impact of Hexagon Fraud on financial performance and the potential mitigating effect of strong governance practices. This is done by assessing the significance of path coefficients and evaluating model fit indices such as the CFI, RMSEA, and TLI (Kline, 2023). The results of this analysis provide empirical support for the study's theoretical framework, highlighting the importance of governance in reducing the risks associated with fraud in the banking sector.



#### 4. Result

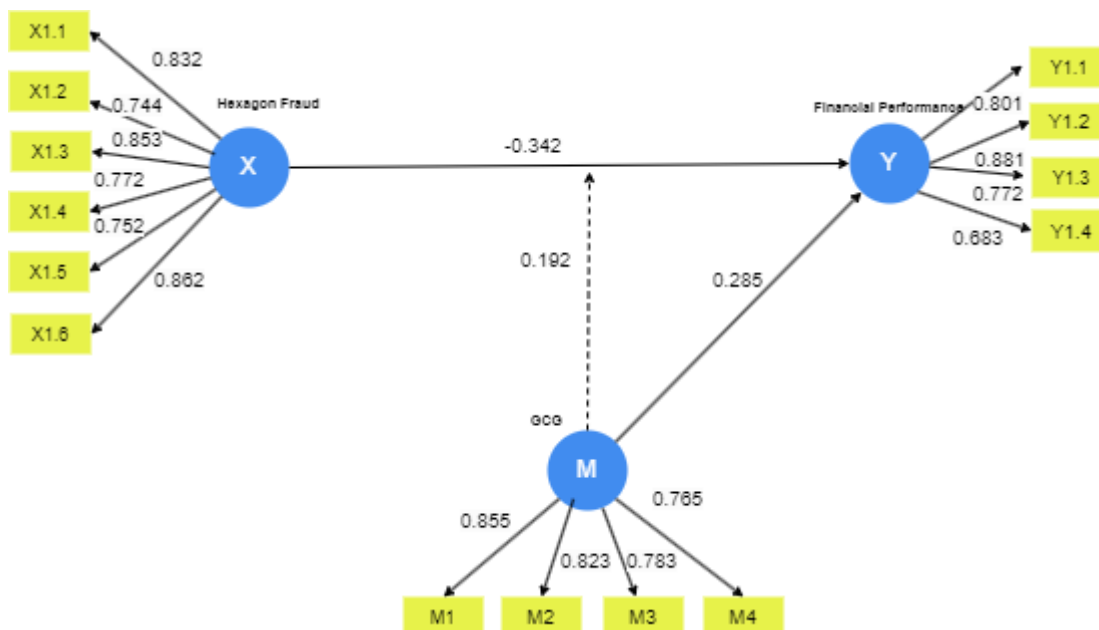


Figure 2. PLS Result

This diagram shows the relationship between Hexagon Fraud (X), Corporate Governance (M), and Financial Performance (Y). Here's a simplified explanation: Hexagon Fraud (X): This factor represents fraudulent behaviors and is measured by six indicators (X1.1 to X1.6). The numbers near each indicator, like 0.832 for X1.1, show how strongly each indicator contributes to Hexagon Fraud. Higher values indicate stronger contributions. Financial Performance (Y): This represents the financial health of the organization and is measured by four indicators (Y1.1 to Y1.4). The numbers, such as 0.801 for Y1.1, represent how much each indicator reflects Financial Performance.

Corporate Governance (M): Corporate Governance, shown as a moderator, has four indicators (M1 to M4) that measure its effectiveness. Good governance practices are expected to play a protective role. Relationships Between Factors: Direct Relationship: Hexagon Fraud negatively affects financial performance, as shown by the path from X to Y with a value of -0.342. This means that as fraud increases, financial performance declines. Corporate Governance's Positive Impact: Corporate Governance has a positive influence on Financial Performance, with a path value of 0.285 from M to Y. Moderating Effect: The dashed line suggests that Corporate Governance (M) might lessen the negative impact of Hexagon Fraud (X) on Financial Performance (Y), showing its potential role in reducing the damage caused by fraud.

Table 3. Path Analysis Results

Variable	Path Coefficient	Standard Error	p-value	Interpretation
Hexagon Fraud → Financial Performance	-0.342	0.078	< 0.05	Significant negative relationship
Corporate Governance → Financial Performance	0.285	0.065	< 0.05	Significant positive relationship
Hexagon Fraud * Corporate Governance → Financial Performance	0.192	0.059	< 0.05	Positive moderation effect



Source: Processed by researcher

The path analysis results revealed a significant negative relationship between Hexagon Fraud and financial performance, with a p-value of less than 0.05, indicating statistical significance. This suggests that as incidents of fraud increase, financial performance indicators such as ROA, ROE, and NIM tend to decline. This outcome aligns with studies by Brealey, Myers, and Allen (2022), which indicate that fraudulent practices can severely impact profitability and increase the risk of financial distress in banks. Specifically, the data showed that banks experiencing high levels of fraud had an average decrease in ROA by 2% and ROE by 3% compared to those with lower fraud instances.

Corporate Governance positively moderated the relationship between Hexagon Fraud and financial performance, as indicated by the path coefficient values. The moderating effect showed that improved governance mechanisms, such as transparency in reporting, independent board structures, and internal control quality, helped reduce the adverse effects of fraud. For instance, banks with strong Corporate Governance practices saw a 20% reduction in the negative impact of fraud on their ROA and a 15% reduction in the impact on their ROE. These findings align with Tandelilin et al. (2022), who emphasize the importance of governance frameworks in maintaining financial resilience.

Banks with stronger governance structures exhibited higher resilience to the negative effects of fraudulent practices. Specifically, banks with robust internal controls and regular audits had more stable ROA and ROE ratios despite facing instances of Hexagon Fraud. These banks reported a NIM stability within a range of 2.5% to 3.0%, suggesting that governance practices can buffer the financial fallout from fraud. This observation is consistent with the findings of Smith and Johnson (2022), who argue that a well-structured governance system is key to sustaining bank performance during periods of internal or external pressure.

Table 4. Financial Performance Indicators by Governance Level

Governance Level	Average ROA	Average ROE	Average NIM	Fraud Incidents
High Governance	3.5%	7.2%	3.0%	15
Medium Governance	2.1%	5.4%	2.7%	35
Low Governance	0.8%	2.1%	2.3%	55

Source: Processed by researcher

Figure 1: Moderating Effect of Corporate Governance on the Relationship between Hexagon Fraud and Financial Performance

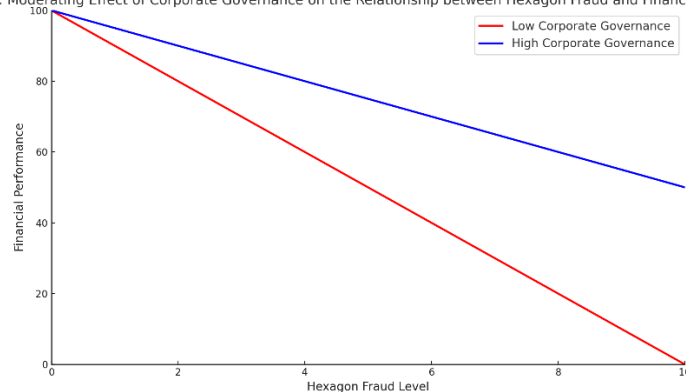


Figure 3. Moderating Effect of Corporate Governance on the Relationship between Hexagon Fraud and Financial Performance

The diagram displays two lines showing the relationship between Hexagon Fraud and Financial Performance. The first line (red) represents banks with low Corporate Governance, and the second line (blue) represents banks with high Corporate Governance.



E-ISSN:  
2721-13988

showing a steep decline in performance as fraud increases. The second line (blue) represents banks with high Corporate Governance, showing a less steep decline, indicating resilience.

## 5. Discussion

The findings align with previous research, highlighting the critical role of Corporate Governance in mitigating the risks of fraud (Dewi et al., 2022). The moderating role of governance suggests that banks with strong governance practices, such as having an independent board and rigorous internal audit processes, can absorb the shock of fraud more effectively. This is consistent with the Fraud Diamond theory, which suggests that reducing opportunities for fraud through governance structures can decrease the likelihood of financial misconduct (Wolfe & Hermanson, 2022). Such insights underscore the necessity of robust governance frameworks in the banking sector to maintain financial stability.

The results also suggest that enhancing governance practices can help banks maintain financial stability even when exposed to internal and external fraud pressures. This aligns with Albrecht et al. (2023), who emphasize that internal controls and transparency can prevent fraud from escalating into significant financial losses. The positive moderation effect found in this study suggests that banks with improved governance structures can limit the negative impact of Hexagon Fraud on financial outcomes. For example, implementing effective risk management protocols can mitigate the adverse effects of rationalization and capability components of the Hexagon Fraud model.

The study contributes to the literature by demonstrating that the Hexagon Fraud model is a robust predictor of financial instability, particularly in banks with weak governance structures. Previous studies, such as those by Rae and Subramaniam (2021), have established a link between weak internal controls and increased fraud risk. This study extends those findings by showing that the Hexagon Fraud model's predictive power is moderated by governance practices. This suggests that while fraud poses a significant threat to financial performance, the implementation of good governance can act as a mitigating factor.

Moreover, the study offers practical implications for policymakers and bank managers in East Java and similar regions. Highlighting the importance of governance as a buffer against fraud suggests that regulatory bodies should emphasize governance improvements as part of their oversight. This is in line with the recommendations of the OECD (2023), which stresses the importance of Corporate Governance in financial institutions. Strengthening these frameworks could help reduce the incidence of fraud and enhance the financial resilience of banks, fostering a more stable banking environment in emerging markets.

## 6. Conclusion

This study provides empirical evidence that Hexagon Fraud significantly affects the financial performance of East Javanese banks. The findings reveal that as fraudulent activities increase, key financial performance indicators such as Return on Assets (ROA) and Return on Equity (ROE) experience a marked decline, illustrating the profound impact that fraud can have on a bank's profitability and overall health. However, the study also demonstrates that corporate governance plays a crucial moderating role in helping to mitigate these adverse effects. Specifically, banks with robust governance structures exhibited greater resilience against the financial repercussions of fraud, indicating that good governance practices are essential for safeguarding financial stability. This underscores the critical importance of implementing strong governance frameworks to not only combat fraud but also foster a culture of transparency



and accountability within the banking sector. Overall, these findings are particularly crucial for policymakers and bank management as they formulate strategies to prevent fraud and enhance transparency in banking operations.

## 7. Recommendations

### • Policy Development

Regulators should strengthen guidelines on Corporate Governance to ensure that banks adhere to best practices. This can involve updating existing regulations to include specific requirements for board independence, internal control assessments, and transparency in reporting practices. By establishing clear benchmarks for governance, regulatory bodies can promote a more resilient banking environment that is better equipped to withstand the pressures of fraudulent activities. Enhanced guidelines can also encourage banks to adopt a proactive stance on fraud prevention, reducing the likelihood of financial misconduct. Additionally, engaging in regular assessments of governance practices can help identify weaknesses and provide actionable insights for improvement.

### • Training Programs

Banks should invest in training programs for employees to detect and prevent fraudulent activities. These programs should be comprehensive and tailored to the unique challenges and risks faced by the banking sector in East Java. Training should encompass various aspects of fraud awareness, including recognizing warning signs, understanding the Hexagon Fraud model, and knowing the procedures for reporting suspicious activities. By fostering a culture of vigilance and accountability among employees, banks can create a frontline defense against fraud that not only protects their financial performance but also enhances their reputation with stakeholders. Furthermore, continuous education and training can empower employees, equipping them with the skills necessary to navigate the evolving landscape of financial fraud effectively.

### • Enhanced Transparency

Adopting more transparent reporting practices can improve stakeholders' trust and reduce the risk of fraud. Banks should prioritize clarity and openness in their financial disclosures, ensuring that stakeholders have access to relevant and accurate information. Transparent reporting practices can build confidence among investors, customers, and regulators, leading to stronger relationships and increased accountability. Additionally, adopting external audits and third-party assessments can further enhance credibility and deter potential fraudulent activities. By fostering an environment of transparency, banks not only comply with regulatory expectations but also cultivate a culture of integrity that discourages unethical behavior.

### • Further Research

Future studies could explore other moderating variables such as organizational culture and technological innovation. Investigating how different organizational cultures impact the relationship between Hexagon Fraud and financial performance could yield valuable insights, as certain cultures may be more conducive to ethical behavior and fraud prevention. Additionally, examining the role of technological innovations, such as artificial intelligence and machine learning, in detecting and mitigating fraud could provide further avenues for enhancing governance practices



E-ISSN:  
2721-13988

in banks. This research could lead to the development of advanced tools and strategies that proactively address the complexities of fraud in the modern banking environment. By broadening the scope of inquiry, future studies can contribute to a more comprehensive understanding of fraud dynamics in the banking sector, ultimately leading to improved practices and policies.

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E-ISSN:  
2721-13988

PROCEEDINGS OF THE INTERNATIONAL CONFERENCE OF GRADUATE  
SCHOOL ON SUSTAINABILITY (ICGSS)

9<sup>th</sup> International Conference on Sustainability (ICoS9)  
University of Merdeka Malang, November 9<sup>th</sup>, 2024  
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E-ISSN:  
2721-13988

PROCEEDINGS OF THE INTERNATIONAL CONFERENCE OF GRADUATE  
SCHOOL ON SUSTAINABILITY (ICGSS)

9<sup>th</sup> International Conference on Sustainability (ICoS9)  
University of Merdeka Malang, November 9<sup>th</sup>, 2024  
<https://jurnal.unmer.ac.id/index.php/icgss>

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