

The Role of Red Flags on Fraud Detection: The Public Sector Investigative Auditor's Perspective

Dhimaz Pratama Putra¹, Yoremia Lestari Ginting²

Mulawarman University, Samarinda, Indonesia.

 Corresponding author: ginting.yoremia@feb.unmul.ac.id

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Abstract

Red flags are early indicators that help auditors detect potential fraud before it develops further. This study aims to understand the role of red flags in detecting fraud from the perspective of auditors at the East Kalimantan Provincial Representative Office of the Financial and Development Supervisory Agency (BPKP). The study uses a descriptive qualitative approach with in-depth interviews with BPKP investigative auditors. Data analysis was conducted using Miles and Huberman's interactive model through the stages of collection, reduction, presentation, and conclusion drawing, with the help of NVivo 15. The results of the study show that auditors interpret red flags as symptoms of unusual behavior or transaction patterns that need to be further investigated. Auditors follow up on red flags with in-depth analysis, additional evidence testing, and coordination with relevant parties. These findings emphasize the importance of understanding and responding quickly to red flags in order to improve the effectiveness of internal controls and prevent state losses, as well as the need for fraud detection guidelines in the public sector. In addition, current literature lacks studies that propose qualitative method on employs red flags and fraud detection in investigative audit type.

Keywords: Investigative Auditor; Fraud Detection; Fraud, Red Flags; Public Sector.

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INTRODUCTION

Fraud is an issue often faced by various organizations, both in the public and private sectors. Fraud is a criminal act committed intentionally by one or more individuals in the form of deception, irregularities, or illegal actions to obtain benefits or cause losses to an organization or company (Awaliah, 2023). In Indonesia, cases of fraud have become a major concern, particularly in government agencies responsible for managing public funds (Asriadi et al., 2021). One approach used to detect fraud is through the identification of red flags or early warning signs. Red flags are unusual situations that deviate from normal conditions and indicate potential irregularities requiring further investigation (Gizta, 2020).

Although the presence of red flags does not always indicate the occurrence of fraud, red flags are generally found in every fraud case and serve as warning signals for auditors to obtain preliminary evidence in detecting fraud within an institution or organization (Masri et al., 2022). Based on the 2024 Report to the Nations from the ACFE (Association of Certified Fraud Examiners), 75% of fraud perpetrators exhibit at least one of eight major warning signs (red flags). The most common sign is living beyond one's means, where the perpetrator has a luxurious lifestyle that is not commensurate with their income. In addition, financial difficulties, unusual relationships with vendors/customers, and defensive and manipulative attitudes are also strong indicators of fraud.

Previous studies have examined the relationship between red flags and auditors' ability to detect fraud. Red flags and auditor training have been found to significantly enhance professional skepticism and auditors' ability to detect fraud (Gizta, 2020). Furthermore, red flags and audit tenure have a positive effect on fraud detection, while time pressure has a negative effect (Meidiyustiani & Lestari, 2022). Conversely, (Susilawati et al., 2022) concluded that red flags do not always have a significant effect (Susilawati et al., 2022). These differences in results indicate that there are still gaps in the literature regarding the effectiveness of red flags as a key indicator of fraud.

This study aims to explore the role of red flags in fraud detection and to examine how investigative auditors encounter, interpret, and follow up on red flags in practice. The main research questions are: what do red flags mean to investigative auditors at the East Kalimantan Provincial Representative Office of the Financial and Development Supervisory Agency (BPKP), and how do auditors respond to red flags during the fraud detection process? To address these questions, this study employs a qualitative approach based on in-depth interviews with public sector investigative auditors. The findings are expected to contribute to the academic literature on red flags and fraud detection in public sector audit contexts by providing context-specific insights from investigative audit practice.

In academic literature, red flags are commonly conceptualized as warning signals that alert auditors to potential fraud risks and support fraud detection processes. Prior studies have examined red flags in relation to fraud theory, particularly the Fraud Triangle, emphasizing how such indicators draw auditors' attention to conditions associated with fraudulent behavior. Rather than functioning as automatic evidence of fraud, red flags require professional interpretation and contextual evaluation by auditors during investigative audits. However, empirical evidence on how red flags are interpreted and operationalized in investigative audit settings within the public sector remains limited, particularly in emerging economy contexts.

Literature Review

Fraud Triangle Theory

In 1953, Cressey developed a three-factor theory of fraud that causes people to commit fraud, known as the Fraud Triangle Theory. This framework was developed by gathering information from interviews with convicted fraudsters in the United States. Awang et al. (2020) concluded that pressure, opportunity, and rationalization are important elements in committing fraud.

Pressure is an emotional state in which a person feels strong pressure or compulsion to do something. This pressure can come from within a person or from outside. Pressure can take the form of family, financial, social, and work problems. One of the many types of pressure is financial pressure. Financial pressure refers to a condition in which individuals or organizations experience financial stress. Factors such as urgent needs, substantial debts, or an excessively luxurious lifestyle may encourage individuals or organizations to seek illegal or unethical means to obtain the required funds (Awaliah, 2023).

An opportunity is a condition or situation that allows someone to commit fraud with little risk of being caught. Factors such as weak internal controls, lack of supervision, or unrestricted access to the resources of a company or institution can create opportunities for someone who wants to commit fraud. Fraudsters must be able to see loopholes to commit fraud while minimizing the risk of their actions being discovered by others.

Rationalization is a process whereby perpetrators of fraud justify their fraudulent actions so that they do not feel guilty or ashamed. Rationalization is an individual's justification guided by personal means. False rationalization leads perpetrators to believe that it is acceptable to conceal information or deceive others (Awang et al., 2020). In other words, perpetrators tend to rationalize their actions with various reasons, such as the need to survive in fierce business competition, feeling unfairly treated, or assuming that "everyone else is doing it too."

Red Flags

Red flags are unusual and out-of-the-ordinary circumstances. "Red flags" are indicators that something is out of the ordinary and requires further investigation (Gizta, 2020). Auditors must be able to detect fraud early on. It is impossible to use the same detection methods for all types of fraud because each has unique characteristics. Therefore, auditors need to be aware of the types of fraud that may occur. Most evidence of fraud is indirect. Symptoms such as changes in behavior, suspicious documents, customer complaints, or suspicions from coworkers are usually signs of fraud. Initially, fraud can be seen from certain characteristics, such as individual behavior and surrounding conditions. The term red flags is often used in various audit literature, meaning danger signs, signs that something is not right and needs attention. Auditors and investigators use red flags as an indication of fraud in a financial report. Red flags can also be described as conditions that are unusual or different from normal conditions. In other words, red flags are indications of something unusual that requires further investigation. Red flags do not necessarily indicate whether someone is guilty or not, Erong et al. (2023) state that red flags function as warning signs indicating that fraud is occurring or has occurred.

METHOD

This study adopts a descriptive qualitative approach to explore the role of red flags in fraud detection from the perspective of investigative auditors. Data were collected through semi-structured in-depth interviews with three investigative auditors from the East Kalimantan Provincial Representative Office of the Financial and Development Supervisory Agency (BPKP), all of whom had direct experience in identifying and following up red flag indications in the public sector. Informants were selected using purposive sampling based on their professional involvement in fraud detection processes and their substantial experience with red flags. The three participants represented different functional roles within investigative audit teams, including a technical controller, a team leader, and a team member, with professional experience ranging from six to sixteen years. This variation enabled the study to capture diverse professional judgments and perspectives within the same organizational context. Data analysis was conducted inductively following the interactive model of Miles and Huberman, encompassing data reduction, data display, and conclusion drawing. Initial codes were developed directly from interview transcripts without predetermined categories, allowing themes to emerge from auditors' narratives regarding red flags and fraud detection practices. The coding process involved iterative reading, coding, and refinement using NVivo 15 software to organize and compare patterns across participants. Theme validation was achieved through cross-case comparison using

matrix coding queries, which enabled the identification of consistent patterns and variations among informants. Data collection was concluded after the third interview, as no new substantive themes emerged and participants' responses showed consistent patterns, indicating that data saturation had been reached. Analytical rigor was enhanced through peer debriefing with academic supervisors during the interpretation stage. Researcher bias was addressed by maintaining a close connection to the data through verbatim quotations, focusing analysis strictly on red flags as the central unit of analysis, and systematically comparing responses across participants to avoid reliance on a single perspective.

RESULTS AND DISCUSSION

Red Flags in The Public Sector

Red flags in the context of auditing often arise through behavior that is considered unusual. One form of this can be seen in a person's lifestyle that is not in line with their job profile. This inconsistency is an early indicator of potential misconduct. In addition to direct observation, indications of unusual behavior can also be detected through a systematically organized complaint or whistleblowing system. This system allows anyone, including individuals within the workplace who are committed to anti-corruption, to report suspicious behavior. Thus, red flags do not only originate from personal observations, but can also be obtained through formal reports submitted via internal oversight mechanisms. In the context of projects, irregularities are also often seen in budget mark-ups and insufficient work volumes. These conditions usually become the starting point for BPKP auditors to calculate potential state losses. The evaluation carried out by auditors not only assesses whether the project is running according to plan, but also examines the quality, volume, and compliance with applicable regulations. If discrepancies or deficiencies are found, they are considered an indication of illegal profits obtained through irregularities. In other words, the first signs of fraud can be interpreted as inconsistencies in the implementation of projects that are supposed to meet established standards and specifications.

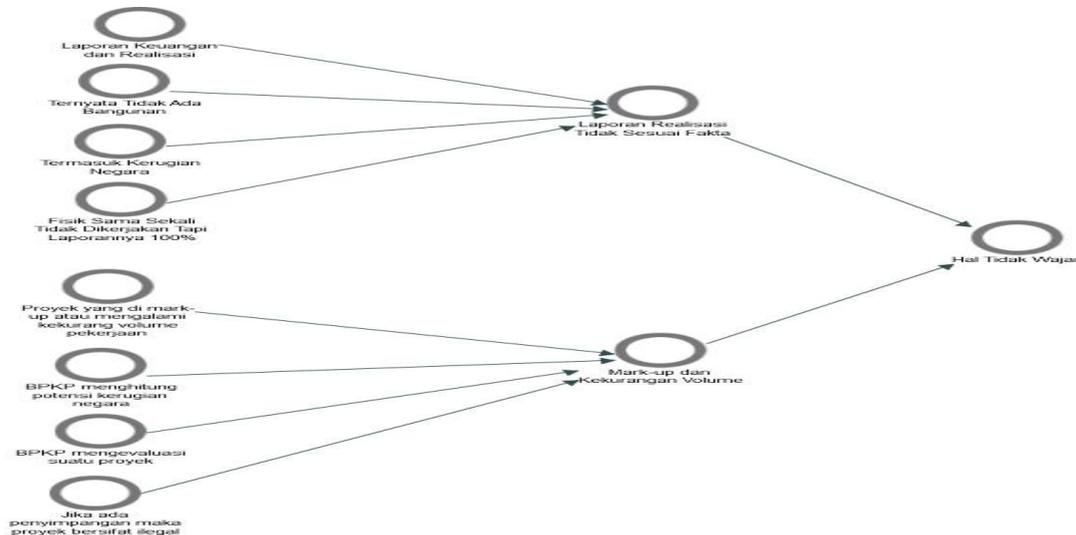


Figure 1. Unusual Behavior

Another phenomenon that indicates red flags is irregularities in the management of village funds. For example, a village head who previously worked as a farmer suddenly obtained the authority to manage large amounts of village funds, amounting to billions of rupiah. This situation poses a risk of abuse of authority, especially when the funds are diverted for personal gain, while the accountability report continues to state that they were used for development. In cases such as this, lack of transparency becomes a major problem because the village development reports that should be published in the APBDes (Village Budget) are never made public. The community only knows about projects that have been completed without ever being informed in advance about the budget used. This situation

raises red flags in the form of financial statement manipulation, budget misuse, and weak public accountability. The lack of transparency opens up opportunities for fraud that is difficult to detect without a comprehensive audit.

In addition, irregularities are often seen in the discrepancies between budget realization reports and actual conditions in the field. A common case is when reports show full budget absorption, for example, Rp100 million for irrigation construction, but physical verification proves that the construction does not exist at all. This situation clearly causes losses to the state, because funds have been disbursed but no results have been obtained. Reports that appear administratively perfect may actually indicate fictitious activities designed to cover up irregularities. Thus, irregularities in audits can take various forms, ranging from suspicious individual lifestyles, project irregularities involving mark-ups or volume deficiencies, non-transparent management of village funds, to financial reports that do not reflect the actual conditions in the field. All of these indicators are early signs that auditors view as red flags in detecting potential fraud.

Red flags are seen as indicative early signals, not direct evidence of irregularities. Their function is more as an early detection tool that must be followed up with verification before auditors draw conclusions. In other words, these signs only indicate the potential for something unusual, but additional evidence is still needed to avoid misinterpretation. One of the early warning signs that auditors often look for is performance that is inconsistent with actual conditions in the field. For example, when an employee is rarely present but always meets their work targets, this situation raises suspicion. Such conditions indicate that work achievements are not obtained fairly, which may be an indication of data manipulation or reporting that does not reflect the actual situation.

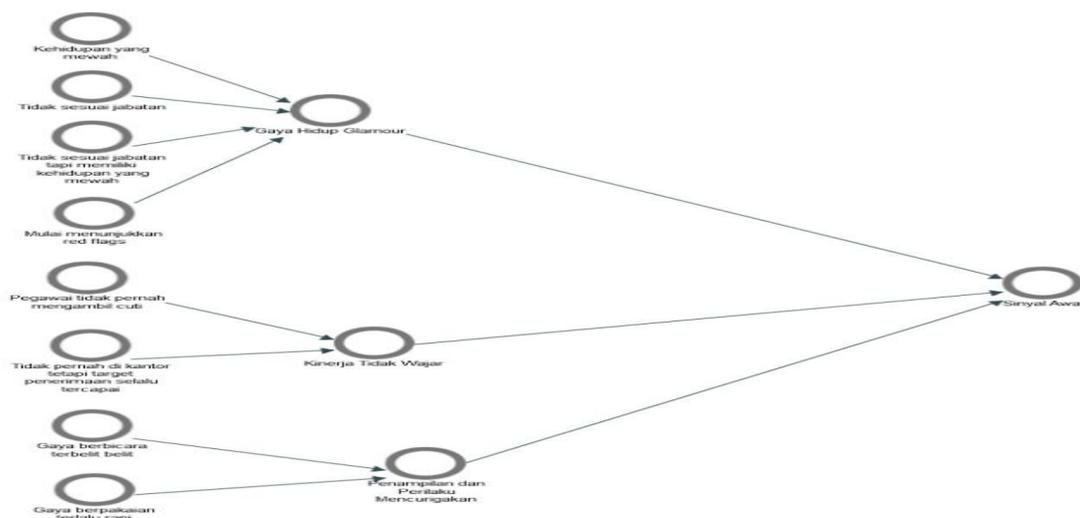


Figure 2. Early Sign

Auditors emphasize that this is an important consideration in detecting fraud. Another early warning sign may be employees who never take their vacation entitlement. Although this may appear to be a positive commitment, auditors view this as a suspicious sign. An unwillingness to take vacation is often interpreted as a self-protection mechanism to avoid giving others the opportunity to discover irregularities when the individual is not at work. Thus, behavior that appears to be overly disciplined may actually be concealing irregularities.

In addition, a lifestyle that is not in line with one's job status is also an important indicator. Auditors assess that when a temporary employee with a limited salary is able to live a luxurious lifestyle, own expensive assets, or have excessive consumption habits, these conditions are considered red flags. A comparison with other professions that reasonably have additional income, such as doctors or civil servants with side jobs, confirms that the assessment of a reasonable lifestyle must take background into account. Thus, a lifestyle that far exceeds official income should be suspected as an early sign of

irregularity. During the audit observation process, appearance and behavior often provide early signals. Noticeable changes in dress style, overly contrived attitudes, unexplained tardiness, convoluted answers, and a tendency to shift responsibility to others can raise suspicion. Although nonverbal and not directly admissible as evidence, this series of behaviors serves as an indicator that prompts auditors to conduct a more in-depth examination.

Furthermore, sudden changes in behavior after someone is placed in a strategic position are also considered early warning signs. Auditors highlight opportunistic attitudes that arise when individuals realize the financial benefits of their position. Unnatural changes in expression, work patterns, or interaction styles in such positions indicate potential irregularities that warrant attention. Thus, early warning signs can emerge from various aspects, ranging from unusual performance, suspicious work habits, inappropriate lifestyles, to changes in attitude when in a strategic position. All of these signs cannot be used as definitive evidence, but they serve as important indicators that require further verification before auditors draw conclusions about the existence of fraud.

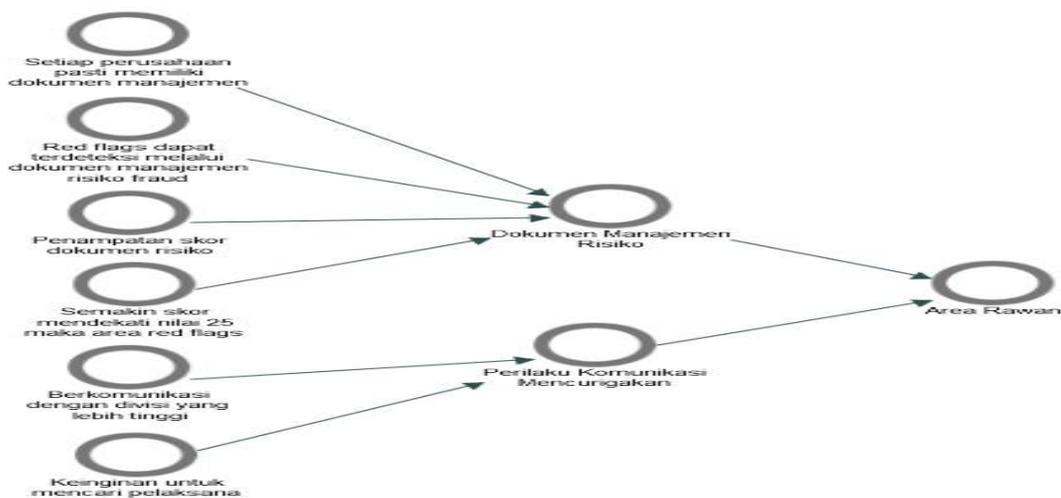


Figure 3. Vulnerable Area

Red flags often appear in the deepest areas of an organization, especially those related to structure and potential abuse of authority. In an organizational system, each level has its own functions and roles, but not all positions are given full authority. Usually, this authority is only attached to managerial positions, which opens up opportunities for abuse. Thus, red flags can be interpreted as indicators that point to vulnerabilities in the organizational structure, even though they are not direct evidence of fraud. The existence of red flags needs to be analyzed carefully because they are essentially early indicators that require further attention. The analysis can be conducted using a personal, systemic, or structural approach. One important instrument that plays a role in the detection stage is the fraud risk management document. This document not only serves an administrative function, but also acts as a systematic map for identifying areas that potentially contain red flags. Every organization generally has a risk management document that identifies potential irregularities in various business processes, including control mechanisms.

For example, in the treasurer function, which is responsible for disbursing cash, there is a risk of abuse of authority. This risk is then controlled by an authorization mechanism. In practice, fraud risk management documents have mapped out various potential irregularities in each stage of the business process, from planning, implementation, payment, to handover of work. This identification is also accompanied by a risk assessment based on probability and impact, measured on a scale of 1 to 5. The product of these two aspects produces a risk score, which is then categorized to determine the level of vigilance. If the score is in the range of 20 to 25, the condition is classified as a red flag because it indicates a significant potential for irregularities and requires an immediate response from

the auditor. This risk management-based approach shows that red flags are not only identified from field findings, but can also be predicted early on through structured and documented risk assessments. Thus, fraud risk management documents serve as predictive tools that enable auditors to trace vulnerabilities before projects or business activities are carried out.

In addition to structural aspects, red flag-prone areas can also be identified through communication behaviors that do not comply with organizational procedures. Deviant communication patterns, such as excessive interaction, unreasonable visit frequency, or attempts to bypass established bureaucratic channels, can signal potential irregularities. For example, when someone is present at a project site too often without a clear reason or directly attempts to contact the highest authority by bypassing the coordination level, this indicates a hidden agenda or conflict of interest. Such actions can be an early sign that irregular practices are taking place and should be brought to the attention of auditors. Strategic positions within an organization are also one of the main vulnerable areas. Positions with full authority in decision-making, such as in the selection of raw material suppliers, carry a high risk of being misused for certain interests. Therefore, strategic positions are not only the center of control in business processes, but also vulnerable points that need to be closely monitored to prevent fraud.

Tiered Approach: Internal Follow-up

A tiered approach indicates that auditors do not immediately make decisions when they encounter red flags. Instead, follow-up processes are carried out in stages, with reference first made to applicable internal policies and regulations. This approach reflects the principle of auditor prudence in determining measures appropriate to the level of deviation found, as is exemplified by the following quote:

“So, if we have found a red flag, the first step is to look at the policies made by shareholders or company owners. Usually, there are rules on whether the violation can be subject to a claim for compensation, refund, or other sanctions such as SP1, SP2, SP3, and even criminal sanctions”. (RF Informant)

A statement from one of the informants confirmed that follow-up on red flags was not spontaneous, but followed policies established by the company owner or shareholders. Each violation is considered in accordance with applicable regulations, whether it warrants administrative sanctions such as SP1 or SP3, claims for compensation, refunds, or even criminal sanctions. This approach shows that red flags are handled in a gradual and tiered manner, with organizational policy as the main reference.

“Usually, every company, both in government and private, has a legal team or legal team. In the government, there is a legal bureau, while in SOEs there is a legal team and an internal supervisory unit (SPI). In general, company policy will direct the case to be audited first, usually through an internal audit. This audit is conducted to see how long the practice has been happening, whether this is the first case or has been going on for a long time, and how big the impact is”. (RF Informant)

The above statement indicates that in dealing with red flags, organizations do not immediately impose sanctions, but rather refer to formal procedures through legal teams or internal oversight units. The existence of legal offices in government agencies and legal teams and SPI in state-owned enterprises is an important part of ensuring that processes are carried out in accordance with regulations. Internal audits are then used as a first step to assess the extent of the case, whether it is incidental or recurring, and the magnitude of the impact. This confirms that a tiered approach is taken, involving legal and oversight functions before a final decision is made.

“So, the process is gradual, starting from internal or familial settlement, then if it is not resolved, it is brought to the legal realm”. (Informant RF)

Furthermore, the informant explained that red flags are resolved in stages, with priority given to internal or family channels first. If the issue is not resolved through these mechanisms, only then is the case taken to court. This shows that the tiered approach emphasizes persuasive resolution before formal legal measures are taken.

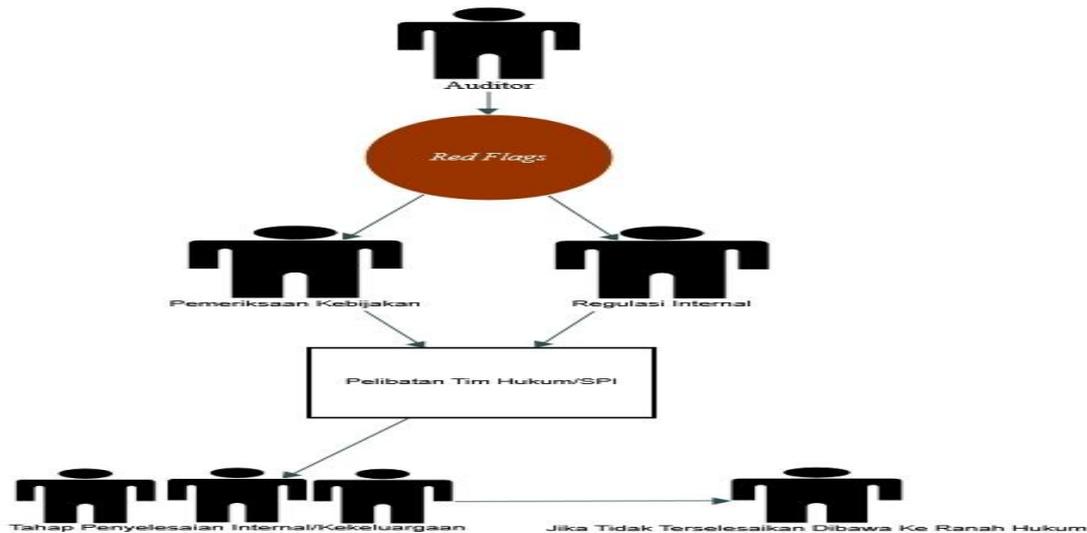


Figure 4. Tiered Approach: Internal Follow-up

The Hot Porridge Theory: A Strategy for Uncovering Fraud

The hot porridge theory approach describes the auditor's strategy of handling red flags carefully and gradually. Rather than going straight to the main suspect, the auditor chooses to start the investigation with the parties at the initial level first. This strategy is used so that the investigation process runs more smoothly and the information obtained is stronger before reaching the core of the problem.

“To reveal a fraud case is hidden. So, you can't be accused right away, for example, like a chicken thief who is just caught. Usually we use the hot porridge theory”. (HM Informant)

“The theory of hot porridge is if you eat it from the side first, yes. So, let's start with what activities first. For example, this is a village fund activity, so let's first confirm what is in the evidence of accountability”. (HM Informant)

“We check who works, starting from the outermost point first, for example from the TPK first, then to the heads, then the treasurer, secretary and finally the village head concerned. Usually, we check the suspect last”. (HM Informant)

The informant's statement illustrates that when dealing with indications of fraud, auditors do not only highlight the main perpetrators, but also apply a phased strategy known as the hot porridge approach. This strategy is analogous to eating hot porridge from the edges first to avoid rejection from the suspected parties, so that auditors begin their examination with the parties on the outer layers or those with smaller administrative roles. This approach aims to build a comprehensive understanding of the audited activities through confirmation of accountability evidence and the chronology of implementation. By examining parties such as the activity implementation team, head of department, treasurer, and secretary first, auditors can gather more neutral information and avoid resistance from the “main actors.” This step allows auditors to compile stronger findings before finally confirming with parties suspected of being at the center of the irregularities, such as the village head. This approach reflects the principle of prudence and a structured investigative strategy in the process of tracing red flags.

CONCLUSIONS

Based on the findings from investigative auditors at the East Kalimantan Provincial Representative Office of the Financial and Development Supervisory Agency (BPKP), this study demonstrates how red flags function as important analytical tools in supporting

fraud detection within a specific investigative audit context. From the auditors' perspectives, red flags are understood not only as early indicators of potential fraud, but also as reference points that guide professional judgment, determine audit follow-up actions, and inform decisions to conduct investigative audits and PKKN audits (Calculation of State Financial Losses). The study identifies several red flags commonly encountered in practice, including discrepancies between reports and actual conditions, suspicious risk management documents, closed communication behaviors, indications of unusual lifestyles, irregular performance patterns, and questionable preliminary reports. These indicators assist auditors in directing their audit focus and assessing the need for deeper examination.

Furthermore, the findings suggest that the follow-up of red flags plays a role in clarifying accountability by helping auditors identify parties most closely associated with potential fraud occurrences. This process is supported by auditors' interpersonal and observational skills in interpreting situational cues and individual responses during the audit process. Rather than positioning red flags as universally applicable tools across the public sector, the conclusions of this study reflect context-specific insights shaped by organizational procedures, audit mandates, and professional experiences within a single institutional and regional setting. Accordingly, the findings should be interpreted as qualitative insights into investigative audit practices, providing empirical understanding of how red flags are operationalized in practice rather than as broadly generalizable conclusions.

This study offers process-oriented insights into how investigative auditors perceive and apply red flags in investigative audits. The findings should be interpreted cautiously, as the study does not provide empirical evidence of measurable improvements in audit effectiveness, fraud prevention, or reductions in state financial losses.

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