# CHAPTER I

# INTRODUCTION

## 1.1 Background of the Study

Financial statements are written reports on operational activities and management performance with interested parties (investors, creditors, and auditors) to indicate the company's condition at a specific time (Donald E. Kieso, 2018). The financial statements most frequently prepared are (1) the statement of financial position, (2) the income statement (statement of comprehensive income), (3) the statement of changes in the equity, (4) the statement of cash flows and (5) notes to the financial statement.

Financial statements aim to provide relevant financial information that benefits many users of financial statements in making decisions and show management's performance in the use of resources. Therefore, financial statements must be prepared in a proper way for interested parties. In addition, the financial statements in Indonesia must be arranged based on *Standard Akuntansi Keuangan (SAK)* that has been determined by *Ikatan Akuntan Indonesia (IAI)*.

Investors and creditors are categorized as the primary user of financial statements. Investors and creditors require the financial information to assess a company's ability to generate net cash inflows and understand management's ability to protect and enhance company assets to generate future net cash flow. The auditor also uses the financial statement to check for compliance based on applicable accounting standards. Then, the company also uses the financial

statements as a basis for making decisions. As there is an influence of financial statements in making decisions that interested parties will take, the financial statements should be free from fraud to receive reliable information.

Fraud is an action to deprive another money or property intentionally and unfairly by guile and deception, according to ACFE (Association of Certified Fraud Examiners). Fraud can be committed internally (employees, managers, officers or owners) or externally (customers, vendors and other parties). In 2018, the ACFE report showed that the company suffered losses due to fraud being about 5% of the company's gross income. Therefore, it can be concluded that fraud will harm the company. Distrust of investors will affect the company's performance since the investors are unwilling to invest; then, the company does not have sufficient funds to conduct operational activities.

There are three types of fraud which are (1) asset misappropriation, (2) corruption and (3) financial statement fraud. The writer would like to conduct several amounts of research regarding financial statement fraud. Fraudulent Financial Statements occurs when the management manipulates the financial statements to make the company look better (W. Steve Albrecht,2018). The manipulated information is considered to be invalid when used in decision-making. In conclusion, fraud is an action that benefits someone or group by harm other parties (individuals, companies or institutions).

**Table 1.1 Table of Fraud Information with the Most Detrimental Act in Indonesia**

| No. | Type of Fraud | 2016 | | 2019 | |
|---|---|---|---|---|---|
| | | Total Cases | Percentage | Total Cases | Percentage |
| 1. | *Korupsi* (Corruption) | 178 | 77% | 167 | 69.9% |
| 2. | *Penyalahgunaan Aktiva/Kekayaan Organisasi* (Asset misappropriation) | 41 | 19% | 50 | 20.9% |
| 3. | *Kecurangan Laporan Keuangan* (Financial Statement Fraud) | 10 | 4% | 22 | 9.2% |

Source: ACFE Indonesia (2016 and 2019)

Over 50% of fraud occurs in Indonesia based on ACFE (Association of Certified Fraud Examiners) Indonesia is corruption. Based on ACFE, the most fraud that occurs in the world is asset misappropriation. Based on the survey that ACFE Indonesia conducted in 2018, asset misappropriation fraud is between 30% - 35%. However, ACFE (2016) stated that fraudulent financial reporting is the most detrimental act. Indonesia is suspected of performing fraudulent financial statements as several frauds have not been revealed, like deception in financial information on the IDX and deception in tax information.

Donald R. Cressy, in the professional literature on SAS No. 99, has introduced the fraud triangle. The fraud triangle is one of the methods used to investigate the factors of fraud. The fraud triangle has explained three general factors that cause fraud in the financial statement are (1) pressure, (2) opportunity and (3) rationalization. Several factors that can arise from the first general factors (pressure) are financial stability, external pressure, personal financial situations and financial targets. Several factors that can arise from the second general factor (opportunity) are the nature of the entity, ineffective monitoring, unstable organization structure and internal control. In the third general factor (rationalizations), auditors play an essential part in identifying the risks of material misstatement. Based on this theory, fraud appears when those factors occur.

According to The Nation on Occupational Fraud and Abuse (2018), in between 84% - 86% of occupational fraud cases, the perpetrators showed at least one symptom of fraud behavior. Over 50% of the cases showed more than two behavioral symptoms. The perpetrators always have three elements before deciding to do fraud: motivation, opportunity and rationalization, indicated by specific behavioral symptoms.

**Table 1.2 Table of Fraud Perpetrators**

| No. | Fraud Perpetrators | Percentage |
|---|---|---|
| 1. | Employee | 31.8% |
| 2. | Manager | 23.7% |
| 3. | Owner/executive | 29.4% |
| 4. | Others | 15.1% |

Source: ACFE Indonesia (2019)

On the other hand, firm size is the company's size seen from the value of equity, sales value or asset value (Riyanto, 2013) in *KajianPustaka.com*. The more significant revenue and total assets could categorize a company as a large firm to generate greater profits. In contrast, lower revenue would make the company face losses if there is a higher fixed cost on both variables. In this research, the writer using market capitalization in measuring firm size. Market capitalization is the total market value of all outstanding shares determined by the stock market. This method is a more efficient method for estimating a company's value by predicting its worth for publicly traded companies. The more significant market capitalization then the company is popular to the public. The advantages of having a large market capitalization are that companies have better financing terms from banks by selling corporate bonds and benefiting from competitive advantages.

In addition, good corporate governance should be implemented in a company to avoid fraud in the financial statement. According to Soekrisno Agoes,

Good Corporate Governance (GCG) is a system that regulates the relationship between the stakeholders, the commissioners, the directors and another stakeholder carried out with a transparency process in determining goals, achievement, and assessing the company performance (Edusaham, 2020). Therefore, Good Corporate Governance is one of several methods to ensure the management act in the stakeholders' interest. The objective of corporate governance is to create value-added to all stakeholders.

Furthermore, financial stability also determines whether the company performs well or badly. Financial stability means a stable condition of the financial system to reduce financial imbalances that arise from real economic activities. The instability of financial conditions in the long-term period would have many impacts, such as financial crisis, hyperinflation and stock market crashes. On the other side, the financial instability of corporate will provide a large opportunity for companies to commit fraud.

Table 1.3 below shows that when the Beneish M-Score is greater than -2.22, the company is indicated as a manipulator. In this case, PT Agung Podomoro Land (APLN) is indicated as a manipulator in 2018; meanwhile, PT Bumi Serpong Damai Tbk (BSDE) is indicated as a manipulator in 2018 and 2019.

**Table 1.3 Beneish M-Score of Several Property, Real Estate, and Building Construction Companies Listed in Indonesia Stock Exchange during 2018 – 2019**

| Company Code | Year | Beneish M-Score | Description |
|---|---|---|---|
| APLN | 2018 | -2.16 | Manipulator |
| | 2019 | -2.52 | Non-Manipulator |
| BSDE | 2018 | 1.68 | Manipulator |
| | 2019 | 1.99 | Manipulator |

Source: Prepared by the writer (2020)

Several cases of fraudulent financial statements in Indonesia occur to cover the loss and attract interested parties. One of Indonesia's fraudulent financial statements cases is MYRX (PT. Hanson International Tbk). According to *Kompas.com* in an article of *Jejak Hitam PT Hanson International, Manipulasi Laporan Keuangan 2016* has stated that PT Hanson International has been proven to have manipulated the annual financial statements 2016 based on OJK *(Otoritas Jasa Keuangan)* report. There is manipulation in accounting treatment-related sales of lots available for sale (Kasiba) that cause a significant increase in sales with 732 billion rupiahs gross value. In this case, PT Hanson International has violated *PSAK 44 (Akuntansi Aktivitas Real Estat)* because of no recognition of the entire accrual method in 2016. However, the recognition of sales revenue can be recognized on a full accrual basis if it meets the criteria, including the settlement of a sale and purchase agreement (PPJB). As a result of not submitting PPJB to the auditors, the revenue of PT Hanson International was overstated with a material value of 613 billion rupiahs in the annual report 2016.

In various studies, the writer used fraud triangle, fraud diamond, and fraud pentagon analysis in detecting financial fraud. However, several writers used the Beneish M-Score model to detect financial fraud in the last few years. Independent variables that can be used in this research are firm size, corporate governance (ineffective monitoring and auditor switch), and financial stability. Meanwhile dependent variable is fraudulent financial statements measured using a Beneish M-Score proxy. Generally, the proxy is used to analyze fraudulent financial statements in a manufacturing company. However, the writer desires to know how to analyze
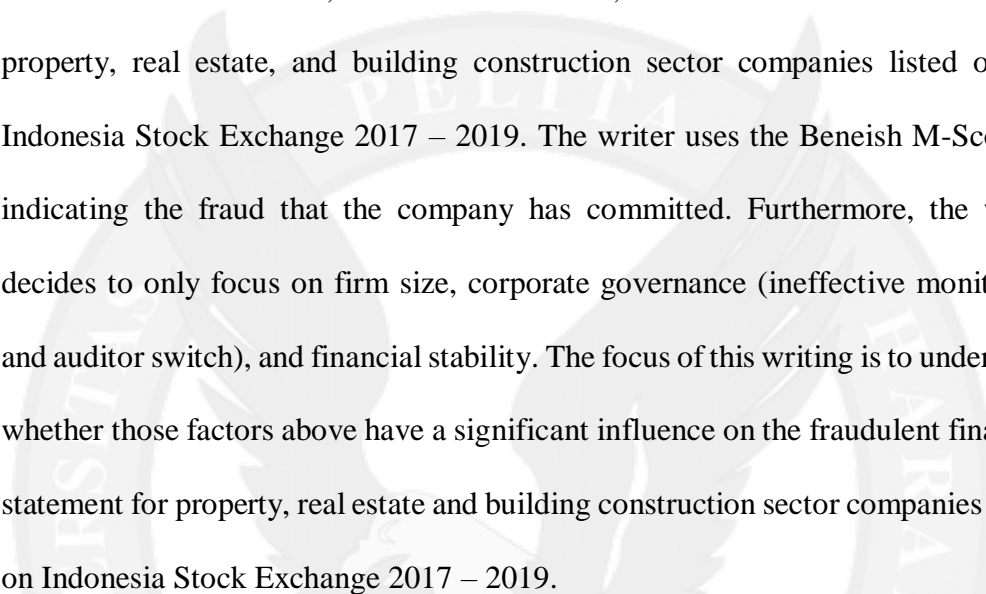
fraudulent financial statements on the property, real estate, and building construction companies using the Beneish M-Score proxy.

Thus, the researcher would desire to do research entitled ***"The Impact of Firm Size, Corporate Governance and Financial Stability to Fraudulent Financial Statements of Property, Real Estate and Building Construction Sectors Listed on Indonesia Stock Exchange."***

## 1.2    Problem Limitation

With respect to the recent corporate accounting scandal over financial statements practices in Indonesia, the writer conducts on factors that have significant influence in detecting fraudulent financial statements. The problem limitation of this research, which will be studied, are annual financial statements on property, real estate, and building construction sector companies listed on the Indonesia Stock Exchange 2017 – 2019. The writer uses the Beneish M-Score in indicating the fraud that the company has committed. Furthermore, the writer decides to only focus on firm size, corporate governance (ineffective monitoring and auditor switch), and financial stability. The focus of this writing is to understand whether those factors above have a significant influence on the fraudulent financial statement for property, real estate and building construction sector companies listed on Indonesia Stock Exchange 2017 – 2019.

**1.3    Problem Formulation**

To elevate the issues discussed in this study, the writer makes the formulation of the problem as follow:

1.    Does the firm size have a significant partial impact to Fraudulent Financial Statements?

2.    Does the ineffective monitoring have a significant partial impact to Fraudulent Financial Statements?

3.    Does the auditor switch have a significant partial impact to Fraudulent Financial Statements?

4.    Does the financial stability have a significant partial impact to Fraudulent Financial Statements?

5.    Do the firm size, ineffective monitoring, auditor switch and financial stability have a significant simultaneous impact to Fraudulent Financial Statements?

**1.4    Objective of the Research**

In accordance with the formulation of the problem, the objectives of this study are to find empirical evidence on:

1.    To identify whether firm size has a significant partial impact to Fraudulent Financial Statements

2.    To identify whether ineffective monitoring has a significant partial impact to Fraudulent Financial Statements

3.    To identify whether auditor switch has a significant partial impact to Fraudulent Financial Statements

4.    To identify whether financial stability has a significant partial impact to Fraudulent Financial Statements

5.    To identify whether firm size, ineffective monitoring, auditor switch and financial stability have a significant simultaneous impact to Fraudulent Financial Statements

**1.5    Benefit of the Research**

This research is expected to provide benefits for various parties related to the research topic, including:

**1.5.1   Theoretical Benefit**

1.    For Writer

This study is expected to give the writer a better understanding regarding the impact of firm size, corporate governance and financial stability on fraudulent financial statements.

2.     For Academicians

This study is expected to provide deeper information and contribute to the development of scientific knowledge, especially in financial accounting and management behavior, especially in the field of auditing. Besides, this research also can be used as a reference and comparison with previous research related to factors that affect fraudulent financial statements.

**1.5.2   Practical Benefit**

1.     For the Company

This study is expected to provide true financial information of the company to collect the trust of the people by convincing honesty. Moreover, the company can also examine whether the decision right now is the right decision.

2.     For the Financial Statement Users

This study is expected to provide information and become guidance in making a decision for the financial statement users. The decisions used to choose the company that deserves to be used as a party to manage the company by investing in shares or bonds.