

CHAPTER I

INTRODUCTION

1.1 Background of The Study

Financial statements are very essential for every company. Financial statements are the written form of every transaction that happened in the company to convey the business performance and activity. Financial statements also act as the source of information, either internally or externally (Apriliana & Agustina, 2017). By providing information internally it is to help the company's management to make the decisions for every single business activities which are operating, financing, and investing. Meanwhile, providing information externally is for the investors to have an overview of the company and ensure them to invest in the company. External information also can be used by creditors so that they can rate the company's credibility based on the company's performance and financial health. Since many financial statement users rely on financial statements to make a decision, it is very important to keep in mind that the financial statements provided by the company must be free from any misstatements and errors.

Misstatements and errors can lead to the wrong decision made by the company's management and also can make the investors disappointed. Thus, providing reliable and free from errors in financial statements is very important in business activity. In preparing and presenting the financial statement, the company's management has the chance of reporting fraudulent financial reports. Fraudulent financial reporting means that an intention by the company to misstate

and misrepresent the firm's current performance and current state of finances. This fraudulent act aims to trick investors with satisfactory financial statements so that they are attracted to invest in the company. Auditing and Assurance services define fraudulent financial reporting as deliberate misstatements, omissions from amounts, or disclosures intending to deceive users of financial statements. This fraudulent act is against the law and it can be harmful either for internal or external users of the financial statements. Internal users such as the management board can face a legal issue and receive punishment from the governing body. While external users can be harmed by the fake financial statements in which they invest their money in the wrong company and ends up losing their money. There are three common cases of fraudulent financial reporting. The first one is Asset misappropriation. The second one is providing fraudulent statements. The last form of fraud is corruption.

Fraudulent financial reporting has become so common and we can see that there are so many well-known fraudulent scandals did by several international top companies. Enron scandal was one of the most famous and controversial accounting scandals in fraudulent financial reporting. The scandal that was faced by Enron is that the company's management is found guilty of fraudulent financial reporting by creating a special purpose vehicle to hide their bad debts (Troy Segal, 2020). The management not only tried to hide the bad debts but also tried to recreate the financial statements with high profits to make it interesting for investors. Therefore, what the management recorded in the financial statements was not reflecting the actual operating activities. The regulator has slowly realized and finally in 2001, Enron declared bankruptcy.

The latest and quite popular one is Garuda Indonesia. Garuda Indonesia was accused of manipulating the financial statements. It was first originated when there is a huge fluctuation of income in Garuda Indonesia income statement. In 2017, the management had recorded a loss for the year of approximately 216.5 billion USD. Surprisingly in 2018, the management successfully recorded 809.85 thousand USD profit for the year. After a long checking procedure had been done, the regulator found out that Garuda Indonesia had been using SPV (Special Purpose Vehicle) which is PT. Mahata Aero Teknologi in which this SPV was having an account payable to Garuda Indonesia. Those receivables from the SPV were recorded as income in Garuda Indonesia's financial statement. Based on PSAK, an accounting standard in Indonesia, Receivable can never be recorded as an income. It means, Garuda Indonesia had committed fraud.

This research aims to analyze the determinants that can indicate fraudulent financial reporting. The research will be using the Fraud Diamond approach that consists of four elements, which are pressure, opportunity, rationalization, and capability. The pressure element will be proxied by using financial leverage and profitability ratio. Financial leverage explains the use of debt in financing the company. According to Zainudin and Hashim, when a company finances its assets using debt, debt will automatically become higher. A higher debt amount can increase the chance of a company committing fraud in financial reporting. The illustration is like when a company would like to borrow money, creditors will consider the current company's debt structure. When the company debt is too high, creditors will become reluctant to provide loans because of the high risk that the

company cannot pay off the debts. A profitability ratio is a ratio that shows the ability of a company to generate profit from its sales. Company with a low profitability will not be attractive to investors and shareholders also will not be happy. Therefore, when the level of profitability is low, the management might overstate the company's sales and revenues to make the income statement becomes more attractive. This act by the management is a fraud. So the level of profitability may affect the management's decision to commit fraud or not.

The opportunity element will be proxied by using external auditor quality. External auditor quality shows the quality of the external auditor that a company uses. The assessment often compares the big four auditing companies and non-big four auditing companies. Deangelo (1981) states that the audit quality of public accountants can be valued by the size of the auditing company. Raenaldi (2015) proves that big four companies have a significant influence on fraudulent financial reporting.

The rationalization element will be proxied by using total accruals to the total assets index. The total accruals to total assets index indicate the quality of a company's cash flow. According to professor Messod Beneish, the higher the total accruals show the higher chance of fraudulent financial reporting.

The capability element will be proxied by using director change. Director change shows whether a company has a change in director or not. According to the fraud theory, the capacity of the board of directors has a higher chance of committing fraud. Change in director is an attempt made to improve the company performance. Changing the director means that the previous director's performance

is not good or competent enough. The previous director might have taken advantage of a director that has enough information to commit fraud.

Two companies from the LQ45 index which are AKR Corporindo and Kalbe Farma are used by the writer to find out whether fraud had been committed or not. By using the Beneish M-Score model, the writer found out that those two companies commit fraud three years respectively from 2017 to 2019.

Based on this phenomenon, the writer is interested in conducting this research to find out the determinants of fraudulent financial reporting by using the diamond fraud theory in LQ45 companies listed in the Indonesia Stock Exchange from 2017 through 2019. Hence the title of this research is “**THE DETERMINANTS OF FRAUDULENT FINANCIAL REPORTING THROUGH FRAUD DIAMOND THEORY IN LQ45 COMPANIES LISTED IN INDONESIA STOCK EXCHANGE.**”

1.2 Problem Limitation

This research will be limited to some extent. This research will only focus on companies listed in the LQ45 index on Indonesia Stock Exchange. The reason for choosing LQ45 companies is because LQ45 only measures companies that have great liquidity and market capitalization. It means LQ45 only measures companies that are good in terms of performance whether financial or fundamental.

The dependent variable of this study is fraudulent financial reporting and the independent variables will be limited to financial leverage, profitability, external auditor quality, total accruals to total assets, and director change. The

selection of financial leverage and profitability as part of the pressure element is because they are the most common and accurate variables. External auditor quality since auditor quality is one of the elements that has the biggest effect on a fraudulent financial statement. Total accruals to total assets and director change since they are the most possible variables that can be measured in rationalization and capability elements.

1.3 Problem Formulation

Based on the background of this research, it is still uncertain about the correlation between financial leverage, profitability, external auditor quality, total accruals to total assets, and director change with the dependent variables which is fraudulent financial reporting. Therefore, below stated the problem formulations to help attain the objectives of this study:

1. Does financial leverage significantly affect fraudulent financial reporting?
2. Does profitability ratio significantly affect fraudulent financial reporting?
3. Does external auditor quality significantly affect fraudulent financial reporting?
4. Does total accrual to total asset significantly affect fraudulent financial reporting?
5. Does director change significantly affect fraudulent financial reporting?

6. Do financial leverage, profitability ratio, external auditor quality, total accrual to total asset, and director change simultaneously affect fraudulent financial reporting?

1.4 Objectives of The Research

The description above has shown the problem formulation for this research and below will be stated the objective of this study:

1. To analyze whether financial leverage significantly affects fraudulent financial reporting.
2. To analyze whether profitability ratio significantly affects fraudulent financial reporting.
3. To analyze whether the quality of external auditors significantly affects fraudulent financial reporting.
4. To analyze whether total accrual to total asset significantly affects fraudulent financial reporting.
5. To analyze whether the change of director significantly affects fraudulent financial reporting.
6. To analyze whether financial leverage, profitability ratio, external auditor quality, total accrual to total asset, and director change simultaneously affect fraudulent financial reporting.

1.5 Benefit of The Research

This research is expected to give benefit to many individuals and groups, including the writer itself, the management, government, future academicians, and also investors.

1.5.1 Theoretical Benefit

1. For the writer, this research is expected to be a platform in which the writer can gain information on implementing the theories about fraudulent financial reporting.
2. For future academicians, this research is expected to be a model and example to make research on a similar topic. This research is also expected to be a fundamental reference for academic knowledge.

1.5.2 Practical Benefit

1. For the management, this research is expected to be a guideline so that the management will not wrongly direct the company towards fraudulent financial reporting and to show the real determinants of fraudulent financial reporting.
2. For the investors, this research is expected to be a reference to find out the determinants of fraudulent financial reporting in order to prevent a wrong investment decision.
3. For the government, this research is expected to be a helpful device to determine the companies that commit fraudulent financial reporting.