CHAPTER I

INTRODUCTION

1.1. Background of the Study

Since the onset of Covid-19 pandemic, the competition in business has increased significantly. In Indonesia, business competition is reflected in Figure 1.1 which shows that Business Competition Index (IPU) increased to 4,87 in the year of 2022, surpassing the KPPU's target of 4,7 (*Komisi Pengawas Persaingan Usaha*, 2023). In such a competitive market, demonstrating a good financial performance is crucial for a company to build shareholders trust and attract potential investors (Yuliana et al., 2019). To achieve this, companies often adopt leverage as a strategy, using borrowed funds to finance their business operation and drive growth. When the company relies heavily on debt financing, the creditors is likely to monitor the company's financial health and accounting practices which reduces the likelihood of the management to engage in opportunistic behavior that could lead to financial statement manipulation (Abbas et al., 2021). To extend, leverage can serve as a discipline mechanism to promote more accurate and strengthen financial statements integrity. However, this pressure could also lead to conflict of interest as described in agency theory where managers might manipulate financial statement to make it more favorable (Hoesada & Pradika, 2019). Retrieved from CNBC (2024), the case of financial statement integrity happens on PT Kimia Farma which had significant changes in the year 2023, which recorded the total profit in the year of 2023 is Rp

1,48 trillion, compared to the previous year's performance which suffered a loss of Rp 190,4 million. These significant changes highlighted the impact of leverage on financial statements, especially in the consumer goods sector where companies frequently rely on debt to finance their business operation and present strong financial performance to compete in the market. Given the high amount of debt used, companies in this sector are under pressure to maintain their credibility in their financial disclosures. Understanding the relationship between leverage and integrity of finance not only enlightens the potential risk of financial reporting, but also promotes more accurate valuations and more robust regulatory framework aimed at promoting conservatism accounting and preventing corporate scandals linked to excessive debt.

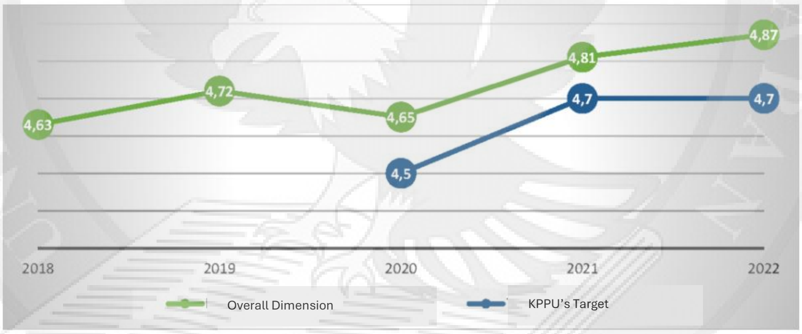

Figure 1. 1 Business Competition Index in Indonesia Period 2018-2022
Source: *Komisi Pengawas Persaingan Usaha* (2023)

As mentioned in the explanation of POJK NOMOR 29 /POJK.04/2016, Annual Report, which consists of financial and non-financial information, refers to a crucial source of information for investors or shareholders when making investment decisions. Furthermore, the report is also important for the regulators, such as *Otoritas Jasa Keuangan* (OJK), to help in conducting supervision to preserve the interests of investors or shareholders (Mashuri et al., 2023).. Moreover, a good quality financial statement can ultimately be a promotional tool for the company in enhancing the competitiveness of the company. Lowering the risk of facing unpleasant surprises for the stakeholders and making analysis is also the purpose of a high integrity of financial statements

Leverage reflects a company's use of liabilities or debt to finance its business operation (Adkins, 2024). High Leverage shows that the company possesses a high level of debt and possesses high financial risk. A High Leverage company not only needs to maintain sufficient cash flow to meet its obligation, but also give more disclosed information compared to the low leverage company to eliminate shareholder's doubts about their rights (Safitri & Bahri, 2021). With stricter regulations, a company with a high leverage needs to ensure the accuracy and reliability of its financial statements. The high leverage company as researched by Widodo and Annisa (2023), shows that high leverage companies take a longer time to be audited, meaning that there are tested more on the compliance and adherence to the accounting regulations. This means that the financial statements produced are likely to be more reliable and encompass integrity, which can be a positive signal to the external parties as explained in the signalling theory. However, in the relation to agency theory, a high leverage company's agent, in this case managers, may present a manipulated strong financial statement to attract investors and secure funding while this is also views as beneficial to creditors who prefer low leverage to protect their investments (Pangi & Weku, 2023). When there are no creditors and the company is unable to generate enough money to cover its debt payment, it can lead to the company’s bankruptcy. Study by Abbas et al., (2021) shows that high leverage does not mean that the financial statements are in doubt to the creditors as there is a possibility of creditors have already aware of the company’s actual condition. However, the pressure of these situations may lead to the manipulation of financial statements. Managers who aim to achieve a short-term goal manipulate the suitable percentage of assets with debt financing. This situation therefore becomes a concern of the integrity of the financial statements.

Table 1. 1 Table of Phenomenon

Company	Year	DAR	MBV
PT. DHARMA SATYA NUSANTARA TBK	2019	0.67	1.32
	2020	0.56	1.04
	2021	0.49	0.77
	2022	0.47	0.80
	2023	0.45	0.67
PT. SAMPOERNA AGRO TBK	2019	0.56	1.09
	2020	0.61	0.81
	2021	0.53	0.81
	2022	0.49	0.74
	2023	0.45	0.70
PT. MULTI BINTANG INDONESIA TBK	2019	0.60	0.37
	2020	0.51	0.27
	2021	0.62	0.84
	2022	0.68	0.77
	2023	0.59	0.58

Source: Prepared by Writer (2024)

The research uses Market Book Value (MBV) to measure integrity of financial statements and Debt to Asset (DAR) to measure leverage. We can infer that the higher DAR is due to the higher reliance on debt to finance the company’s assets. On the other hand, the higher MBV refers to the more conservative of the financial statements (Hoesada & Pradika, 2019).

The first phenomenon shown in the table shows the PT Dharma Satya Nusantara Tbk the increasing the Debt to Asset ratio (DAR), peaking in 2019 which also the number of Market to Book ratio decrease from 1.32 in 2019. This indicates a higher reliance of debt and higher financial statements integrity for the company in the period of 2019.

The second phenomenon shows PT Samporna Agro Tbk possess the decreasing Debt to Asset ratio (DAR), at the lowest in 2023 which also the number of Market to Book ratio decrease from 1.09 to 0.70 in 2023. This indicates a lower reliance of debt and lower financial statements integrity for the company in the period of 2023. However, the results in 2020 and 2021 show a different pattern from the following years as the value of market to book value almost the same for both years despite the decreasing DAR.

The third phenomenon of PT Multi Bintang Indonesia Tbk shows the lowest MBV and DAR in 2020. The drop of DAR ratio reflects the lower reliance of debt in the period and lower conservatism the company has during 2019 – 2023. However, the phenomenon shows the decreasing MBV from 2021 to 2023 but there is an increase from 2021 to 2022 despite the lower MBV and DAR during 2021-2023.

The consumer goods sector was chosen in this research due to its heavy reliance on leverage to finance its operation, highlighting the critical role of financial statement integrity. The consumer goods sector plays a crucial part in the country’s economy as it provides daily goods that people need, overall contributing to the country’s economic health (Devianto et al., 2023).

In relation to leverage, this sector provides a clear example of how the use of debt to fund a company's operation affects financial integrity. In addition, investors are particularly interested in this sector because the products or services are produced for people's daily needs. The regulators also closely watch these companies to follow the regulation and ethical stand when reporting financial statements.

The Study of Dang & Tran (2020) explored the relationship between leverage and accounting conservatism in Vietnam. Unlike Dang & Tran (2020), this research employs market to book ratio rather than non-operating accrual method in relation to accounting conservatism as an outcome of integrity of financial statements. There is research of Hong (2024), who analyzed the effects of financial characteristics on accounting conservatism, identifying leverage as one of the influenced factors among the ten factors tested in the research. This research specifically targets and focuses more on the impact of leverage towards integrity of financial statements compared to Hong's approach. Aldoseri (2022) investigated the managerial determinants of accounting conservatism during Covid-19 pandemic in Saudi Arabia, using the Book to Market ratio. In contrast, this research uses the Market to Book ratio, reflecting a different approach of accounting conservatism. The Research of Putra (2022) also examines the influence of leverage on the integrity of financial statement, with firm size as a moderating variable. Unlike Putra (2022), this research focuses on leverage as the main independent variable and the components of corporate governance as the control variables.

The Board of Independent Commissioners refers to a group of people who supervises and is responsible for the management of the policies and providing recommendations not only in accordance with the company's goal but also legal and ethical compliance. Therefore, the relevance of the Board of Independent in the case of finding the impact of leverage towards the integrity of financial statements is within their role to provide independent oversight, and reducing the risk of financial reporting, especially when the company's leverage is high. Liquidity refers to the extend how fast the company is able to convert cash to pay its obligations according to Riyanto (2001, p.25) on (Djohan, 2023). Managerial ownership aligns managers' other shareholders in the company, encouraging responsible and accurate financial statements and ensuring the long-term health and accuracy of financial statements. Firm size, on the other hand, is chosen due to the belief that larger companies offer more resources and expertise, as a result, it produces an accurate financial statement.

With the leverage as the main independent variable and integrity of financial statement as the dependent variable, this study focuses primarily on the impact of Leverage as the main variable towards the integrity of financial statements. It also includes Firm Size, Liquidity, Board of Independent Commissioners and Managerial Ownership as control variables. In addition, the consumer goods sector is chosen due to the high reliance on leverage, providing an ideal context for examining financial statement integrity associated with leverage. Therefore, this study is conducted with the title "**The Impact of Leverage Towards The Integrity of Financial Statements**".

1.2. Problem Formulation

Building on the background discussed previously, the research problem is stated as follows:

1. Does leverage have significant impact towards the integrity of financial statements?

1.3. Objective of the Research

The Objective of the research, which needed to be focused on, is as follows:

1. To examine whether leverage have significant impact on the integrity of financial statements.

1.4. Benefits of the Research

This research provides insights and advantages to investors and stakeholders by offering knowledge, both theoretical and practical benefits, as outlined below:

1.4.1. Theoritical Benefit

In theoritical perspective, this study aims to enhance the understanding on how leverage impacts integrity of financial statements. Hence, helping stakeholders to assess whether higher debt levels may impact the transparency and reliability of a company's financial reporting. It is expected to contribute to the improved decision making to the shareholders, investors, and readers by considering the level of leverage. Moreover, this findings provide valuable insights for future research to explore the connection of leverage and financial reporting in consumer goods sector.

1.4.2. Practical Benefit

1. For investors

This research aims to enhance investors' knowledge on leverage and its influence on financial statements integrity, enabling a more informed decision to be made.

2. For the shareholders

This research aims to enchance the shareholders' awareness of the financial health and improve the corporate governance practices.

3. For regulators

The research aims to enhance the regulators' awareness to develop more robust and effective regulations to ensure financial statements integrity and transparency.

4. For Academic Researches

This research aims to add the foundation for further academic study and contributes to the advancement of knowledge in finance and accounting area.

1.5. Problem Limitation

To achieve a more focused research scope, this research limits the discussion as follows:

1. This research focused on leverage using debt to asset ratio
2. This research focused on integrity of financial statement using share market price to book value

3. This research focused on Consumer Goods companies listed on Indonesian Stock Exchange as population from the period of 2019-2023.
4. This research utilized only one model regression