

CHAPTER I INTRODUCTION

1.1 Research Background

In a company, there are many important instruments that can be used as tools to show the conditions of a company, whether financially or in other aspects. One of those instruments is the financial statement of the company. Financial statement is a structured presentation that can provide information regarding a company's cash flows, financial position and performance. Financial statement can also showcase the management's attitude toward the resources that they are held responsible for. (Sihombing, 2014).

In the Basic Framework of Preparation and Presentation of Financial Statements issued by the *Ikatan Akuntansi Indonesia* (IAI) it is said that users of financial statements include investors, employees, government, and the society (IAI in Sihombing, 2014). According to PSAK 01, a complete financial statement should include:

- a) Financial Position Report
- b) Statement of Comprehensive Income during the period
- c) Statement of Changes in Equity during the period
- d) Statement of Cash Flows during the period
- e) Notes to Financial Statement containing important accounting policy summary and other explanatory information
- f) Financial Position report at the beginning of the comparative period

Stated in *Statement of Financial Accounting Concept (SFAC)* No.1, one of the objectives of the financial statement is to help the creditors or investors in making a rational decision regarding investments, credits, and other similar decisions. The managers become motivated to increase their company's performance because they realize the importance of the information included in the financial statement (Diany dan Ratmono, 2014). Generally, financial statements are prone to manipulation by the

party who prioritizes their own interests and wants which is one of the many forms of fraud.

Often times, earnings manipulation happens because the company wants to make investors interested in buying their shares. There are many companies that are already listed on the Indonesian Stock Exchange that are prone to financial statement fraud. It is usually caused by the company's management who implements earnings management practices. Susceptible corporate governance is often associated with financial statement fraud.

This is supported by Dechow et al. (1996) which proves that the incidence of fraud is highest in companies with weak corporate governance, such as companies dominated by insiders (people who are most aware of the companies' smallest details) and do not have audit committees (Skousen et al., 2009). To help address the issue of fraud, the American Institute of Certified Public Accountant (AICPA) published the Statement of Auditing Standards no. 99 (SAS No. 99) on the Consideration of Fraud in a Financial Statement Audit in October 2002 (Skousen et al., 2009).

According to Rezaee (2002), the purpose of SAS No.99 is to maximize the effectiveness of the auditor's performance in detecting fraud by assessing fraud risk factors within a company. Financial statement fraud has a close relationship with profit manipulation which is often done by the company's management (Rezaee, 2002). According to Rezaee (2005) in Sihombing (2014), the definition of financial statement fraud is "a deliberate attempt by corporations to deceive or mislead users of published financial statements, especially investors and creditors, by preparing and disseminating materially misstated financial statements."

One of the biggest fraud scandals in the world happened in 2002 to ENRON, a company in the energy industry. This scandal also involved a reputable public accounting firm, Arthur Andersen. ENRON's management recorded the company's profit of USD 600,000,000 at the time they were experiencing a loss. This form of financial statement manipulation was done by ENRON so they could keep their investors assured. However, this did not make things better. ENRON's debt increased and eventually they went bankrupt in 2001 (Tuanakotta, 2007). There are still many

examples of financial statement manipulation besides ENRON which defraud numerous investors.

According to Skousen et al (2009), companies often perform earnings management to attract the attention of investors. Companies are required to improve and increase their value in the stock market. If the company cannot do this, then it might go bankrupt. Financial statement fraud is a serious problem that can cause many negative impacts on users of financial statements. Therefore, the role and performance of the auditors should be improved so that fraud can be detected and prevented as early as possible before it develops into a major scandal (Skousen et al., 2009). Nevertheless, the auditor cannot serve as the guarantor of the absence of fraud; the detection of material misstatements in the financial statements is the primary objective of SAS 99.

In Indonesia, there has been an absence in research of fraud diamond as a tool to assess fraudulent financial statement. Therefore, this research is to use fraud diamond as an assessment tool. However, due to the limitation of the data mining for two uncontrollable aspects of fraud diamond (rationalization and capability), this research measures merely pressure and opportunity as the quantifiable indicators of financial statement fraud. There have not been that many researches related to fraud diamond analysis. This is due to the difficulty of measuring the qualitative variables that exist. Now, however, some of these qualitative variables have been quantified.

The variables of the fraud diamond require variable proxies in order to be analyzed. Pressure is proxied with Pressure from Investors and Pressure within Management; Opportunity is proxied with Leadership Control and Day-to-Day Control. A number of fraud investigators suggest that financial ratios are quite the effective tools to detect fraud (Bai, Yen, Yang, 2008). However, researchers often get mixed results when using financial ratios to detect fraud, thus there is a lack of empirical evidence regarding this matter (Dalnial et al., 2014).

In this research, a new model is proposed because in the previous similar researches there have not been a linkage between the financial ratios, meanwhile linkage between financial ratios could indicate some important information and help detect symptoms of fraud in a company. Therefore, this study is conducted under the

title "Fraud Diamond Analysis In Controllable Aspects of Financial Statement Fraud: Empirical Study of Manufacturing Companies Listed on Indonesia Stock Exchange (BEI) Year 2014-2016 under the Sector of Consumer Goods Industries."

1.2 Research Formulation

According to Cressey (1953) fraud triangle is a major factor that causes a company's management to commit fraud which consists of: pressure, opportunity, and rationalization. However, there is another factor that must be considered in analyzing fraud. Wolfe and Hermanson (2004) discuss factor that can trigger the occurrence of fraud, which is capability. Thus, the fraud diamond was formed in which it consists of the fraud triangle by Cressey plus the capability factor.

However, for the explanation written in the next chapter, this research's focus will only be on the controllable aspects of the fraud diamond which are pressure and opportunity. Some research questions that can be formulated are:

- 1.) Can Pressure from Investors be used to assess financial statement fraud?
- 2.) Can Pressure within Management be used to assess financial statement fraud?
- 3.) Can Leadership Control be used to assess financial statement fraud?
- 4.) Can Day-to-Day Control be used to assess financial statement fraud?

1.3 Purpose and Benefits of Research

This study is conducted with the purpose of obtaining evidence on the linkage of the following variables with the occurrence of financial statement fraud:

- 1.) Pressure from Investors with the occurrence of financial statement fraud
- 2.) Pressure within Management with the occurrence of financial statement fraud
- 3.) Leadership Control with the occurrence of financial statement fraud
- 4.) Day-to-Day Control with the occurrence of financial statement fraud

The benefits of this research are purposively for:

- 1.) Management, this research can give them a point of view in which they should be responsible in protecting the interests of companies such as the investors.

- 2.) Investors, this research can be an analytical tool for them in assessing and analyzing their investment in a particular company.
- 3.) Society, this research can provide information regarding the phenomenon of fraud that has been happening in Indonesia and other countries, and on how to detect and prevent the occurrence of fraud as early as possible.
- 4.) Accounting expertise, this research can contribute to the development of forensic accounting and investigative audit studies in the case of fraud examination.
- 5.) Other related areas, this research can serve as a reference for similar research in the future.

1.4 Systematics of Writing

CHAPTER I: INTRODUCTION

This chapter contains the research background, formulation of the problem, the purpose and benefits of research, and the systematics of writing.

CHAPTER II: LITERATURE REVIEW

This chapter describes the theories used in this study and similar previous research results. This chapter also explains the conceptual framework and research hypotheses.

CHAPTER III: RESEARCH METHOD

This chapter describes the research methods used in the research implementation. The description includes measurements of variables, population and samples, types and sources of data, data collection methods, identification of variables, and methods of data analysis.

CHAPTER IV: DATA ANALYSIS AND DISCUSSION

This chapter contains the quantitative analysis, and results and explanations related to the results of the research.

CHAPTER V: CONCLUSION

This chapter contains research conclusions, limitations, and suggestions. To overcome the limitations of the research, further research is needed with expansion of other variables.