CHAPTER I

INTRODUCTION

1.1. Research background

Financial statements are collections of summary reports on an organization's financial results, financial position, and cash flows. Financial statements are a medium of communication used externally and internally by a company to provide information beyond a certain period about its business operations. These become a benchmark of the proficiency and viability of a company's performance, and it is anticipated that companies are transparent in providing the information needed by interested parties. Management, company owners, creditors, investors, suppliers, customers, and even the government are interested parties who utilize the information presented in these financial statements. One crucial standard that must be met while generating financial statements is that they must be reliable, not misleading, and not materially wrong because the readers can use the information as a decision-making factor in the future (Ulfah, Nuraina, and Wijaya, 2017).

The company sometimes presents the results of its performance contrary to the actual situation with the intention that the company will get a "good" impression and judgment from parties that read it. This issue can be a consolation and inspiration for organizations to be seen as significant and dependable; however, under specific conditions, it can also pressurize related parties to commit various acts of fraud by force of company performance and manipulation of certain parts of the financial statements so that the company can be viewed as remarkable. Therefore, most companies present improper information, which can harm many parties (Sihombing & Rahardjo, 2014).

Statement on Auditing Standards No.99 (AICPA, 2002) states that fraud is an intentional act to produce material misstatements in the financial statements which are the subject of an audit. Tuanakotta (2014) defines actions that take illicit profits as money, goods/properties, services, not paying for assistance, or obtaining business as fraud. Meanwhile, Albrecht (2012) defines fraud as a deception against others with a misrepresentation. Such deception includes anything the human mind can think of and use to exploit others. That way, we understand that fraud is an act against the law that harms other parties for the perpetrator's benefit. Fraud is often difficult to detect because it only involves small amounts of money or goods being stolen or misused over time (Crowe Horwath, 2011). Fraud has become a rapidly growing cancer over the last few years; in fact, it is prevalent in many countries, in various industries, and is carried out by different levels of actors. Apriliana (2017) defines *fraudulent financial reporting* as deliberate misstatements, commissions from amounts, or disclosures to deceive users of financial statements.

Generally, fraud might occur in the absence of efficient prevention and detection. In Indonesia, there is no exception to the fact that fraud happens in all types of organizations, even tiny enterprises that are listed on the international stock market until they become public. Companies with cases in financial fraud reports include PT Asabri and PT Asuransi Jiwasraya, firms in Indonesia that have financial statement fraud cases. The current instance of false financial reporting by PT Asabri (2012-2019) is a fraud in managing finance and investment money. The following case recently occurred and has become a hot topic of public discussion, namely the PT Asuransi Jiwasraya (Persero) incident in 2019 concerning indications of fraud in its financial reports. The BPK audit results in 2010-2019 found that the company manipulated financial reports, which caused the company to suffer losses. These losses were caused by savings plan products and investments, which resulted in liquidity pressures. The BPK also assessed that there was engineering during the buying and selling of shares, so the purchased shares did not reflect the actual price. As a result, Jiwasraya suffered losses of up to Rp. 6.4 Trillion. In 2017 Jiwasraya received an unqualified opinion in its financial statements. Which was caused by a shortage of reserves of Rp. 7.7 Trillion should have suffered a loss (Beritasatu, 2019). Based on the case explained above, several companies that commit fraudulent financial reporting are companies from the insurance sector. Financial reports are essential for various parties and companies in various sectors, including insurance companies. So financial reports must be made following the actual data. The auditor’s role is also very much needed to detect fraud so that fraud can be immediately handled and prevented. The government has also issued laws and regulations regarding sanctions and penalties for those who violate them.

As time passes, fraudulent financial reporting keeps increasing; all parties cannot underestimate this. With this harshness of fraud, the auditors must know what factors can detect fraud in a company. An acknowledged theory, the "fraud triangle," has often been debated in the literature. This theory consists of three elements (pressure, opportunity, and rationalization) significant for fraud. Fraud most likely will not occur if one of the elements did not exist, and the severity of fraud depends on the elements' strength. However, Wolfe and Hermanson (2004) claimed in their research "fraud diamond" that even though fraud only occurs when all three elements co-exist, it is unlikely for the scam to happen unless the fourth element is present, which is the capability.

Along with technological advances, knowledge about fraud theory has also increased. Fraud Pentagon Theory (Crowe, 2011) was born as the new evolution from Fraud Triangle Theory (Cressy, 1953) and Fraud Diamond Theory (Wolfe & Hermanson, 2004). Crowe stated that arrogance is also affecting the detection of fraud. Without eliminating the elements of the Fraud Triangle Theory and Fraud Diamond Theory, Crowe added a new component, arrogance, into the old theories known as Crowe's Fraud Pentagon Theory. This theory consists of five elements: Pressure, opportunity, rationalization, capability, and arrogance.

Fraud Triangle Theory and Fraud Diamond Theory have dominated previous research since these theories are pretty known among the auditors and have stayed too long in the fraud research. Since Fraud Pentagon Theory is still new and lacks analysis, this paper aims to study the influence of the Fraud Pentagon Theory in detecting fraudulent financial reporting, especially in insurance companies in Indonesia. To examine the elements in the fraud pentagon theory, a variable proxy is needed that can represent each element. Therefore, the brokers used in this study include pressure proxied by financial targets, financial stability, and external pressure. Opportunity proxied by the ineffectiveness of supervision and the nature of the industry. Rationalization is proxied by a change in auditors. Competence is proxied by changes in the board of directors, and arrogance is proxied by the frequency of CEO photos in the annual report and political connections. These elements will be tested for their effect on fraudulent financial reporting. Fraud in financial reporting is proxied by the company's earnings management.

Previous studies have tested the pentagon fraud theory related to fraudulent financial statements. Previous research from Septriani and Handayani (2017) found that companies have a significant influence from financial stability (pressure), ineffective monitoring (opportunity), and rationalization of the possibility of fraud in financial statements. However, financial targets, the nature of industry, rationalization, and arrogance do not affect fraud detection in financial statements. Further research from Ulfah, Nuraina, & Wijaya (2017) concluded that changes in auditors' and auditor opinions significantly influence fraud in financial statements. Meanwhile, the other variables from the pentagon theory have no significant effect on fraudulent financial statements.

Research from Bawakes, Simanjuntak, & Daat (2018) stated that financial stability and frequent CEO pictures positively and significantly affect fraudulent financial reporting. Meanwhile, the quality of external auditors and changes in auditors have a positive but insignificant effect on fraudulent financial reporting. Meanwhile, other factors have a negative effect. In Indonesia, research using the pentagon theory to examine fraudulent financial statements has been carried out a lot. However, there are still inconsistencies in previous studies' results, so researchers are motivated to conduct this research using a sample of insurance sector companies listed on the Indonesia Stock Exchange (BEI).

Another difference between this study and previous research is the use of the pentagon theory in detecting fraud in financial reporting at insurance companies listed on the Indonesia Stock Exchange. The sample selection was carried out because there needs to be research examining the fraudulent financial statements of insurance companies on the IDX. Also, insurance companies are a sector prone to financial fraud. The research time span was narrowed to only four years (2018-2021), making the research results more relevant to current conditions. Based on the discussion of the problems that have been done, the authors are interested in conducting research titled The Analysis Influence of Fraud Pentagon Theory in Detecting Fraudulent Financial Reporting (Empirical Study of Insurance Companies Listed on Indonesia Stock Exchange).

1.2 Problem Statements

This research seeks to address the following questions:

1. Do financial targets, financial stability, and external pressure affect the practice of fraudulent financial reporting insurance companies listed on the IDX?
2. Do ineffective monitoring and the nature of industry affect the occurrence of fraudulent financial reporting insurance companies listed on the IDX?
3. Do auditor changes impact the act of fraudulent financial reporting insurance companies listed on the IDX?
4. Does the change of company directors affect the activities of fraudulent financial reporting insurance companies listed on the IDX?
5. Do the frequency number of the CEO's picture and political connection affect the practice of fraudulent financial reporting insurance companies listed on the IDX?

1.3 Research Objectives

Based on the problem formulation above, this study aims to find out:

1. To determine and analyze financial target, financial stability, and external pressure that affect the practice of fraudulent financial reporting in insurance companies listed on the IDX
2. To determine and analyze ineffective monitoring and the nature of industry give an effect of the occurrence of fraudulent financial reporting insurance companies listed on the IDX.

3. Defining and analyzing auditor changes impact the act of fraudulent financial reporting insurance companies listed on the IDX.
4. To determine and analyze company directors' effect on the activities of fraudulent financial reporting insurance companies listed on the IDX.
5. To determine and analyze the frequency number of CEOs pictured and political connections affecting the practice of fraudulent financial reporting insurance companies listed on the IDX.

1.4 Research Benefits

The authors have several benefits that can be obtained from the results of this study as follows:

1. For investors, this study is anticipated to serve as a reference for investors or future investors in assessing the probability of fraud inside a corporation.
2. For a company, this study is anticipated to aid companies in formulating more effective measures to avoid their recurrence in the future.
3. For academics this study is anticipated to offer academics the knowledge they need to undertake more research.

1.5 Writing Systematic

This research is divided into five chapters. First, Chapter I's introduction discusses the general description that becomes research. It consists of background, problem statement, research objectives, research benefits, and writing systematically. Second, Chapter II, the literature review is discussing the theory and previous studies of the research problem. Third, Chapter III, research methodology is to provide an overview of the research plan. This chapter consists of the types of research, types, and sources of data and analysis methods.

Fourth Chapter IV, analysis and discussion is contains data and processing results from the chapter research methodology. And finally, in Chapter V, the conclusion and suggestion contain a decision about the research results, implications and limitations for future research.