CHAPTER I

INTRODUCTION

1.1 Background

The financial report is a media for companies to provide information to the users. In accordance with the Fundamental Concepts in Preparation of Financial Statements, the information presented in the financial statements must meet the qualitative characteristics. According to Statements of Financial Accounting Concepts No. 8, qualitative characteristics are categorized into two, fundamental and enhancing quality. The fundamental quality consists of relevant and faithful representation, while the enhancing quality consists of comparability, verifiability, timeliness, and understandability. The information presented in the financial statements must be relevant and faithful representation, it means that the needs of users in the decision-making process must be met and the information should be complete, neutral, and free from error. The information presented will be more useful if it is comparable between one company with another company in the industry or comparing the same company for different periods and can be verified. In addition, the information presented should be available in time to be capable of influencing users' decision and should be presented clearly and concisely.

At the time of publishing financial statements, the company actually want to portray the best possible condition of their company. The financial statements present more information than just numbers because it includes information concerning the company's financial position and performance which is useful for making economic decisions.

Information should be directed to the general needs of the user and does not depend on the needs and desires of particular parties. According to Prakoso (2009), there should be no attempt to present information in favor of some parties because it would harm the other parties who have different interests. The information that is presented on the basis of specific needs and desires of the particular parties raises the risk of fraud because the financial statements do not describe the actual condition of the company.

Association of Certified Fraud Examiners (ACFE, 2014) defines fraud in the broadest sense as any crime to gain an advantage by using deception as its principal. More specifically, Black's Law Dictionary (2004) defines fraud as a knowing misrepresentation of the truth or concealment of a material fact to induce others to act to his or her detriment. Consequently, fraud includes any intentional or deliberate act to deprive property or money by guile, deception, or other unfair means. Data from Association of Certified Fraud Examiners (ACFE, 2014) shows that of the three categories of fraud, only 9% of the cases involved financial statement fraud, asset misappropriations are the most common, occurring in 85% of the cases, and corruption schemes fell in the middle which is 37% of the cases. Nevertheless, financial statement fraud cases had the greatest financial impact with a median loss of US$1 Million, while corruption and asset misappropriations causing median loss of US$200,000 and US$130,000, respectively. This makes the study of fraudulent financial statements becomes interesting.

There are some well-known cases of fraud, one of them is Enron. According to Tunakotta (2012), businesses were shocked by the revelation of an Enron's scandal. Enron's management manipulates financial statements by recording the company's profit amounted to U$600 Million when the company suffered losses. This is done by management in order not to lose investors. At the end, Enron was facing bankruptcy.

In 2002, Lippo Bank case had become a hot topic. At that time, there is a significant difference between financial information to the public and the Jakarta Stock Exchange (JSX). It mentioned that the assets in the public report of Rp24 Trillion, with a net profit of Rp99 Billion. However, a month later, a report to the JSX, Lippo Bank assets decreased into Rp22.8 Trillion and suffered losses of up to Rp1.3 Trillion. (news.liputan6.com accessed on March, 10th 2017)

Stock Exchange Commission Press (2006) states that the American International Group (AIG), the largest insurance company in the United States, in 2005, restated financial statements for four years. As a result, it reduces the net assets of the company to US$2.7 Billion. AIG has been proven to do fraud in improving earnings by making fake reinsurance transaction and improve loss provision in the balance sheet.

In 2008, financial statements of Century Bank is manipulated by the owner, Robert Tantular. The amount embezzled is Rp13 Trillion. The allegation of manipulation was corroborated by the findings of *Badan Pemeriksa Keuangan (BPK)* which showed that the capital adequacy ratio (CAR) of Century Bank as of October 2008 was -3.5 percent. Meanwhile, in unaudited financial statements as of September 2008, the capital adequacy ratio (CAR) is 2.5 percent. (news.liputan6.com, accessed on May, 21st 2017)

In August 2009, press notifies manipulation of financial statements in Waskita Corporation. In the 2008 financial year, it was revealed that there are misstatements of assets in 2005 amounted to Rp5 Billion. The value of Rp5 Billion consists of two ongoing projects, the first project is the renovation project of Riau Governor's Office. The project started in 2004 and has already 100% completed with contract value amounted to Rp13.8 Billion. But at the end of 2005, there was additional work with value Rp3 Billion. Until the end of 2008, the balance still appears on the company's balance sheet as a receivable. The second project is the construction of a Bulian Sports, Jambi. The contract value amounted to Rp34 Billion and Waskita Karya Corporation recognizes contract revenue of Rp2 Billion. The balance is still outstanding by the end of 2008. The contract was terminated by the government because it is signed by an unauthorized person. In 2005, the value of the assets of Waskita Karya Corporation was Rp1.6 Trillion, and the value is increased by the management in 2005 by Rp5 Billion, or by 0.3% of the value of these assets. (tempo.co: 2009, accessed on March, 15th 2017)

Stock Exchange Commission Press (2010) stated that an investment bank, Lehman Brothers Holdings (LBH), has been proven doing manipulation on accounting standard (window dressing). In 2008, LBH recorded collateral loans transaction as the company's sales. Examiner concluded that the transaction motive is to reduce the company's debts.

In 2011, one of internal fraud cases has happened where the relationship manager of Citibank, Inong Malinda Dee, embezzled billions of customer's funds. Deputy governor of Bank of Indonesia for supervision at that time stated that there are three factors that trigger internal fraud in the bank; weak implementation of Standard Operating Procedure (SOP), lack of information systems, and human resources. (tempo.co: 2011, accessed on May, 21st 2017)

In October 2011, Olympus, a Japanese camera manufacturer claims to have hidden investment losses in the company's securities during the decades since the 1980s. During this time, Olympus cover losses by using acquisition funds. Olympus' parties found a US$2.2 Billion (Rp18.7 Trillion) suspicious funds related to the acquisition of British medical equipment manufacturers, Gyrus, in 2008, which also involves costs of advisor US$687 Million (Rp5.83 Trillion) and payment to three local investment company US$ 773 Million (Rp6.57 Trillion). Those funds are found to be used to cover investment losses in the past. It looks very suspicious when a few months later, payments to three local investment company were removed from the book. (finance.detik.com: 2011, accessed on March, 15th 2017)

In July 2015, also revealed cases of fraudulent financial statements in the one of a largest electronics company, Toshiba. Toshiba has been proven to increase their profits by US$1.22 Billion in five years. Fraud case experienced by Toshiba impact on the resignation of the company's CEO. (Tessa and Harto, 2016)

From several fraud cases above, it found that fraud occurs because management wants to cover up the real condition of their company. It is driven by the pressure to show a good financial statement to the potential investors. The occurrence of fraud is also due to the lack of supervision to the parties who have high authority in the company, thus it increases the opportunity in committing fraud. Lack of employees' ethics and the weak punishment imposed on offenders also increase the likelihood of financial statements fraud.

Fraud behavior in the presentation of financial statements is an important concern, so if this action can be detected and eliminated, financial statements will be trusted by the stakeholders. Moreover, the auditor will be able to improve the audit quality. Cressey (1953, in Skousen et al., 2008) proposed a concept of fraud triangle as an illustration depicting fraud risk factors. Fraud triangle concept was introduced in the professional literature on the Statement on Auditing Standards (SAS) 99, Consideration of Fraud in A Financial Statement Audit. In the fraud triangle concept, it mentions three common conditions that lead to fraud, namely pressure/motive, opportunity, and attitude/rationalization (Turner et al., 2003). According to the Cressey's theory, pressure/motive, opportunity, and attitude/rationalization are always present in a fraud situation. Analysis using the fraud triangle in detecting fraudulent financial statements had previously been done by Cressey (1953), Turner et al., (2003), Lou and Wang (2009), Skousen et al., (2009), Kurniawati (2012), and Hassan and Naser (2013).

Rezaee (2002) stated that the existence of fraudulent financial statements is closely related to earnings management action. Fraud is often preceded by a misstatement or earnings management in the quarter report which is not considered as material, eventually grew into a report which is certainly misleading and valued as material.

The reason for why the banking sub-sector is used as the research object is based on the report of the Association of Certified Fraud Examiner (ACFE) in 2014 which indicates the fact that the financial and banking sector is a sector that experienced the largest cases of fraud than other sectors. This also proved by the rise of fraud cases in the fields of finance and banking in Indonesia. Based on this background, the study entitled:

"Analysis of Fraud Triangle in Detecting Fraudulent Financial Statements (Empirical Study of Banking Industry in Indonesia Stock Exchange)"

1.2 Problem Statements

Referring to the background that has been presented above, the formulation of the problem which will be presented in this study are:

1. Is pressure able to be used to detect fraudulent financial statements?
2. Is opportunity able to be used to detect fraudulent financial statements?
3. Is rationalization able to be used to detect fraudulent financial statements?
4. Do pressure, opportunity, and rationalization simultaneously affect the occurrence of fraudulent financial statements?

1.3 Research Objectives and Benefits

1.3.1 Research Objectives

According to the problem statements that will be discussed in this research, the objectives of this research are:

1. To determine whether pressure can be used to detect fraudulent financial statements.
2. To determine whether opportunity can be used to detect fraudulent financial statements.
3. To determine whether rationalization can be used to detect fraudulent financial statements.
4. To determine whether pressure, opportunity, and rationalization simultaneously affect the occurrence of fraudulent financial statements.

1.3.2 Research Benefits

1. Theoretical benefit

   Provides additional reference in the field of auditing in the development of research on fraudulent financial statements in Indonesia and provide an overview of the effect of pressure, opportunity, and rationalization to fraudulent financial statements.

2. Practical benefit

   The results of this study are expected to give practical contribution and benefit to the public accounting firm to be able to provide better audit services and provide added value to the company as the owner of financial statements and to the public as the users of financial statements.

1.4 Writing Systematic

Chapter I is an introduction part which discusses the background, problem statements, research objectives, research benefits and writing systematic. Chapter II consists of the theoretical framework. This chapter discusses about theoretical basis used, the results of previous studies, framework, and the development of research hypothesis. Chapter III consists of research methodology. In this chapter discusses methods of research that includes definition and measurement of variables, population and sample, types and source of data, methods of data collection, and data analysis methods. Chapter IV consists of the data analysis. This part will discuss the research objects, data analysis, and interpretation of test results performed on the data obtained. And the last, chapter V is closing. This chapter provides conclusion and limitation of research also suggestion for the next research.