

## **CHAPTER 1**

### **INTRODUCTION**

#### **1.1 Research Background**

At first glance, financial statements may appear straightforward in their presentation. However, the critical information they contain encourages managers to enhance company performance in order to sustain the organization's continuity. These statements serve as documentation of a company's financial data compiled within a specific accounting period, offering a comprehensive overview of its financial condition, particularly in monetary aspects. They disclose essential insights into the company's financial standing, reflect its past performance, and illustrate cash flow activities that are valuable for stakeholders and other interested parties..

Financial statements are documents that contain comprehensive information related to an entity's financial condition, which include the Balance Sheet, Income Statement, Cash Flow Statement, Statement of Changes in Equity, and Notes to the Financial Statements. The primary function of these reports is to present financial data that reflect the overall financial status of the entity. The preparation of financial statements must comply with the Financial Accounting Standards (SAK) established by the Indonesian Accounting Association (IAI). A quality financial statement is one that presents information in a clear and understandable manner for users, covering aspects such as entity description, company performance, and all operational activities within the organization.

When a company issues its financial statements, its goal is to showcase its position and condition in the most positive light (Skousen et al., 2008). However, the presence of a significant error in the report can make the information inaccurate and unsuitable for informed decision-making, as it does not represent the true circumstances. As a result, the data might not be useful to certain stakeholders, leading to a lack of transparency and possible disadvantage to others. This situation introduces a risk that may continue to have implications in the future.

For this reason, financial statements should be prepared with transparency, accuracy, and free from errors. Nonetheless, fraudulent practices in financial reporting continue to occur frequently. According to the 2020 Report to the Nations on Occupational Fraud and Abuse by the Association of Certified Fraud Examiners (ACFE), fraud involving financial statements accounts for approximately 10% of all fraud incidents and results in the greatest financial losses. Additionally, the 2019 ACFE Indonesia survey shows that financial reports are the main source for uncovering fraudulent acts, representing 38.9% of detected cases, compared to just 9.6% discovered through external audits. These statistics highlight the urgent need for stakeholders to utilize effective fraud detection strategies to improve the quality of financial decision-making.

Cases of fraud scandals in recent years have increasingly highlighted the failure of audits, resulting in significant consequences for the business world. Fraud itself is a deliberate act of deception carried out by irresponsible individuals, and it constitutes a violation of the law. Such actions can be

committed by parties from within or outside the organization. In this context, the auditor has the responsibility to trace how the fraud was perpetrated and identify those involved.

One of the most notorious fraud scandals remembered globally is the accounting manipulation carried out by the American energy company, Enron. Based in Houston, Texas, Enron Corporation was founded in 1985 and eventually ceased operations in 2007. The company engaged in unethical practices such as falsifying revenue reports and altering balance sheets to create the illusion of strong financial performance. As a result of these deceptive acts, Enron's share price, which had once soared to US\$ 90.56, plummeted to below US\$ 1 following the exposure of the scandal. This collapse led to shareholder losses estimated at US\$ 11 billion, or around Rp 159.5 trillion (at an exchange rate of Rp 14,500/US\$), marking the largest bankruptcy case of that period. Furthermore, the scandal also brought about the downfall of Enron's accounting firm, Arthur Andersen LLP one of the then 'Big Five' alongside PwC, Deloitte, EY, and KPMG which admitted to criminal misconduct and subsequently surrendered its license to practice.

In Indonesia, various fraud cases have also surfaced. One notable case involved PT Envy Technologies Indonesia Tbk (ENVY), a technology services and trading company, which was embroiled in allegations related to its 2019 financial statements. The incident raised concerns on the Indonesia Stock Exchange (IDX), especially as it occurred during a period when emissions were gaining momentum again. Another case, although not involving a publicly listed

company, affected PT Kereta Api Indonesia (KAI), a state-owned enterprise that had issued bonds on the Indonesian capital market. This case dates back to 2006 and involved the manipulation of the previous year's financial reports. The company reported a profit of Rp 6.9 billion, whereas it actually suffered a loss of Rp 63 billion highlighting a significant misrepresentation in the financial statements.

The case came to public attention when one of KAI's commissioners, Hekinus Manao, refused to approve the submission of the financial statements, causing the company's Annual General Meeting (AGM) to be postponed. In a statement to the Indonesian Institute of Accountants, Hekinus Manao identified three key issues in KAI's financial reports. First, the company had an obligation to pay value-added tax (VAT) amounting to Rp 95.2 billion, which was incorrectly reported as accounts receivable from several customers who had already paid the tax. Second, regarding inventory recorded in 2002, the losses were not immediately recognized but were instead amortized gradually over a five-year period. By the end of 2005, the remaining unrecognized losses were recorded as an expense of approximately Rp 6 billion.

The third issue involved government assistance amounting to Rp 674.5 billion and state capital investment of Rp 70 billion, which the management continued to present in the balance sheet as of December 31, 2005, as part of liabilities consistent with prior years—even though their status had not yet been definitively established. KAI's 2005 financial statements were audited by the Public Accounting Firm S. Mannan. In 2004, the audit was conducted jointly by

KAP S. Mannan and the Supreme Audit Board (BPK), while in previous years it was handled solely by BPK. This controversy was widely reported in the media, including by the state-run news agency, Antara. “I know that the financial report audited by the public accountant is incorrect, because although I’m not an accounting expert, I understand that a loss has been turned into a profit,” said Hekinus Manao, as quoted by Antara on July 26, 2006.

Considering the significance of fraud in financial reporting, this study aims to explore and examine the factors that contribute to fraudulent practices in financial statements. The researcher selected fraudulent financial reporting as the dependent variable, given the crucial role financial statements play in a company. The information presented in financial reports serves as a reflection of the company’s operations over a specific period. These reports also provide essential insights for investors, enabling them to evaluate and make informed investment decisions. Acknowledging the vital role of financial statements in building a positive corporate image, managers are driven to enhance company performance. To support this objective, the discussion in this study is grounded in established professional literature and relevant empirical research.

A study by Merrisa Yesiariani and Isti Rahayu (2016), which applied the Fraud Diamond theory to detect fraudulent financial reporting in LQ-45 companies listed on the Indonesia Stock Exchange, found that external pressure (LEV) and rationalization (TATA) had a significant positive influence on financial statement fraud. However, differing results were reported by Ni Komang Astri Y., I Made Sadha S., and I Putu Sudana (2019), who also analyzed

the factors influencing fraudulent financial reporting using the Fraud Diamond framework. Their findings indicated that pressure did not have a significant effect, suggesting that insider ownership does not necessarily drive management or executives to commit fraud. Similarly, capability was also found to be insignificant, implying that changes in the board of directors are not strong indicators of fraudulent activity. On the other hand, opportunity was shown to have a significant impact, highlighting its role as a key factor in the occurrence of financial statement fraud.

The findings indicate that the more opportunities management has, the greater the potential for fraudulent financial reporting within an organization. Rationalization also emerges as a significant factor influencing fraudulent behavior. The results underscore that management's ability to justify unethical actions is a crucial element in the occurrence of financial statement fraud. In particular, when management applies subjective judgment, especially in the use of accrual accounting principles, the risk of manipulation and fraud increases.

This study is grounded in the Fraud Diamond Theory, which expands upon the earlier Fraud Triangle Model. The Fraud Diamond introduces an important fourth element—capability. As stated by Wolfe and Hermanson (2004), fraud is unlikely to occur without an individual who has the capability to carry it out. This capability is influenced by a combination of organizational position, intelligence or creativity, and persuasive abilities. These traits collectively enhance an individual's capacity to exploit opportunities and commit fraudulent acts effectively.

For instance, an individual in a lower-level position may recognize an opportunity to engage in fraud, but cannot act on it while being monitored by an honest superior. In contrast, individuals in higher positions have greater authority and access, thus increasing their ability to identify and exploit opportunities for fraud.

Recent studies have increasingly examined the link between corruption and education level, which is reasonable, as committing fraud often requires both intelligence and creativity. Intelligence allows an individual to identify opportunities, while creativity enables them to exploit these opportunities and conceal their fraudulent actions. Persuasive ability, meanwhile, involves the capacity to manipulate, pressure, or deceive others to facilitate the fraudulent scheme. Possessing even one of these traits can enable a person to engage in corrupt behavior.

Based on the explanation above, the researcher is interested in conducting research with the title ***"FRAUD DETECTION IN COMPANY FINANCIAL STATEMENTS USING DIAMONDS FRAUD THEORY (Case Study: Companies In The Infrastructure Sector Listed on The Indonesia Stock Exchange For The Period 2018 to 2024)"***

## **1.2 Problem Statement**

Based on the background described above, the formulation of the problem in this study is:

1. How does financial stability affect fraudulent financial statements?
2. What is the effect of external pressure on fraudulent financial reporting?

3. What is the effect of financial targets on fraudulent financial reporting?
4. How does the nature of industry influence fraudulent financial statements?
5. What is the effect of rationalization on fraudulent financial statements?
6. How does Capability affect fraudulent financial reporting?

### **1.3 Objective of the Research**

This research wants to achieve several objectives, namely:

1. To determine the effect of financial stability on fraudulent financial statements.
2. To determine the effect of external pressure on fraudulent financial statements.
3. To determine the effect of financial targets on fraudulent financial statements.
4. To determine the effect of the nature of industry on fraudulent financial statements.
5. To determine the effect of Rationalization on fraudulent financial statements.
6. To determine the effect of Capability on fraudulent financial statements.

### **1.4 Contribution of the Research**

This research is expected to provide benefits, as follows:

1. For Researchers

This research is a place to apply the theory that has been learned and obtained during the lecture period as well as additional insight into the effect



of the diamond fraud theory on fraudulent financial statements.

2. For Investors

It is hoped that this research can be a reference in consideration for making investment decisions in companies.

3. For the Company

It is hoped that this research can be used by interested parties or stakeholders as a reference in detecting potential fraud in financial statements in companies.

4. For Further Researchers

It is hoped that this research can help and become a reference in further studies related to fraud in financial statements as well as further study.

## **1.5 Scope of the Research**

The scope of this study focuses on examining the influence of the Fraud Diamond Theory, which includes four main variables: pressure (measured through financial stability, personal financial need, external pressure, and financial targets), opportunity (reflected in the nature of the industry and effectiveness of monitoring), rationalization (assessed through indicators such as rationalization, auditor changes, and audit opinion), and capability. These variables are analyzed in relation to fraudulent financial reporting in infrastructure sector companies listed on the Indonesia Stock Exchange during the period 2018 to 2021.

## **1.6 Systematic Writing**

The writing of this thesis is divided into 5 chapters with the following systematic writing:

## **CHAPTER 1 INTRODUCTION**

This chapter outlines the problem background, the formulation of the problem, the objectives of the research, the significance of the study, and the structure of the writing.

## **CHAPTER 2: LITERATURE REVIEW**

This chapter presents a review of prior studies, the theoretical framework relevant to the research, the formulation of hypotheses, and the development of the analytical model..

## **CHAPTER 3: RESEARCH METHODS**

This chapter explores the research design; identification of variables, their operational definitions, and measurement methods; the types and sources of data; data collection techniques; the population, sample, and sampling methods; as well as the techniques used for data analysis..

## **CHAPTER 4: ANALYSIS AND DISCUSSION**

This chapter explains the profile of the research object, presents the data, analyzes the findings, and discusses the results of the study.

## **CHAPTER 5: CONCLUSION**

This chapter contains the conclusions of the research results, limitations of the study, and suggestions that are useful for further research.