

CHAPTER I

INTRODUCTION

1.1 Research Background

Financial statements are a tool used by stakeholders to measure the performance of a company in which there is a variety of information relating to the company's financial condition, such as the financial position statement, income statement, cash flow statement that can be used by company managers and investors to make economic decisions (Indonesian Institute of Accountants, 2009). For most users of financial reports, financial statements are useful for making strategic decisions, as well as a form of accountability from the company's management for the use of resources or capital entrusted by investors to management. So it can be concluded that the financial statements are a communication tool that contains information about the financial condition of a company that is used by stakeholders as a benchmark in making strategic decisions in the future.

Information can be said to be good if it meets several criteria, including relevant, complete, reliable, easy to understand, can be verified, and can be accessed (Romney and Steinbart, 2015). Therefore, the management of the company responsible for corporate financial reporting must be able to meet these criteria so that it can be used as a benchmark in deciding strategic decisions for the company. However, there are still many companies that present financial statements that do not meet these criteria because of the existence of fraudulent practices within the

company. Financial statements are representative of the financial health condition of a company, so that management often takes illegal actions such as manipulating financial statements to make the company looks good to stakeholders, of course, this violates accounting principles (Trisnaningsih, 2019).

Fraudulent financial reporting is a form of business that is usually deliberately carried out by unscrupulous management in a company to fool, even mislead the users and readers of the financial statements. The fraudsters present by manipulating the material value of the financial statements, this is due to the interest of the company so that the financial sector is always in a condition that looks attractive in the eyes of users of financial statements (Kurnia and Anis, 2017). Fraudulent financial statements can be related to several schemes such as falsification, intentional misinterpretation and wrong execution of accounting standards in the application of principles. Therefore, any kind of frauds activity within the company will create a bad image that reduces the value of the company and make the company lose the trust of related parties (Rezaee, 2005).

Based on a survey conducted by ACFE (Association of Certified Fraud Examiners) in 2016, the most detrimental fraud in Indonesia was fraudulent financial statements. This is allegedly due to the many cases of financial statement fraud that have not been revealed to the public. One case of fraud that was revealed to the public is a case from PT. Tiga Pilar Sejahtera Food (AISA.IJ). AISA is a multinational company that specializes in food and has a head office located in Jakarta. AISA did double bookkeeping and window dressing in preparing the 2017 financial statements based on the evidence found by Ernst and Young. Another case related to a fraudulent

financial statement is Garuda Indonesia in 2018, PT Garuda Indonesia (GIAA.IJ) Tbk claims to have recorded brilliant financial performance in 2018, with a net profit of US \$ 809 thousand or around Rp. 11.33 billion. However, two company commissioners refused to sign the financial statements because they suspected that there were irregularities in recording transactions to polish the 2018 annual financial statements. (Simamora, 2019)

The auditor has an important role to reduce the occurrence of fraud to detect any possible fraud that will occur in a company. American Institute of Certified Public Accounts (AICPA) issued Statement of Auditing Standard (SAS) No. 99 about Consideration of Fraud in an Audit Financial Statement in 2002. The purpose of the issuance of these standards is to improve the effectiveness of the auditor in detecting fraud by judging on risk factors based on the theoretical explanation by Cressey (1953), known as the fraud triangle theory. There are three conditions in fraudulent financial statements by fraud triangle theory, i.e. pressure, opportunity and rationalization. Next, Wolfe and Hermanson (2004) state that a fraud triangle can be developed in order prevent and detect fraud by adding one element, namely the ability (competence), known as fraud diamond theory, they believed that fraud can occur by having more capabilities possessed by management. The most recent development of fraud theory was proposed by Crowe Howart in 2011 by adding arrogance as one of the elements of Fraud Pentagon Theory.

Pentagon fraud theory consists of five factors. The first factor in pentagon fraud is pressure. Pressure is a condition that makes perpetrators commit fraud, there is motivation in management to commit fraud (Aprilia, 2017). In this study, the pressure

was measured using financial stability (ACHANGE) and external pressure (LEV). The second factor is opportunity. Opportunities to cheat financial statements will arise if supervision in the company's operational activities is inadequate. Opportunities in this study were measured by external auditor quality (EXTAUD). The third factor is the rationalization. Parties who commit financial statement fraud tend to justify the deviant behaviour committed. Rationalization can be represented by a change in auditor (AUDCHANGE). The fourth factor is ability. Ability is a competency or ability possessed by someone to commit fraud (Aprilia, 2017). Ability can be measured by a change in director (DCHANGE). The fifth factor is arrogance. Arrogance is the nature of superiority over the rights held and feels that internal control and company policies do not apply to him (Crowe Howart, 2011). Arrogance can be measured by the frequent number of CEO's picture in the company's annual report.

Research related to pentagon fraud has been carried out by several researchers, for example by research conducted by Taufiq Akbar (2017) the empirical evidence suggests that the factor which can lead to fraudulent financial reporting is the pressure. While other indicators such as opportunity, rationalization, capability and arrogance are not elements that can be used to measure the occurrence of fraudulent financial reporting. Ulfah, Nuraina, and Wijaya (2017) on their research found that change in auditor and auditor's opinion as an indicator of the rationalization has a significant positive effect on a fraudulent financial statement, and others such as Financial Target, Financial Stability, External Pressure, Institutional Ownership, Ineffective Monitoring, Quality of Auditor, Change in Director and the Frequent number of CEO pic has no significant impact on a fraudulent financial statement. Silvia Maulidina and

Triandi (2019) found that pressure and rationalization have a significant effect on a fraudulent financial statement. While others opportunity, competency, and arrogance have no significant effect on a fraudulent financial statement. Evy Rahman Utami and Nandya Octanti Pusparini (2019) the study provides results that five variables significantly influence the fraudulent financial statement, including quality of external auditors, changes in auditor, changes in director, financial distress, and the frequent number of CEO pictures. Trisnaningsih (2019) found that only Ineffective Monitoring has a significant impact on the fraudulent financial statement. Leverage, Change in auditor, change in director and frequent number of CEO have no impact on a fraudulent financial statement. Each previous researcher found different results each other, it makes this research would be interesting to conduct.

The inconsistency of the results in previous research is the reason for the author to conduct this research. In this research, the samples used in this study are consumer goods companies that listed on IDX during 2017-2019. Consumer Goods industry is chosen as object research for this research because consumer goods company tend to have third-party touchpoints such as suppliers, transporters, stockiest, distributors that can significantly increase the risk of collusive frauds that are difficult to detect. Based on Deloitte report (2015), consumer goods also had most experiences theft of goods, bribery and corruption

The author uses F-score model in measuring financial statement fraud because the F-Score is considered more effective and recommended as a first-pass screening for auditors in detecting material misstatement in the company's financial statements (Sukrisnadi, 2010). Then the author adds indicator for arrogance as independent

variables namely CEO duality and use of Partial Least Square (PLS) to analyze the data through software warppls, PLS is a powerful analytical method because it is not based on many assumptions (Wold, 1985)

Based on the explanation above that fraud practices can materially harm many parties and loss of trust for potential investors, the study should be conducted to find out the effect of the fraud pentagon theory on fraudulent financial statements. This research can become a reference for related parties in monitoring the performance of company management.

1.2 Problem Statements

Based on the research background, then the problem to be studied in this research are:

1. Does pressure influence the fraudulent financial statement?
2. Does Opportunity influence fraudulent financial statement?
3. Does rationalization influence fraudulent financial statement?
4. Does competency influence fraudulent financial statement?
5. Does arrogance influence fraudulent financial statement?

1.3 Research Objectives

This study aims to understand the influence of fraud pentagon theory in detecting fraudulent financial reporting. The researcher states the objectives of this research as follows:

1. To determine the influence of the pressure variable on fraudulent financial statement
2. To determine the influence of opportunity variable on fraudulent financial statement
3. To determine the influence of rationalization variable on fraudulent financial statement
4. To determine the influence of competency variable on fraudulent financial statement
5. To determine the influence of arrogance variable on fraudulent financial statement

1.4 Research Benefits

This study benefits several parties such as:

1. To research academics

This research is expected to be able to contribute to developing theory in the field of auditing

2. To company

This research is expected to be able to contribute to making policies related to the prevention of fraudulent financial statement

3. To CPA firms

This research is expected to be input and consideration in taking actions related to the prevention of fraud on financial statements

4. To stakeholders

This research provides information for users of financial statements to understand the factors that cause fraud so as not to make mistakes in decision making

1.5 Writing Systematic

Writing this research will be divided into 5 chapters, they will be prepared as follows:

1. Chapter I, introduction, discusses the general description that becomes research. It consists of background, problem statement, research objectives, research benefits, and writing systematically.
2. Chapter II, literature review, discusses the theory and previous study relate to the research problem. This is helpful as think base to solve the problem.
3. Chapter III, research methodology, provides an overview of a plan for doing the research. Along with theories from the literature review, this chapter will encompass the research. This chapter includes the type of research, types and source of data, and analysis method.
4. Chapter IV, analysis and discussion, contains data, processing result based on research methodology.

5. Chapter V, Conclusion and Suggestion, contains a conclusion about research result. It also contains implication and limitation for future research.

