CHAPTER I

INTRODUCTION

1.1 Research Background

Nowadays, both public and private banking institutions have become trusted entities for the public, providing transaction such as deposit, and investment services. They play a crucial role in the global economy by offering vital financial services and upholding public trust. However, these institutions are not immune to the occurrence of fraudulent financial reporting, which can have serve implications for stakeholders, the economy, and overall social welfare. Financial reports serve as a critical means of communication between management and various parties seeking information from these reports. The primary purpose of financial reports is to provide information regarding an entity's financial position, financial performance, and cash flows. This information is utilized by a diverse range of report users who make economic decisions that drive the growth and development of companies (Alvionika & Meiranto, 2021).

Financial reports show the condition of the entity financially and serve as a means of communication between the company's financial data and interested parties who need the company's financial data. However, this company's encouragement to present financial reports as well as possible. Therefore, it supposed to be look "good" in front of stakeholders to create a good image for the company, many companies still present financial reports that do not match based on accounting policies that have been applied. When a public company publishes its financial report, the company wants to describe the situation and conditions in the best condition.

It states in the Guidelines of Pernyataan Standar Akuntansi Keuangan (PSAK) No. 1 regarding the purpose of financial reports, which to provide financial information of entities useful to most users of financial statements in making economic decisions. However, the performance results in the financial statements are more aimed at getting a "good" impression from various parties. The motivational drive forces the company to commit fraudulent practices by manipulation in the company's annual report section. Fraudulent financial reports cause many losses, especially for investors. It because the financial statements do not represent the actual conditions of the company and it also affect decisions taken by users of financial statements to be undetermined and results in failure to get the capital gains that have determined.

The company's motive for committing fraud is to show a good financial statement, even though the actual financial performance is against the actual existing company position and it encourages and forces companies to manipulate certain parts of their annual report (Hidayah & Saptarini, 2019). Fraud in financial statements causes many parties to feel disadvantaged, especially investors. It also affects due to the financial statements do not reflected the actual conditions that should occur in the company, then the decisions taken by users of financial statements become irrational and have an impact on the failure to get the expected return. Fraud in financial statement has two types, first in accounting cycle, called errors that can occur due to mistakes, misinterpretations, or negligence in recording financial transactions. These errors are unintentional and can be corrected through appropriate accounting adjustments. However, when there is an intentional act to deceive or manipulate financial information for personal gain or to mislead stakeholders, it is considered fraud that performed cause of management intentions. Second, earnings management that refers to the intentional manipulation of a company's financial results to portray a more favorable picture than the actual performance. This is often done to meet financial targets, boost stock prices, or hide financial troubles. Earnings management is a form of financial statement fraud and can involve practices such as aggressive revenue recognition, manipulating expenses, and improperly adjusting reserves. Third, corruption, involves the misuse of power or position for personal gain or to benefit others at the expense of the organization. In the context of accounting, corruption can manifest as bribery, kickbacks, embezzlement, or other illicit activities aimed at diverting funds or resources for personal enrichment. Both earnings management and corruption involve intentional actions by top management or individuals within the organization. These acts are considered serious ethical and legal violations and can lead to severe consequences, such as financial penalties, legal actions, damage to the company's reputation, and potential imprisonment for those involved. The top management will committed fraudulent financial reporting to perform earning management and corruption which poses a major threat to the stability and integrity of the banking sector. As an important pillar of the global economy, the credibility of the banking industry depends on accurate and transparent financial information.

The well-known case of fraudulent financial reporting is a company from the technology sector. In July 2015, a case of fraudulent financial reporting was revealed by the world's technology giant, Toshiba Corporation. Toshiba has inflated profits worth USD 1.22 billion in five years. The fraud case that Toshiba experienced had an impact on the resignation of the Toshiba CEO (Harto, 2016).

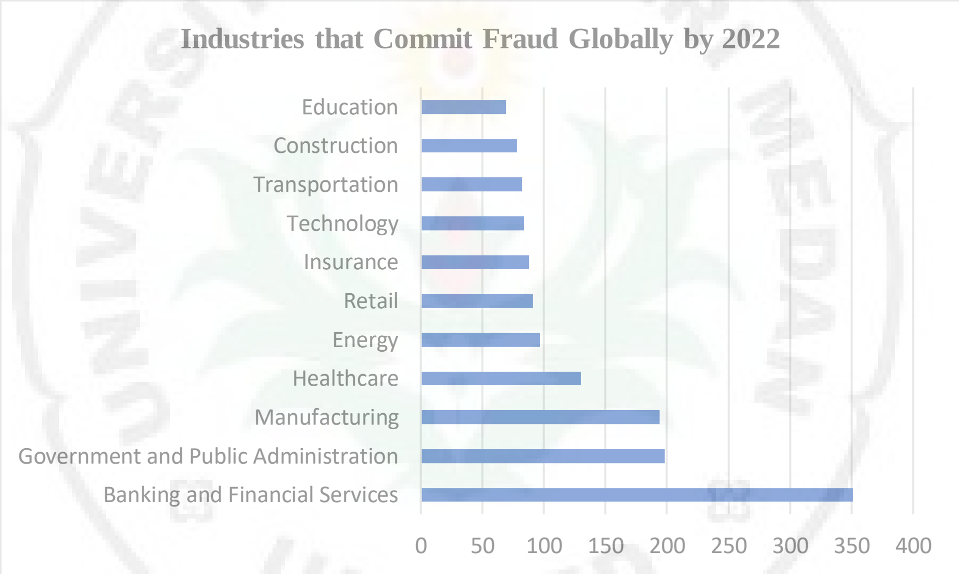

Figure 1.1
Industries That Commit Fraud
Source: Association of Certified Fraud Examiner (2022) Report to Nation

The results of a survey by the Association of Certified Fraud Examiners to Nation Report (ACFE, 2022) about 351 cases of financial statement fraud occurred in companies banking and financial services sector, which the total is higher than the average case of financial statement fraud that occurs in various industrial fields. In addition, fraud was committed by individuals with employee positions at 61%, including owners, executives, and managers. Furthermore, the department that most committed fraud came from operations with 15%, accounting 12%, upper management 11%, and sales 11%. It also illustrates that the banking and financial services industry has a considerable risk of fraud cases occurring in financial statements.

The significant rise in reported financial frauds and subsequent instances of business failures have raised doubts about the credibility and authenticity of corporate financial statements. Many cases have occurred regarding fraudulent financial statements engaged in Indonesia’s banking industry. One of the banking fraud cases occurred PT. Maybank Indonesia Tbk. perpetrator by the Head of the Cipulir Branch by stealing Rp. 22 billion in money by falsifying customer belonging to Winda Lunardi data and then withdrawing funds and transferring them to colleagues without the customer's knowledge. This happened due to weak internal controls in banking companies so that criminal loopholes in banking still occur today (Finance.detik.com accessed February, 23 2023).

Fraudulent financial reporting is one of the problem that cannot be taken easily. Fraud always occurs from year to year. In this case, the audit profession is necessary to detect early the possibility of fraud and the possibility of a prolonged scandal. The auditor must be able to consider the possibility of fraud from different perspectives. The complexity and sophistication of fraudulent financial reporting schemes have evolved over time, making it increasingly challenging for regulators, auditors, and other stakeholders to detect and prevent such fraud. Fraudsters often employ creative techniques to manipulate financial statements, such as inflating revenues, understating expenses, fabricating transactions, or hiding liabilities, to present a favorable financial picture.

Another fraud case occurred at Bank Bukopin that where it revised its financial statements for the last three years, namely in 2015, 2016, and 2017. OJK, as an Indonesian financial authority, monitored that activity and audited Bank Bukopin. Bank Bukopin is suspected of committing fraud in handling 100,000 credit cards. The credit balance and commission income generated from these transactions do not match the growth. In 2016, Bank Bukopin manipulated and changed its net profit from IDR 1.08 trillion to IDR 183.56 billion. The financing of a subsidiary of Bank Syariah Bukopin refer to the allowance for impairment losses on debtors was also revised, which resulted in the allowance for impairment losses on assets increasing from Rp 649.09 billion to Rp 797.65 billion and the company's expenses increasing from Rp 148.6 billion. Bank Bukopin had been "punished" for this incident before the authorities clarified. The amount of equity held at the end of 2016 was from IDR 9.53 trillion to IDR 5.52 trillion because the profit previously presented needed to be corrected. This decline in equity contributed to Bukopin's capital adequacy ratio (CAR) (detik.com accessed February, 23 2023 2018).

Banking fraud case also occurred at Bank BPR KS BAS, which the financial services authority (OJK) has investigated. The Director and a shareholder carried out this case and started when BPR employees were commanded to process the granting of credit to 54 debtors with a total value of IDR. 24.225 billion from March 2014 to December 2014. The process was not in accordance, false records and not carrying out the necessary steps to ensure the Bank's compliance with banking regulations. This shows the weakness of internal control, management reviews of existing branches in the banking sector and more supervision is needed so that high level management does not commit acts of fraud.

According to those cases, a stigma emerged from investors, namely the existence of fraud in a company's financial reporting resulting in a loss of investor confidence. Therefore, management uses methods to manipulate the company's financial reporting to make investors continually invest. Fraudulent behavior is carried out intentionally by management to trick clients through financial reports against investors and creditors by manipulating several items in the financial statements. Efforts to detect fraud that occurs in financial statements were developed by Crowe Horwath (2011), adding an arrogance element used to complement the fraud diamond theory, such as pressure, opportunity, rationalization, and capability.

Prior studies try to show a relationship between pentagon fraud in detecting fraud. However, there are still differences in the research results, and there are inconsistencies in the results such as Samirah et al (2022), Sidauruk et al., (2022), and Jaunanda et al., (2020). The majority of these empirical studies were performed using pentagon fraud in detecting fraudulent financial reporting. In his research, several independent variables are used in detecting fraudulent financial reporting, such as personal financial need, ineffective monitoring, change in auditor, change in director, and a frequent number of CEO pictures.

According to Dian Wahyuni et al., (2022) it explained the personal financial need of the pressure component. Personal financial need is a condition where the company's finances are influenced by the number of shares owned by managers. The huge number of shareholdings by insiders, the greater the possibility of manipulation of financial statements. Executive share ownership in the company makes them feel they have claim rights on its income and assets. Ineffective monitoring is a condition where the supervisory level is weak in monitoring a company's performance. Change in auditor is a management rationalization which is a justification proving the presence of indications of fraud. Change in director is a group of capabilities that prove how much a party can commit fraud. A frequent number of CEO pictures is a new group put forward by Horwath, namely in the form of arrogance, as evidenced by the frequency of CEO photos appearing in the annual report, which symbolizes existence and arrogance.

In a more detail, previous research it was found out that:

1. Ayuningtyas et al., (2021) his research showed that the personal financial need variable did not affect the presence of fraud in financial statements. Meanwhile, the study conducted by Nur Fajri, (2018) found that personal financial need affects the detecting fraudulent financial reporting
2. Alvionika and Meiranto (2021) his research showed that the ineffective monitoring variable does not affect the presence of fraud in financial reports, but several other variables can prove fraudulent financial reporting.
3. Prischayani (2019) in his research, it shows that the change in auditor variable does not affect the presence of fraud in financial reports, while the research conducted by Rusmana and Tanjung (2020) shows that change in auditors affects detecting fraudulent financial reporting.

4. Warsidi and Bambang Agus Pramuka (2018) in his research, it shows that the change in the director variable does not affect the existence of fraud in financial reports, while the research conducted by Rusmana and Tanjung (2020) shows that change in directors affects fraud in financial reports
5. Prischayani (2019) in his research shows that the frequent number of CEO picture variables does not affect fraudulent financial reporting. In contrast Harto (2016) shows that the frequent number of CEO pictures affects fraud in financial reports due to the arrogant nature of corporate executives.

The findings of prior research have shown inconsistent results, and instances of fraudulent financial reporting persist, particularly within the banking sector. Given this, the author believes it is necessary to undertake a new study in order to establish whether a set of pentagon fraud components, as determined by the author and represented by proxies, can indeed impact the probability of fraudulent financial reporting. This study will utilize different years and variables to provide further evidence on the subject.

The fraud pentagon theory, originally developed by Crowe, encompasses five key elements: pressure, opportunity, rationalization, competence, and arrogance. To conduct research on these elements, proxies for each variable are required. For instance, personal financial need serves as a proxy for measuring pressure, while ineffective monitoring represents a proxy for measuring opportunity. Change in auditors is used as a proxy for measuring rationalization, directors reform for competence, and the frequency of CEO pictures for arrogance. These five factors are believed to act as driving forces behind the increase in fraud, particularly in recent years. The constant pressure on companies to present themselves favorably to attract investors can lead them to engage in illegal activities, such as committing fraud.

The pentagon fraud model is the newest one that has been recognized internationally and examined by many researchers. The previous model, namely fraud diamond that only used four elements. Crowe Horwath developed a new element, namely arrogance, which can detect management tendencies to commit fraud. Meanwhile, hexagon fraud uses a new element, namely collusion, the latest model of fraud after the pentagon fraud, which develops collusive elements in the form of the development of arrogant elements. However, this research is still new and has yet to be examined by many researchers. The latest elements have the same properties and types of elements development of arrogant elements.

This study will focus on the intentional of top management committed intention of fraudulent financial reporting and the calculation will uses earnings management to measure fraudulent financial reporting. The earning management is financial fraud or financial crime, as a result incorrect recognition of profits. Many practices such as income smoothing and big bath method are used to deceive certain related stakeholders firm's economic performance or affect the contractual output that depends on it report accounting financial numbers (Bilan and Jurickova, 2021).

Seeing the phenomenon, the researcher wants to do research again and interested with the title **"The Likelihood of Fraudulent Financial Reporting (Using The Fraud Pentagon Model on Indonesia’s Public Listed Banking Companies)".**

1.2 Problem Identifications

Based on the background states above, the researcher formulate the problem identification as follows:

1. Financial fraud occurs, namely misuse of information by individuals or groups (management) of companies to obtain personal gain.
2. Financial statement fraud tends to be due to pressure, opportunity, and rationalization by the perpetrator, but financial statement fraud can occur because the perpetrator has the capability and arrogance in him.
3. Fraud in financial reports occurs not only in state-owned companies but also in private companies with more independent oversight. However, this does not apply because the perpetrators of fraud that occur in every company require five conditions that cause fraud.
4. More detection tools are needed that can be used to detect fraudulent acts in financial reporting due to lack of internal controls and management review in banking industries especially at the branches

1.3 Scope of Research

Problem boundaries are essential, so the problem under this study is directed and avoids different interpretations. Therefore the author focuses on the problem of personal financial need, Ineffective Monitoring, change in external auditor, change in director, and frequent number of CEO pictures of banking companies listed on the Indonesia Stock Exchange for lately 2021 that report their finances in full and have been audited.

1.4 Research Questions

Based on the background above, the formulation of the problem to be examined in this study is as follows:

1. Does Personal Financial Need affect the detection of fraudulent financial reporting?
2. Does the ineffective monitoring variable affect the detection of fraudulent financial reporting?
3. Does the change in auditor variable affect fraudulent financial reporting?
4. Does the variable change of company directors affect fraudulent financial reporting?
5. Does the frequent number of CEO picture variables affect fraudulent financial reporting?

1.5 Research Objectives

The purpose of this study is to obtain empirical evidence regarding a relationship with the following variables:

1. To determine the effect of Personal Financial Need on Fraudulent Financial Reporting on banking companies listed on the Indonesia Stock Exchange in lately 2021
2. To determine the effect of Ineffective Monitoring on Fraudulent Financial Reporting on banking companies listed on the Indonesia Stock Exchange in lately 2021

3. To determine the effect of Auditor Change on Fraudulent Financial Reporting on banking companies listed on the Indonesia Stock Exchange in lately 2021
4. To determine the effect of the Change of Directors on Fraudulent Financial Reporting on banking companies listed on the Indonesia Stock Exchange in lately 2021.
5. To determine the effect of the Frequent Number of CEO Pictures on Fradulent Financial Reporting on banking companies registered on the Indonesia Stock Exchange in lately 2021.

1.6 Research Output

This study results are expected to benefit interested parties in predicting fraudulent financial reporting :

1. For author

   The objective is to acquire hands-on experience in the analysis of financial reports, gain valuable insights, effectively utilize the knowledge and expertise acquired during college to pursue a professional career in the fields of finance and this endeavor provides an opportunity to deeply engage with a critical area of business and finance, contributing to the broader understanding of organizational integrity and financial security. Through comprehensive research and analysis, the author can develop a profound expertise in auditing practices, fraud detection, and risk mitigation strategies, which are highly valued skills in the professional world. Moreover, a thesis focused on audit and fraud allows students to investigate real-world challenges faced by businesses, governments, and institutions in maintaining transparency and safeguarding their financial operations.

2. For academic

   The primary aim of this study is to serve as a scholarly reference, contributing to the advancement of scientific knowledge and providing significant value to students conducting further research at the Medan State University. Researching audit and fraud topics keeps academic institutions updated on the latest developments and challenges in the field. This relevance helps institutions tailor their curriculum and courses to meet industry demands and ensure that students are equipped with the latest knowledge and skills.

3. For practitioners

   This research can serve as a valuable resource to identify the factors that impact Fraudulent Financial Reporting. Students' research can offer practitioners benchmarks and standards that can be used to assess the effectiveness of their audit and fraud prevention measures. Comparing their practices against research findings can help practitioners identify areas for improvement. It provides valuable insights that can be utilized by practitioners to better understand and address such factors in their professional practices.