

CHAPTER I

INTRODUCTION

1.1 Research Background

Financial reports are a structured presentation of an entity's financial condition and performance with the goal of giving the majority of stakeholders information about the entity's financial position, financial performance, and cash flow that they may use to make economic decisions (Ikatan Akuntan Indonesia, 2017). Financial reports must, therefore, be timely, relevant, comparative, error-free, feasible to read, free from bias, and consistent. A publicly traded firm genuinely strives to present its situation and state of affairs in the best light when it releases its financial reports. Sometimes, management decides to conduct fraudulent actions to meet the high expectations of investors, stakeholders, and other financial report users. Thus, this action was known as fraud.

Fraud has become a significant problem globally. It is a deceptive and illegal act where an individual or entity intentionally misrepresents information in financial reports. According to an analysis by the Association of Certified Fraud Examiners (2020), 2,504 issues of occupational fraud from 125 countries were examined into between January 2018 and September 2019; these cases resulted in losses over \$3.6 billion. The least frequent but most expensive fraud is fraudulent financial reporting, which has a median loss of \$954,000, resulting in it being the most costly fraud overall (ACFE, 2020). AU Section 316 paragraph 06 emphasizes that the preparation of financial reports can be done by the manipulation, falsification, or alteration of accounting records or supporting documentation, all of which can lead to false

financial reporting. Intentional misuse of accounting rules in relation to numbers, categories, presentation styles, or disclosure can also indicate a fraud scheme.

Numerous instances of fraudulent financial reporting have surfaced, shocking the entire world. Enron, a US energy giant, collapsed in 2001 due to massive accounting fraud. Executives (Ken Lay and Jeff Skilling) hid debt and pressured auditors, leading to billions in losses for investors and employees. The scandal shocked the world and damaged the accounting industry. The accounting industry was severely hurt at the time by losses of US\$32 billion to investors and US\$1 billion to Enron employees. The corporation faces the most significant lawsuits in US history, totaling \$7.18 billion (Zakiy et al., 2022).

A similar case happened to the Japanese company, Toshiba in 2015. The scope of this accounting scam expanded from US\$1.2 billion in earnings manipulation by window-dressing method to US\$2 billion, or ¥224.8 billion, between 2008 and 2014. The exploitation of an accounting technique known as "percent-of-completion," a commonly utilized technique in long-drawn infrastructure projects (Rahman and Bremer, 2017).

One of the major accounting controversies that have ever happened in Indonesia is PT Hanson International Tbk. The financial report fraud controversy involving PT Hanson Internasional, Tbk, was made public by the OJK in 2019. PT Hanson International, Tbk, is suspected of using two cash flow shenanigan techniques to manipulate cash flow financial reporting in overstated cash flow and sales manipulation (Christian et al., 2023). The scandal affects multiple parties concurrently and causes harm to them. Administrative sanctions, in this case,

consist of fines of Rp500,000,000 for PT Hanson International, Tbk, and Rp5,000,000,000 for Benny Tjokrosaputro, the main director of the firm, as well as Rp100,000,000,000 for Adnan Tabrani, the director, and a one-year suspension of STTD afterward the issuance of a sanction letter to Sherly Jokom, the public accountant who conducted the audit of PT Hanson International, Tbk. (Otoritas Jasa Keuangan, 2019).

The most recent rising case comes from a state-owned enterprise engaged in cement production and sales, PT Semen Indonesia Tbk (SIG). In 2023, Badan Pemeriksa Keuangan (BPK), known as the Supreme Audit Agency of Indonesia, found indications of fraud in one of the SIG's subsidiaries, PT. Bima Sepaja Abadi (BSA). The fraud was considered to have occurred between 2018 and 2019, and the modus operandi included fictitious business cooperation, providing working capital to partners without due diligence, and disbursement of funds not by the agreement. The impact of the fraud was losses of IDR 90.52 billion to the state, damaging the company's reputation, and ultimately, penalties from the Financial Services Authority (OJK).

Three conditions have been listed by Cressey (1953) for financial statement fraud to occur. These three variables—pressure, opportunity, and rationalization—form the foundation of Cressey's fraud risk factors approach.

Wolfe & Hermanson (2004) began a development on the fraud theory called fraud diamond. According to Wolfe and Hermanson, capability is another factor that contribute to fraud. A person cannot commit fraud without the necessary aptitude and abilities. Without the right person in the right place with the right

qualifications, many frauds—especially some multibillion-dollar ones—would not have occurred. Fraud is made possible by opportunity, and a person may be drawn toward it by incentives and justifications. Nevertheless, the individual must possess the ability to see an open door as a chance and seize it by going through it again. (Wolfe and Hermanson, 2004).

In 2011, Crowe Horwath added an element to the fraud theory: arrogance. Horwath (2011) asserts that a person's arrogance may drive them to carry out fraud. Fraud can be encouraged by the superiority complex (arrogance). It can happen when someone feels that firm policies don't apply to them because they have authority, connections, or a position that gives them that impression. As evidenced by ACFE Indonesia (2022), more of these perpetrators are in positions of higher authority, such as owners or executives.

Jeff Skilling, Kenneth Lay, Bernard Ebbers, Richard Fuld, and Dennis Kozlowski are some of the big names from the world's most shocking accounting cases, and they were in the top positions (CEO) when the fraud occurred. The arrogance of a company's CEO could create a company culture that is tolerant of fraud and ethical violations (Toscano et al., 2018). One characteristic of corrupt organizations is arrogance as demonstrated by Enron and Lehman Brothers (Johnson et al., 2010), where "leaders of the arrogant corporation substitute the goal of self-glorification for the goals of honest dealing and carrying out the actual work of creating quality items for their clients and turning a return for their investors." (Levine, 2005). The CEOs above underestimated and ignored signs of accounting fraud committed by the company and even refused to admit that there was

accounting fraud even though there was strong evidence. The arrogance of the CEO can make employees reluctant to report or question unethical practices. The arrogance of the CEO can also make the company more vulnerable to financial and reputational crises. Arrogance can also allow cheating to grow.

In general, the Pentagon fraud's contributing aspects included warning signs before the fraud took place. Various research conducted in Indonesia on the use of the fraud pentagon model for fraud detection have varying results. According to Tessa and Harto (2016), the only factors that substantially impact identifying fraudulent financial reporting are pressure and arrogance. Second, Novitasari and Chariri (2018) conclude that rationalization and arrogance, two components of the fraud pentagon, significantly impact identifying false financial statements, while the frequency of false financial reporting was unaffected by the nature of the industry or inadequate supervision. Subsequently, Puspitha and Yasa (2018) determined that every component of the fraud pentagon model has a vital role in identifying fraudulent financial reporting.

The listed manufacturing companies in 2023 are the subject of this study due to the high prevalence of false financial reporting in Indonesian manufacturing sector. This study utilizes a moderating variable, which is the CEO's gender. A study by Hillard and Neidermeyer (2018) presents evidence that, globally, lower-level financial crimes see a higher proportion of female offenders compared to males. The study's findings indicate that professional positions held by women within the firms serve as barriers to their illegal activities. Since males continue to dominate higher-level jobs like CEO, especially in the manufacturing industry, which is

considered a male-dominated industry, and as a result, higher-level financial crimes, like falsifying financial statements, tend to have a higher prevalence of male offenders. Women in high-level corporate roles increase the likelihood that fraud will be found. Regarding business leadership roles, women are more dedicated to ethical principles and risk-averse than men.

This study will utilize the F-Score Model as a metrics tool. The F-Score model, according to Dechow et al. (2011), is a method for spotting fraud that takes the form of a likelihood scale, warning sign, or signal for the possibility of inaccurate statements. The F-Score model has consistently shown results in earlier research, outperforming the Beneish M-Score's capacity to spot or identify the fraud (Aghghaleh, 2016; Hugo, 2019; Hung et al., 2017). The findings of Skousen & Twedt's (2009) research indicate that the F-Score model may be used as a starting point to lower the risk of fraud before determining to invest in particular sectors.

Therefore, based on the aforementioned description, the researcher selected the research title: **“The Influence of Fraud Pentagon on The Likelihood of Fraudulent Financial Reporting on Indonesian’s Listed Manufacturing Companies with CEO’s Gender as The Moderating Variable”**.

1.2 Problem Identifications

Considering the given context on the background, the following issues with this research can be identified that:

1. The Association of Certified Fraud Examiners (ACFE) survey conducted between 2018 and 2022, results that fraudulent financial report is the most costly

fraud schemes among the other 2 schemes which are asset misappropriation and corruption.

2. The existence of fraudulent financial reporting controversies, especially in manufacturing companies, is undoubtedly detrimental to the country and society. Such cases can negatively impact investors and shareholders, lead to incorrect tax calculations that should be paid to the country, create instability in the local financial market, and undermine public trust in companies.
3. Previous research has inconsistent results regarding the five elements in the fraud pentagon regarding the detection of fraudulent financial report, which is why the researchers are willing to reexamine the coherence of the theory and findings of earlier studies. The five factors are pressure, opportunity, rationalization, competence/capability, and arrogance.
4. According to ACFE (2022) data, a significant number of fraudulent financial report controversies occurred under the authority of male executives. For this reason, the research might utilize the gender of the CEOs as a moderating variable to investigate whether or not the perpetrators' gender influences the median loss of fraud incidents.

1.3 Research Limitations

This research is limited to these following variables: fraud pentagon (which consist of pressure, opportunity, competence/capability, rationalization, and arrogance) and CEO's gender on Indonesia's Listed Manufacturing Companies over the period of 2023 after considering various factors including research period and researcher ability.

1.4 Research Problems

Based on the background of the problem mentioned above, the problems addressed in this research are as follows:

1. Does Pressure influence the fraudulent financial reports in Indonesian's listed manufacturing companies in 2023?
2. Does Opportunity influence the fraudulent financial reports in Indonesian's listed manufacturing companies in 2023?
3. Does Rationalization influence the fraudulent financial reports in Indonesian's listed manufacturing companies in 2023?
4. Does Competence/Capability influence the fraudulent financial reports in Indonesian's listed manufacturing companies in 2023?
5. Does Arrogance influence the fraudulent financial reports in Indonesian's listed manufacturing companies in 2023?
6. Do Pressure, Opportunity, Rationalization, Competence/Capability, and Arrogance simultaneously influence the fraudulent financial reports in Indonesian's listed manufacturing companies in 2023?
7. Does CEO's Gender moderate the influence of Fraud Pentagon on fraudulent financial reports in Indonesian's listed manufacturing companies in 2023?

1.5 Research Objectives

Based on the problem formulation above, the objectives of this research are as follows:

1. To examine the influence of Pressure on fraudulent financial reports in Indonesian's listed manufacturing companies in 2023.

2. To examine the influence of Opportunity on fraudulent financial reports in Indonesian's listed manufacturing companies in 2023.
3. To examine the influence of Rationalization on fraudulent financial reports in Indonesian's listed manufacturing companies in 2023.
4. To examine the influence of Competence/Capability on fraudulent financial reports in Indonesian's listed manufacturing companies in 2023.
5. To examine the influence of Arrogance on fraudulent financial reports in Indonesian's listed manufacturing companies in 2023.
6. To examine the influence of Pressure, Opportunity, Rationalization, Competence/Capability, and Arrogance simultaneously on fraudulent financial reports in Indonesian's listed manufacturing companies in 2023.
7. To examine the role of CEO's Gender in moderating the influence of Fraud Pentagon on fraudulent financial reports in Indonesian's listed manufacturing companies in 2023.

1.6 Research Significances

Based on the aforementioned research objectives, these are the following significances of this research:

1. Theoretical Significances

The research can serve as a valuable resource for accounting knowledge on fraud, particularly about fraudulent financial report in particular industries, mainly the listed manufacturing companies in 2023. It can also serve as a guide and point of reference for researchers comparing their findings to those of previous studies. In addition, the research may be taken into consideration by

those firms in the manufacturing sector when identifying, detecting, and preventing fraudulent activities.

2. Practical Significances

a. For companies

It is anticipated that this research will assist companies comprehend the potential of fraud in their financial reporting.

b. For researcher

This research is useful for researcher in adding insight regarding the influence of the fraud pentagon on detecting fraudulent financial reports in manufacturing companies listed on the IDX.

c. For future researchers

It is intended that this study will serve as a valuable resource for scholars/researchers in the future who may address related issues in their field.

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