CHAPTER I

INTRODUCTION

A. Research Background

The information in the financial statements has a crucial role in decision-making for internal and external stakeholders of a company (Gardi et al., 2021). Financial reports reflect the company's performance and provide a clear picture of the financial condition of a company (Shabbir & Wisdom, 2020). The challenge often faced in making financial reports is the pressure to keep the company's image in good condition, especially for companies that publish financial reports on the stock exchange. This factor often encourages fraudulent practices by manipulating data or information in financial statements. The desire to look good in the eyes of stakeholders can encourage unethical practices, such as manipulating numbers or recordings that do not match the actual condition of the company.

Fraudulent practices in falsifying financial statement information carried out by company management or individuals are not allowed because they will harm various parties. The Qur'an has explained the prohibition of committing fraud and must convey the mandate to those entitled to receive it entirely. The surah that conveys this command is Q.S An-Nisa 'verse 58, which reads:

اِنَّ اللّٰهَ يَأْمُرُكُمْ اَنْ تُؤَدُّوا الْاَمٰنٰتِ اِلٰٓى اَهْلِهَاۙ وَاِذَا حَكَمْتُمْ بَيْنَ النَّاسِ اَنْ تَحْكُمُوْا بِالْعَدْلِ ۗ اِنَّ اللّٰهَ نِعِمَّا
يَعِظُكُمْ بِهٖ ۗ اِنَّ اللّٰهَ كَانَ سَمِيْعًا ۢ بَصِيْرًا

Meaning:

“Indeed, Allah commands you to render trusts to whom they are due and when you judge between people to judge with justice. Excellent is that which Allah instructs you. Indeed, Allah is ever Hearing and Seeing.”

Islam firmly orders its people to do business between fellow human beings, namely with justice and pleasure, one form of which is to be honest in conveying the mandate to those entitled to receive it completely and according to the measure (Safuan et al., 2021).

The Association of Chartered Fraud Examiners (ACFE) defines fraud as intentional acts or omissions designed to deceive others, resulting in the victim suffering loss and/or the perpetrator gaining profit. Fraud is divided into three main categories, namely fraudulent financial statements, asset misappropriation, and corruption (ACFE, 2022). These practices result in financial losses for the company and can damage its reputation and reduce its ability to maintain its business continuity.

The Association of Certified Fraud Examiners (ACFE) states in Occupational Fraud 2022: A Report to the Nations that fraudulent financial reporting is the most considerable median loss of fraud, with a percentage of fraudulent financial reporting of 9% in 2022. The median loss caused by fraudulent financial reporting is around $593,000, followed by losses from corruption of $150,000 and misuse of assets of $100,000 (ACFE, 2022). This data indicates that fraudulent financial reporting is a fraud that needs serious attention due to the significant losses caused. The magnitude of fraudulent financial reporting losses is because this type of fraud involves making important decisions such as investments, bonds, lending, and others (Ozcelik, 2020).

Fraudulent financial reporting (FFR) activities have a negative impact on market value, company reputation, the credibility of the accounting profession, and loss of investor confidence in financial reports (Aripin et al., 2022). Fraudulent financial reporting is an action taken to cover up the company's financial condition (Fathmaningrum & Anggarani, 2021). Fraudulent financial reporting has been occurring for a considerable period of time.The many fraud cases in several countries evidence this. One of the biggest cases is the Enron Scandal in 2001, where this energy company kept large amounts of debt on its balance sheet, which resulted in shareholders losing $74 billion, thousands of employees and investors losing their retirement accounts, and many employees losing their jobs.

A recently uncovered case of financial statement fraud occurred in 2022. Civil engineering and infrastructure company Granite Construction from California, United States, was reported for financial reporting fraud violations committed by its former senior vice president, Dale Swanberg. The violations involved manipulating the profit margins of specific projects and under-recording their costs to avoid causing significant losses to investors. The Securities and Exchange Commission (SEC) fined the company $12 million for these financial violations (*SEC.gov | SEC Charges*

Infrastructure Company Granite Construction And Former Executive With Financial Reporting Fraud, 2022).

In Indonesia, fraud cases in financial reporting have also become a common problem. One of the biggest was the case of PT Garuda Indonesia in 2019. The case came to light due to discrepancies in PT Garuda Indonesia Tbk's financial statements for 2018. As a public company, PT Garuda Indonesia must report its financial performance to the Indonesia Stock Exchange for the 2018 financial year. However, its financial statements showed a net profit of $809 thousand, contrasting with the previous year's loss. All members of the Board of Directors and Board of Commissioners of PT Garuda Indonesia (Persero) Tbk. who signed the Annual Report for the period of 2018 have been fined IDR 100 million, or approximately $6,000, for violating OJK Regulation Number 29/POJK.004/2016 regarding Annual Reports of Issuers or Public Companies (*Siaran Pers: Otoritas Jasa Keuangan Berikan Sanksi Kasus PT Garuda Indonesia (Persero)TBK*, 2019).

In Malaysia, many cases of fraudulent financial statements were revealed in the press releases of the Securities Commission Malaysia, including Megan Media Holdings Bhd, Transmile Group Bhd, Axis Incorporation Berhad, Multi-Code Electronic Industries Berhad, Polymate Holdings Berhad, and Silver Bird Berhad. One is the case of manufacturing company, Silver Bird Group Berhad (Silver Bird), a bakery, sales, and distribution business of bakery products. On November 2, 2022, the Kuala

Lumpur Sessions Court convicted former directors of Silver Bird Group Berhad (Silver Bird), including its founder, Dato' Jackson Tan Han Kook and former Group Executive Director, Derec Ching Siew Cheong, for knowingly permitting false statements to Bursa Malaysia Securities. They pleaded guilty to the charge and received a one-day jail term and a fine of RM500,000 or about $104 thousand. The charges were based on misleading unaudited quarterly financial statements for fiscal years 2010 and 2011 (*Former Directors of Silver Bird Group Convicted for Furnishing False Statements - Media Releases*, 2022).

Companies listed on the Stock Exchange are always required to increase profitability to build investor confidence (Setiawati & Lim, 2020). Therefore, these requirements can encourage managers to carry out income smoothing, which is a form of fraud to make financial statements look better. Companies listed on the Stock Exchange have a more significant opportunity to commit fraud than those not listed (Kurniawati et al., 2021).

One of the theories employed to demonstrate and elucidate the factors contributing to fraudulent financial reporting is the fraud pentagon. The fraud pentagon theory is a development of previous fraud theories, namely the fraud triangle theory (Cressey, 1953) and the fraud diamond theory (Wolfe & Hermanson, 2004). According to Horwath (2011), the pentagon fraud theory has five fraud risk factors, which are the development of previous fraud theories. The five risk factors include pressure, opportunity, rationalization, competence, and arrogance.

This research requires variable proxies that support the five elements (risk factors) related to the fraud pentagon. The financial targets, financial stability, personal financial needs, and external pressures serve as the necessary indicators for assessing the pressure element. The opportunity element uses variable proxies for ineffective monitoring, the nature of the industry, and the quality of external auditors. The rationalization element uses the change in auditor variable proxy. The competence element uses the change in director variable proxy. Furthermore, the arrogance element is measured using the proxy variable frequent number of CEO's pictures.

Currently, quite number of researchers have conducted research related to the detection of fraudulent financial reporting using the fraud pentagon theory analysis. Some researchers who have conducted research related to the fraud pentagon include Fathmaningrum and Anggarani (2021), Kurniawati et al. (2021), and Andriani et al. (2022).

According to Fathmaningrum and Anggarani (2021), fraudulent financial reporting is influenced by financial targets. The result indicated that when the ROA value is lower, the profit generated is also low. As a result, if the company's profit is low, it means that the performance of the company is also low. Consequently, the likelihood of fraudulent financial reporting instances increases when the company fails to meet its anticipated targets, prompting managers to employ ambitious tactics to reach the target. This statement is in line with Andriani et al. (2022), which stated that with higher targets, management is forced to manipulate them in order to achieve the predetermined profit target. This result is different from the results obtained by Kurniawati et al. (2021), which stated that financial targets do not affect fraudulent financial reporting.

According to Fathmaningrum and Anggarani (2021), financial stability positively affects fraudulent financial reporting. This statement is not in line with the statements of Kurniawati et al. (2021) and Andriani et al. (2022), which stated that financial stability as measured by changes in the total asset ratio has a negative effect on fraudulent financial reporting. A lack of financial stability in a company does not reduce the risk of fraudulent financial statements. This is because if managers engage in the manipulation of financial statements in order to enhance the outlook of the company when the financial condition is unstable or experiencing a decline, it will exacerbate financial conditions in the future.

According to Fathmaningrum and Anggarani (2021) and Andriani et al. (2022), personal financial needs do not affect fraudulent financial reporting. Both state that personal financial needs have nothing to do with fraudulent financial reporting. The ownership of shares by executives does not exert any additional influence on the company. The distribution of dividends to shareholders is a mandatory obligation for the company, irrespective of whether the shares are owned by executives or other parties.

Kurniawati et al. (2021) and Andriani et al. (2022) stated that external pressure positively affects fraudulent financial reporting. The greater the company's debt, the more pressure it places on company management because there will be a higher risk of failure to pay debt. So, the company's management's effort to convince creditors that they can pay their debts is to show high profits. This will trigger management to commit fraud. Meanwhile, the results of research by Fathmaningrum and Anggarani (2021) showed that external pressure does not affect fraudulent financial reporting.

Fathmaningrum and Anggarani (2021) and Kurniawati et al. (2021) found that ineffective monitoring does not affect fraudulent financial reporting. This statement aligns with the findings of Andriani et al. (2022), that ineffective monitoring has a significant negative effect on financial statement fraud. The significant negative results for BDOUT indicate that independent commissioners tend to reduce the potential for fraud to arise.

The nature of industry does not affect fraudulent financial reporting (Fathmaningrum & Anggarani, 2021; Kurniawati et al., 2021). This statement is supported by the findings of Andriani et al. (2022), which stated that it has no significant effect on fraud in financial statements. This is because the average change in the company's accounts receivable from the previous year does not affect the company's cash turnover. So, there is no encouragement for managers to commit fraud with their financial statements.

According to Andriani et al. (2022), the quality of external auditors does not affect fraudulent financial reporting. The scale of the public accounting firms employing external auditors does not indicate fraudulent financial reporting. This is because every public accounting firms has the same audit standards and clear sanctions when violating standards. This statement is different from the results of research by Fathmaningrum and Anggarani (2021), which showed that the quality of external auditors affects fraudulent financial reporting.

Andriani et al. (2022) revealed that the change in auditor has no significant effect on fraudulent financial reporting. Changing auditors occurs when the company is dissatisfied with the performance or opinion provided by the auditor, so this is not related to the effect of fraudulent financial reporting. This statement aligns with the findings of Fathmaningrum and Anggarani (2021) and Kurniawati et al. (2021).

According to Fathmaningrum and Anggarani (2021), a change in director does not affect fraudulent financial reporting. This statement is in line with the research of Andriani et al. (2022) and Kurniawati et al. (2021) that a change in directors does not affect fraudulent financial reporting because the performance of the board of directors will always be supervised and monitored by the board of commissioners. If the directors' performance is not as expected, the incumbent directors will be replaced by directors who are more competent and perform better.

According to Fathmaningrum and Anggarani (2021) and Kurniawati et al. (2021), frequent CEO pictures do not affect fraudulent financial reporting. The CEO photo attached to the financial statements aims to show and introduce who the CEO of the company is to the public, especially to stakeholders. Research from Andriani et al. (2022) showed the same results. The number of CEO photos on display is the result of positive activities or performances carried out by the company.

Fraudulent financial reporting will always occur if the company still has information asymmetry. Information asymmetry occurs when one party knows information while the other does not. This causes opportunities for fraud, such as manipulating company profits or presenting inaccurate information (Sabrina et al., 2020). This information imbalance can be used as an opportunity to commit fraud, which will benefit one party.

Several prior researchers have investigated the factors influencing fraudulent financial reporting using the fraud pentagon theory. Fathmaningrum and Anggarani (2021) stated that financial targets, financial stability, and the quality of external auditors positively affect fraudulent financial reporting in manufacturing companies in Indonesia and Malaysia. Kurniawati et al. (2021) stated that only external pressure is positive for fraudulent financial reporting in mining companies in Indonesia. Meanwhile, Andriani et al. (2022) stated that what has a positive effect on fraudulent financial reporting is financial targets and external pressure on companies affected by sanctions and cases from the Indonesia Financial Services Authority (Otoritas Jasa Keuangan) list.

The results of previous studies showed that there are still inconsistencies in the research that has been done. Therefore, with the difference in results and the increasing incidence of fraudulent financial reporting in recent years, the researcher is interested in reinvestigating the factors that influence fraudulent financial reporting using the fraud pentagon theory analysis. In addition, the researcher also added financial distress variable as a continuation of the study conducted by Utami and Pusparini (2019). Financial distress is defined as a decline in financial condition that occurs before bankruptcy or liquidation in a company, and this can trigger fraudulent financial reporting because it hides bankruptcy signals from investors (Utami & Pusparini, 2019). The researcher also want to investigate potential disparities in the outcomes of fraudulent financial reporting between Indonesia and Malaysia as a continuation of the study conducted by Fathmaningrum and Anggarani (2021).

In this research, Indonesia and Malaysia were chosen due to several similarities. Both countries are developing their economies and are part of the Asia-Pacific region, which have significant potential for growth and economic complementarity. These two countries belong to one family with almost the same culture, character, and behavior. A survey conducted by ACFE (2022) showed that bot countries are ranked in the top ten in Asia for the highest sample of fraud cases. According to PricewaterhouseCoopers (PwC) report, Malaysia continues to have a concerning number of fraud incidents (PwC, 2020). Malaysia is not free from cases of fraudulent financial reporting as a developing country with unstable economic and political conditions (Aripin et al., 2022). Thus, the researcher chose Malaysia as a suitable country to compare with Indonesia in terms of fraudulent practices so that by comparing the two countries, it is hoped that conclusions can be drawn about whether fraudulent financial reporting in Indonesia is higher or lower than in Malaysia.

This research replicates previous research conducted by Fathmaningrum and Anggarani (2021) and Utami and Pusparini (2019). This research differs from previous studies because it used a comparative approach, comparing indications of financial statement fraud between Indonesia and Malaysia, using a sample of financial statements of manufacturing companies in 2020-2023. According to a survey conducted by ACFE (2022), the manufacturing industry is among those that experience an average loss of $177,000, with a total of 194 fraud scheme cases, of which 12% are fraudulent financial statement cases.

This research is significant because financial statements act as the company's primary communication tool and a form of accountability to various related parties, including investors and other stakeholders. Financial reports must provide honest and useful information for stakeholders, such as investors and creditors, as well as for other users who assist in making informed and rational decisions (Andreani & Laylan, 2022).

With the background, the researcher is interested in conducting research entitled "Fraud Pentagon and Financial Distress on Fraudulent Financial Reporting: Comparative Analysis of Manufacturing Companies in Indonesia and Malaysia 2020-2023". This research aims to analyze the effect of the influence of fraud pentagon theory and financial distress on fraudulent financial reporting.

B. Research Problems

Based on the explanation described above, the problem formulations contained in this research are:

1. a) Does financial target have positive influence on the fraudulent financial reporting in manufacturing companies in Indonesia?

   b) Does financial target have positive influence on the fraudulent financial reporting in manufacturing companies in Malaysia?

2. a) Does financial stability have positive influence on fraudulent financial reporting in manufacturing companies in Indonesia?

   b) Does financial stability have positive influence on fraudulent financial reporting in manufacturing companies in Malaysia?

3. a) Do personal financial needs have positive influence on fraudulent financial reporting in manufacturing companies in Indonesia?

   b) Do personal financial needs have positive influence on fraudulent financial reporting in manufacturing companies in Malaysia?

4. a) Does external pressure have positive influence on fraudulent financial reporting in manufacturing companies in Indonesia?

   b) Does external pressure have positive influence on fraudulent financial reporting in manufacturing companies in Malaysia?

5. a) Does ineffective monitoring have positive influence on fraudulent financial reporting in manufacturing companies in Indonesia?

b) Does ineffective monitoring have positive influence on fraudulent financial reporting in manufacturing companies in Malaysia?

6. a) Does the nature of industry have positive influence on fraudulent financial reporting in manufacturing companies in Indonesia?

   b) Does the nature of industry have positive influence on fraudulent financial reporting in manufacturing companies in Malaysia?

7. a) Does the quality of external auditors have positive influence on fraudulent financial reporting in manufacturing companies in Indonesia?

   b) Does the quality of external auditors have positive influence on fraudulent financial reporting in manufacturing companies in Malaysia?

8. a) Does a change in auditor have positive influence on fraudulent financial reporting in manufacturing companies in Indonesia?

   b) Does a change in auditor have positive influence on fraudulent financial reporting in manufacturing companies in Malaysia?

9. a) Does a change in director have positive influence on fraudulent financial reporting in manufacturing companies in Indonesia?

   b) Does a change in director have positive influence on fraudulent financial reporting in manufacturing companies in Malaysia?

10. a) Does the frequent number of CEO's pictures have positive influence on fraudulent financial reporting in manufacturing companies in Indonesia?

b) Does the frequent number of CEO's pictures have positive influence on fraudulent financial reporting in manufacturing companies in Malaysia?

11. a) Does financial distress have positive influence on fraudulent financial reporting in manufacturing companies in Indonesia?

    b) Does financial distress have positive influence on fraudulent financial reporting in manufacturing companies in Malaysia?

12. Are there differences in fraudulent financial reporting in Indonesia and Malaysia?

C. Research Objectives

This research aims to investigate and provide further explanation regarding fraud indicators in fraud pentagon theory and financial distress in influencing the tendency of fraudulent financial reporting in line with the formulation of the problem, including:

1. a) Financial target can positively influence on fraudulent financial reporting in manufacturing companies in Indonesia.

   b) Financial target can positively influence on fraudulent financial reporting in manufacturing companies in Malaysia.

2. a) Financial stability can positively influence on fraudulent financial reporting in manufacturing companies in Indonesia.

   b) Financial stability can positively influence on fraudulent financial reporting in manufacturing companies in Malaysia.

3. a) Personal financial needs can positively influence on fraudulent financial reporting in manufacturing companies in Indonesia.

   b) Personal financial needs can positively influence on fraudulent financial reporting in manufacturing companies in Malaysia.
4. a) External pressure can positively influence on fraudulent financial reporting in manufacturing companies in Indonesia.

   b) External pressure can positively influence on fraudulent financial reporting in manufacturing companies in Malaysia.
5. a) Ineffective monitoring can positively influence on fraudulent financial reporting in manufacturing companies in Indonesia.

   b) Ineffective monitoring can positively influence on fraudulent financial reporting in manufacturing companies and Malaysia.
6. a) Nature of industry can positively influence on fraudulent financial reporting in manufacturing companies in Indonesia.

   b) Nature of industry can positively influence on fraudulent financial reporting in manufacturing companies in Malaysia.
7. a) Quality of external auditors can positively influence on fraudulent financial reporting in manufacturing companies in Indonesia.

   b) Quality of external auditors can positively influence on fraudulent financial reporting in manufacturing companies in Malaysia.
8. a) Change in auditor can positively influence on fraudulent financial reporting in manufacturing companies in Indonesia.

b) Change in auditor can positively influence on fraudulent financial reporting in manufacturing companies in Malaysia.

9. a) Change in director can positively influence on fraudulent financial reporting in manufacturing companies in Indonesia.

   b) Change in director can positively influence on fraudulent financial reporting in manufacturing companies in Malaysia.

10. a) Frequent number of CEO's pictures can positively influence on fraudulent financial reporting in manufacturing companies in Indonesia.

    b) Frequent number of CEO's pictures can positively influence on fraudulent financial reporting in manufacturing companies in Malaysia.

11. a) Financial distress can positively influence on fraudulent financial reporting in manufacturing companies in Indonesia.

    b) Financial distress can positively influence on fraudulent financial reporting in manufacturing companies in Malaysia.

12. There are differences in fraudulent financial reporting in Indonesia and Malaysia.

D. Research Benefits

The results of this research are expected to provide the following benefits:

1. Theoretical Benefit

It is hoped that this research will provide information and perspectives on the review of the Fraud Pentagon and Financial Distress theories in the tendency of indications of fraudulent financial reporting practices that have the potential to occur in manufacturing companies in Indonesia and Malaysia.

2. Practical Benefits

a. For Academicians: The results of this research are expected to help review the fraud pentagon theory and financial distress in indicating fraudulent financial reporting so that it can be used as reference material for further research.

b. For Auditors: This research is expected to assist auditors in preventing and finding indications of financial statement fraud in manufacturing companies.

c. For Manufacturing Companies: This research is expected to be an evaluation material for management in considering the long-term impact of fraudulent financial reporting to avoid the possibility of the company experiencing losses.