



FACING GLOBAL DIGITAL REVOLUTION

Edited by

Dyah Nirmala Arum Janie, Hendrati Dwi Mulyaningsih,
and Ani Wahyu Rachmawati



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Facing Global Digital Revolution

Editors

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Using diamond fraud analysis to detect fraudulent financial reporting of Indonesian pharmaceutical and chemical companies

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ABSTRACT: This study aimed to detect fraudulent financial reporting using diamond fraud analysis. This rationalization was proxied by an audit and the capability to replace directors suspected of making fraudulent financial statements. The sample comprised 10 pharmaceutical and chemical sub-manufacturing companies listed on the Indonesia Stock Exchange (IDX) from 2012 to 2017. This research was conducted using multiple linear regression analysis. The results showed that external pressure variables measured by leverage ratios influence fraudulent financial reporting. Financial stability and change in terms of value, along with how a change of directors affects fraudulent financial statements, were also examined.

Keywords: fraud diamond analysis, fraudulent financial statements, financial stability, external pressure, financial targets

1 INTRODUCTION

Financial statements are a corporate communication tool regarding financial data or company operational activities. Financial statements reflect company performance within a certain period. Recognizing the importance of financial statements motivates managers to improve company performance. Unfortunately, not all company managers realize the importance of clean financial reports that are free of fraud (Yesiariani, 2016).

Huge fraudulent financial reporting cases continue to take place after the ENRON scandal in December 2001. One Indonesian incident was the case of PT. Kimia Farma, Tbk, in December 2001. The management reported a net profit of IDR 132 billion on December 31, 2001, audited by Hans Tuanakotta and Mustofa (HTM). However, the Ministry of State-Owned Companies (BUMN) and the Capital Market Supervisory Agency (Bapepam) considered that the net profit was too high and contained manipulation. After a re-audit on October 3, 2002, the 2001 financial statements of PT Kimia Farma were restated because auditors found a reasonably simple mistake. In the new financial statements, the profits made were only IDR 99.56 billion, IDR 32.6 billion (24.7%) lower than the initial profit reported. The error was due to IDR 2.7 billion in overstated sales in the raw material industry unit, IDR 23.9 billion in overstated inventory in the central logistics unit, and IDR 8.1 billion in overstated inventory and IDR 10.7 billion in overstated sales in the pharmaceutical wholesalers' unit. The researcher adopted the Annisya, Mafiana, Lindrianasri, and Asmarianti (2016) study, which aims to analyze the data, and found empirical evidence regarding the fraud risk factor according to diamond fraud analysis: pressure, opportunity, rationalization, and capability. This study used eight independent proxy variables: financial targets, financial stability, external pressure, nature of the industry, active monitoring, change in auditors, rationalization, and capability.

Based on this background, we can see that fraudulent financial statements cause a significant loss not only for companies, but also for the users of financial statements. The four conditions mentioned previously motivated the fraudulent financial reporting. Therefore, scholars conducted necessary research regarding fraudulent financial reporting in pharmaceutical and chemical

subsector manufacturing companies in Indonesia. The pharmaceutical and chemical subsector was chosen due to the rapid development of this industry with a market that is sufficiently developed to allow fraudulent financial reporting.

2 LITERATURE REVIEW

The higher the total assets owned by a company, the more wealth it has. A change in the percentage of total assets indicates the occurrence of manipulation in financial statements. Therefore, the ratio of changes in total assets is a proxy for the financial stability variable (Annisya et al., 2016; Sihombing and Rahardjo, 2014), and showing financial stability has a significant positive effect on the risk of fraudulent financial reporting. Yesiariani (2016) shows that financial stability harms detection of fraudulent financial reporting.

H1: Allegedly asset change affects fraudulent financial reporting.

A change in the high percentage of debt indicates manipulation in financial statements. Therefore, we used the leverage ratio as a proxy for the external pressure variable. Yesiariani (2016) and Putriasih, Herawati, and Wahyuni (2016) show that external pressure has a significant positive effect on the risk of financial statement fraud. Annisya et al. (2016) reveal that external pressure has a significant negative effect on fraudulent financial reporting. Based on the description, this study proposes the following hypothesis:

H2: Allegedly leverage affects fraudulent financial reporting.

Pressure on the achievement of financial targets to get performance bonuses and to maintain existing company performance can raise the risk for fraudulent financial reporting. Chyntia and Puji (2016) and Annisya et al. (2016) prove that the return on assets (ROA) variable has a positive but not significant effect on fraudulent financial reporting. Sihombing and Rahardjo (2014) show that financial targets do not significantly influence financial statement fraud. Based on the description, this study proposes the following hypothesis:

H3: Return on assets affects fraudulent financial reporting.

A high ending inventory balance can also generate high profits. It is what triggers management to commit fraud on the inventory balance. So a percentage of change in total inventory can indicate a high level of fraud in financial reporting. Sihombing and Rahardjo (2014) state that the nature of the industry has a positive effect on fraudulent financial reporting. Ardiyani and Utaminingsih (2015) contend that the nature of the industry with a proxy stock (inventory) does not affect financial statement fraud. Based on the description, this study proposes the following hypothesis:

H4: Suspected inventory affects fraudulent financial reporting.

Auditors' opinions provide unqualified, descriptive language. To issue an opinion, an external auditor needs to identify and consider the risk factors that may cause the audit client to commit fraud. The existence of this opinion allows management to rationalize mistakes, because the auditor has tolerated the mistakes through the descriptive language in his opinion. Higher rationalization can therefore lead to fraud in financial reporting. Mafiana et al. (2016) also support Fimanaya and Syafruddin (2014) because the language in independent auditors' reports can be explanatory in some cases, such as reasonable opinions given in part based on other independent reports, additional information required by the Indonesian Accountants' Association, and certain other circumstances. Based on the description, this study proposes the following hypothesis:

H5: Explanatory, unqualified audit opinions affect fraudulent financial reporting.

A change of directors can indicate a company's effort to improve on the performance of previous directors by making changes to the composition of the board of directors or by recruiting new directors who are considered more competent. The more often companies

make changes to directors, the higher their ability to commit fraud in financial statements. Chyntia and Puji (2016) conclude that changes in company directors have no effect in detecting fraudulent financial reporting. Annisya et al. (2016) and Sihombing and Rahardjo (2014) also show that changes in directors have no significant effect on the risk of fraudulent financial reporting. Based on the description, this research suggests the following hypothesis:

H6: Allegedly, a change of directors has an effect on fraudulent financial reporting.

3 METHOD

The population in this study comprised companies engaged in the manufacturing sector of the chemical and pharmaceutical subsectors listed on the Indonesia Stock Exchange (IDX) in 2012–2017. The researchers completed purposive sampling in order to get a representative sample according to the specified criteria.

4 RESULTS AND DISCUSSIONS

Assets change was not proven to affect fraudulent financial statements. The results of this study were consistent with Yesiariani (2016), but failed to prove Annisya et al. (2016) or Sihombing and Rahardjo (2014). The fundamental reason this research was insignificant is that the greater the change in company assets as a proxy for financial stability, the smaller the practice of fraudulent financial reporting. It happened because a large asset change caused the company to get public attention and the news spread quickly. According to Yesiariani (2016), companies have an excellent level of supervision carried out by a board of commissioners to monitor and control management policy. They are directly responsible for business functions such as finance so that even though management faces pressure when there is a threat to financial stability, economic, industrial, and operating conditions will not affect the occurrence of fraudulent financial reporting.

Leverage is proven to affect fraudulent financial reporting. The results of this study were consistent with Yesiariani (2016) and Sihombing and Rahardjo (2014). However, this study contradicted Annisya et al. (2016) and Susanti (2014). The target financial statement has no significant effect, so it cannot be used to detect fraudulent financial reporting. The results of this study were in line with those of Annisya et al. (2016), Sihombing and Rahardjo (2014), and Yesiariani (2016). However, they were contrary to Putriasih et al. (2016).

The fundamental reason this research was not significant is because the higher a company's ROA, the smaller the practice of fraudulent financial reporting. This is because every increase in the ratio of ROA does not become a pressure on the management of the company, because an increase in operational quality accompanies it. A decrease in company profitability can occur due to an unpredictable crisis that hit the industry (Sihombing and Rahardjo, 2014). So even though management faces pressure because it is unable to meet its financial targets, the occurrence of fraudulent financial reporting will remain unaffected.

The nature of the industry proxied by inventory has no significant effect, meaning it cannot be used to detect fraudulent financial reporting. The results of this study corroborate Annisya et al. (2016), Yesiariani (2016), and Susanti (2014). However, this research is not in line with Sihombing and Rahardjo (2016). The absence of a significant influence on the nature of the industry is because any increase or decrease in the inventory change ratio does not compel the company management to commit financial statements fraud (Annisya et al., 2016). Pharmaceutical companies usually produce large quantities of goods to meet high market demand, so changes in inventory cannot be used as an opportunity for management to manipulate financial statements.

Rationalization proxied by unqualified audit opinion with explanatory language cannot be used to detect fraudulent financial reporting. The reasons underlying these insignificant results are the addition of explanatory language in the independent auditor's report in part based on

other independent reports, additional information required by the Indonesian Accountants' Association, and certain other conditions. This given opinion under certain circumstances requires the auditor to add explanatory paragraphs in the audit report, although it does not affect the unqualified opinion expressed by the auditor (Annisa et al., 2016).

A capability that is proxied by a change of directors does not have a significant effect, meaning that it cannot be used to detect fraudulent financial reporting. The results of this study are in line with Annisa et al. (2016), Yesiariani (2016), and Sihombing and Rahardjo (2014). However, it is contrary to Putriasih et al. (2016). The fundamental reason this research was not significant is because the supervision of a board of commissioners is related to the performance of each director. Also, a change in directors made it possible to motivate management to perform better than before because of the recruitment of more competent directors (Annisa et al., 2016).

5 CONCLUSION

Because of the limitations of this study, future studies are expected to add proxy variables from diamond fraud analysis so that the scope of the research variables becomes wider. Future studies might find proxies for financial stability, external pressure, financial targets, nature of the industry, rationalization, and capability because the proxies for these variables are changes in assets, leverage, returns on assets, inventory, audit opinion, and change of directors and are still challenging topics to examine. Subsequent research can increase the number of sample categories in order to predict cases of fraudulent financial statements in other categories, such as nonfinancial and financial companies. Further research should also expand the observation period so that it can better describe fraudulent financial statements. Future studies may find other variables to measure rationalization and capability, and use other methods such as interviews to obtain more accurate and diverse research results.

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