CHAPTER I

INTRODUCTION

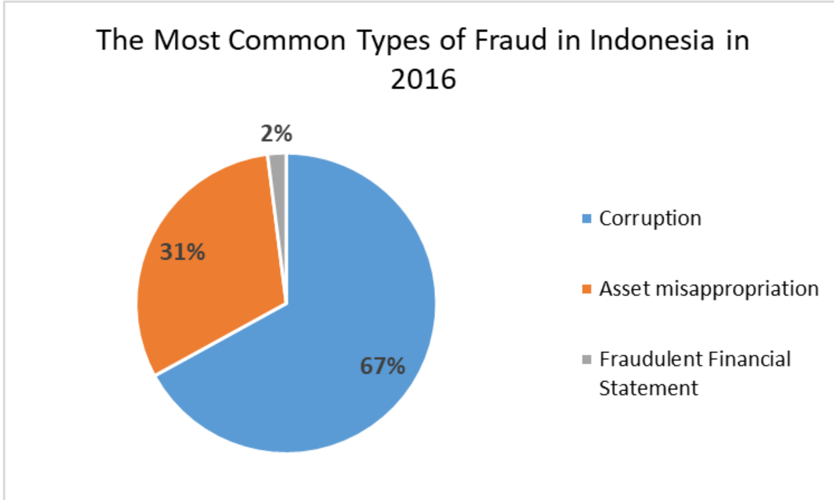
1.1 Background

The final process in an accounting cycle is to get the final result in the form of financial statement. Financial statement is a form of communication tool by top managers to their subordinates and to parties outside the company to provide information about the financial position, performance, and cash flows of a company over a certain period of time. According to the Indonesian Institute of Accountants (IAI, 2009), financial statement provides benefits for most users in making economic decisions and as a communication tool for management accountability about the use of the resources that have been entrusted to them. Moreover, according to ED PSAK No. 01 (Revised 2009), financial statement should be prepared based on generally accepted accounting standards in order to produce a relevant and reliable information (IAI, 2009). Accounting standards contain the rules for recognizing, disclosing, and presenting an item in financial statement. Accounting standards are used so that inter-company financial statements have uniformity in their presentation, so it will make the users of financial statement understand the information easier statement and making the financial statements more comparable. In addition, the use of appropriate accounting standards aims to avoid ambiguity about the contents of the financial statements. However in actual practice, fraudulent practices are still often found in financial statement.

Based on the agency theory proposed by Jensen and Meckling (1976) explains the relationship between manager and shareholders, where manager acts as an agent and shareholders act as principals or owners of the company. Manager prepares financial reports as a form of accountability to shareholders for the authority to manage the company which is delegated by shareholders as owners of the company. Manager who prepares financial statement has more information than the information held by shareholders. Manager has more knowledge of the company information that can be used by management to prepare and present the best financial statement from the perspective of management. Seeing the importance of financial statement for users, management is motivated to prepare financial statement according to their interests by presenting fantastic information to investors, this can be one of the causes of fraud.

According to The Association of Certified Fraud Examiners (ACFE, 2016), fraud is an illegal act that is carried out for certain purposes such as manipulation or giving false information to other parties. Fraud can be carried out by people from internal or external party of the company in order to obtain personal or company gains. One of types of fraud committed by the companies is fraudulent financial statement. Fraudulent financial statement is an intended attempt by companies to deceive and mislead users of financial statements, especially investors and creditors, by misrepresenting and manipulating the material values of financial statement (Sihombing & Rahardjo, 2014). This can be done by presenting the balance in the financial statement lower (understatement) or higher (overstatement) than the actual balance.

Moreover, based on the results of the Indonesian Fraud Survey Results published by the Association of Certified Fraud Examiners (ACFE) Indonesia in 2019, The most common fraud in Indonesia is corruption with a percentage of 64.4%, the second position is asset misappropriation with a percentage of 28.9%, then the third position is fraudulent financial statement with a percentage of 6.7%. Although the percentage of fraudulent financial statement is not as much as corruption and misappropriation of assets, fraudulent financial statements is considered detrimental, this is because fraudulent financial statement is the costliest category of fraud compared to corruption and asset misappropriation. According to the Reports to The Nations 2020 Global Study on Occupational Fraud and Abuse , fraudulent financial statement caused a median loss of $945,000, this number is higher compared to corruption that caused median loss of $200,000 and asset misappropriation that caused median loss of $100,000 (ACFE, 2020).



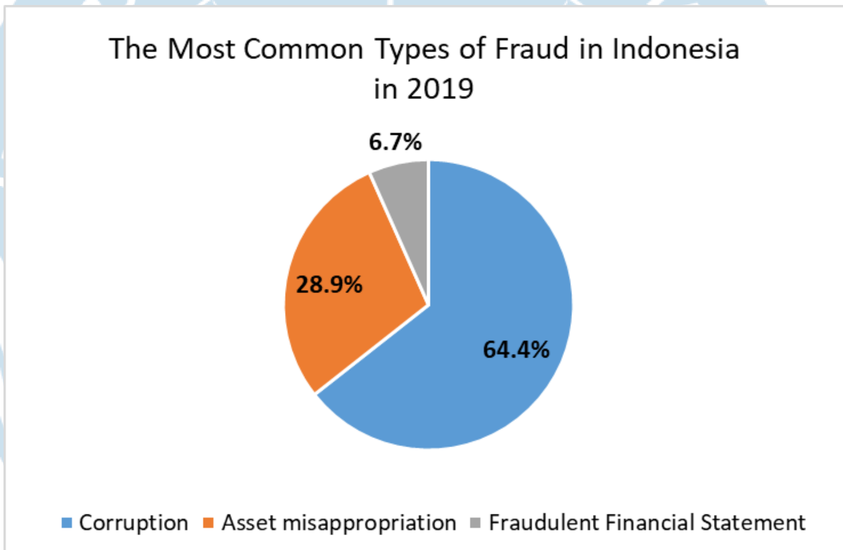


Figure 1.1 Fraud Statistical Data in Indonesia 2016-2019

The Association of Certified Fraud Examiners (ACFE) Indonesia Chapter conducted the Indonesia Fraud Survey in 2016 and 2019. The fraud survey was grouped into three groups of cases, namely corruption, misappropriation of assets, and fraudulent financial statement. The survey results show that the cases of fraudulent financial statement have increased from 2% to 6.7%. Corruption cases decreased from 67% to 64.4%. Meanwhile, cases of asset misappropriation decreased from 31% to 28.9%. Fraudulent financial statement cases experienced a significant increase, which compared to corruption and asset misappropriation that decreased. Fraudulent financial statement also has a negative impact on investors because the decisions they take are irrational and result in failure to get returns from their investment activities.

In Indonesia, there were several fraudulent financial reporting cases in mining industry that caused huge losses. For example is the case of PT Bumi Resources Tbk and its subsidiaries. In 2010 Indonesia Corruption Watch (ICW) reported allegations of manipulation in reporting sales of three coal mining companies belonging to the Bakrie Group to the Directorate General of Taxes. ICW suspects that the reporting manipulation by PT Bumi Resources Tbk. and its subsidiaries from 2003-2008 caused state losses of USD 620.49 million. The Coordinator of ICW's Budget Analysis and Monitoring Division said that the alleged manipulation of sales reports occurred by PT Kaltim Prima Coal (KPC), PT Arutmin Indonesia (Arutmin), and the parent company of the two companies, namely PT Bumi Resources Tbk (Bumi). ICW's calculation showed that Bumi's sales report was USD 1.06 billion lower than the actual one during 2003-2008. This fraudulent act has caused a state loss of USD 143.18 million due to the decrease of revenue from the Coal Production Fund (royalty) (Tempo.co, 2010).

In addition, there is also the case of PT Timah (Persero) Tbk, where PT Timah is suspected of presenting untrue financial statements in the first semester of 2015. This fictitious financial reporting activity was done to cover up the decline of PT Timah financial performance. According to the chairman of the PT. Timah Employees Association, argued that PT Timah's financial condition has not been healthy for the past three years. The inability of the Board of Directors of PT Timah to get out of the loss trap has resulted in the handover of 80% of PT Timah's mining area to business partners. This is because the debt owned by PT Timah continues to increase every year. The financial statement of PT Timah Tbk's during the first semester of 2015 is fictitious because in the first semester of 2015 PT Timah suffer a loss in operating profit of Rp. 59 billion. However, the first semester of 2015 financial statements published by the company's management suffered a loss of Rp. 19 billion. However, the Chairman of the PT Timah Employees Association assessed that the board of directors had committed many public lies through the media. In the press release of the financial statements for the first semester of 2015 which stated that strategies and efficiency have resulted in positive performance. But in fact, during the first semester of 2015 its operating profit suffered a loss (Tambang.co.id, 2016).

Based on the cases described above, fraudulent financial statement occurs due to several factors. Cressey (1953) explained that there are conditions that affect the company's fraudulent activities, namely pressure/motive, opportunity, and rationalization, this theory is known as the Fraud Triangle. The Fraud Triangle theory was then further developed into Fraud Diamond by Wolfe & Hermanson (2004), adding one factor, namely capability. This theory was further developed into the Fraud Pentagon by Horwarth (2011), adding one more factor, namely arrogance. The Pentagon Fraud Theory was further developed by Vousinas (2019) into the Fraud Hexagon, he added one more factor, namely collusion. He argues that one of the key elements in many frauds and financial (white-collar) crimes is collusion. The components in the fraud hexagon cannot be examined directly, elements of the fraud hexagon require proxy variables. In this research, pressure element is proxied by financial target, opportunity is proxied by Nature of Industry and rationalization is proxied by change in auditors. Then, the element of capability is proxied by the President Director's education level, arrogance is proxied by the length of tenure of the President Director and collusion using the proxy of political relations.

The inconsistency of the results of previous studies also encourages researcher to find out the effect of fraud hexagon that consists of pressure, opportunity, rationalization, capability, arrogance and collusion on fraudulent financial statement. The researcher interested to use mining sector companies listed on the Indonesia Stock Exchange (IDX) as the sample of the research. Researcher choose to use mining sector companies as the research sample because based on data from Reports to The Nations 2020 Global Study on Occupational Fraud and Abuse, the mining industry is the industry sector that experienced the highest median loss due to fraud, which was $ 475,000. Moreover, based on data from Indonesia’s Fraud Survey published by ACFE Indonesia (2020) the mining industry is included as top five industries that suffer the most because of fraud in Indonesia.

1.2 Research Problem

Seeing the high losses caused by fraud in the mining sector industry in Indonesia and globally. As well as previous research on the effect of fraud hexagon theory on fraudulent financial statements in the mining industry which showed different results. The researcher is motivated to investigate the effect of the fraud hexagon theory on fraudulent financial statement in mining companies by developing the following research problems:

1. Does financial target has an effect on fraudulent financial statement?
2. Does nature of industry has an effect on fraudulent financial statement?
3. Does change in auditors has an effect on fraudulent financial statement?
4. Does President Director's education level has an effect on fraudulent financial statement?
5. Does length of tenure of President Director has an effect on fraudulent financial statement?
6. Does political connection has an effect on detection of fraudulent financial statement?

1.3 Research Objectives

Based on the research problem stated above, the research objectives to be achieved are:

1. To provide an empirical evidence about the effect of financial target on fraudulent financial statement.
2. To provide an empirical evidence about the effect of nature of industry on fraudulent financial statement.
3. To provide an empirical evidence about the effect of change in auditors on fraudulent financial statement.
4. To provide an empirical evidence about the effect of President Director's education level on fraudulent financial statement.
5. To provide an empirical evidence about the effect of President Director's length of tenure on fraudulent financial statement.

6. To provide an empirical evidence about the effect of political connection on fraudulent financial statement.

1.4 Research Contributions

This research is conducted in order to contribute in:

1. For Academics

   This research uses the fraud hexagon theory, which is relatively new method to detect fraudulent financial statement, this research is expected to provide a new understanding of fraudulent financial statements and to better understand what factors can allow fraudulent financial statements to occur. Finally this research is hoped to provide more empirical evidence regarding the effect of fraud hexagon elements on fraudulent financial statement and can be a reference for the further research.

1.5 Writing Systematic

The writing systematic for this research is prepared systematically as follows:

Chapter I	**INTRODUCTION**
	This chapter consists research background, research problems, research objectives, research contributions, and writing systematic.
Chapter II	**LITERATURE REVIEW**
	This chapter contains explanations of the theories that support this research, including: agency theory, definition of fraud, types of fraud, definition and purpose of financial statement, fraudulent financial statement, fraud hexagon theory, description of previous research, hypothesis development and research framework.
Chapter III	**RESEARCH METHODOLOGY**
	This chapter contains types of research, research population and sample, types of data, sources of data, independent and

dependent variables, data analysis method and hypothesis testing.

Chapter IV **RESULT AND ANALYSIS**

This chapter describes the description of the research object and the results of the data analysis carried out, including:, descriptive statistics, classic assumption test, hypothesis testing, and discussion of the testing results.

Chapter V **CONCLUSION AND SUGGESTION**

This chapter consist of the conclusion, limitations of the research and suggestion for future research.