

CHAPTER I INTRODUCTION

1.1 Background

Financial Report is a tool commonly used by entities in communicating circumstances and financial condition of company to the internal and external parties of entities. A complete financial statement is a report consisting of the cash flow statement, income statement, balance sheet, notes to the financial statements and statement of changes in equity (Kieso, Weygandt, & Warfield, 2018). Generally Fraud is an act of illegal and violation of the law, which aims to benefit personally. IAI (2012) describes the meaning of fraud is "Every act of accounting which arise from fraudulent financial reporting either of misstatement or intentionally omission in the amounts or disclosures in financial statements to deceive the user of financial statement, or misstatements which arise from improper act to assets (often referred to the embezzlement or misuse) relating to the theft of the entity assets which result the financial statements of the entity are not presented in accordance with the accounting principles which generally accepted in Indonesia".

In the daily lives, the fraud have occurred in various types of business, as micro business, small, medium or large. This fraud is asset misappropriation & Fraudulent Financial Statement. Asset Misappropriation is the kind of act of fraud committed by using or taking company property for personal gain. as for using the company's money, merchandise inventory of the companies, use official cars for private purposes. While the fraudulent financial statement is the kind of act of fraud committed by concealing financial information, set the contents of the financial statements and change the content in the financial statements for the purposes to trick the readers of financial statements for corporate or personal interests.

Factors that cause the occurrence of fraud, among which in theory Fraud Triangle Cressey (1953) a fraud caused by three factor that is opportunity, pressure and rationalization, or commonly known as the fraud triangle. Pressure is an act of fraud due to the presence of a pressure of financial and non-financial, both derived from themselves or pressure from the organization. Opportunity is an act of fraud that occurs due to the weakness of a system in which the weakness exploited so as

to be able to commit fraud. Rationality is the thought that justifies his actions as a behavior that is called fair, which in moral will be accepted in the normal society.

The era development continuously increase also increased the level of fraud, one of them is fraudulent financial statement. The act of fraudulent financial statements is cause by the companies that manipulate the financial statements of companies for the purposes to attract the interest of investors to invest their funds into the company. The cases of fraud that have happened in this world as in the case of health south corporation, Enron, WorldCom, Tyco, international commerce and banks of credit and many more other fraud cases that have happened. One of the fraud case that have happened in Indonesia is “The Scandal of manipulation financial statement in PT. Kimia Farma Tbk”.

PT Kimia Farma or commonly called PT. KAEF is a drug dealer owned by government company in Indonesia. The result of audited report of 31 December 2001 showed that the management of PT Kimia Farma reported a net profit of Rp 132 billion, and this report has been audited by Hans Tuanakotta & Mustafa (HTM). However, the Ministry of Bapepam and State-owned enterprises provide an assessment that the reported net income is exorbitant and contain manipulation components. After re-auditing, on October 3, 2002 financial statements of PT Kimia Farma 2001 restated for the results of re-audit has revealed basic error. After the financial report has been re-audit, the financial statement presented the net profit Rp 99.56 billion, or the amount decreased from previous financial report of Rp 32.6 billion, or 24.7% than the net profit before re-audit.

An error occurred in Kimia Farma financial statements caused by the Raw Material Industry unit that overstated the sales in the amount of USD 2.7 billion, the units Pharmaceutical Wholesalers be overstated inventory as much as Rp 8.1 billion and overstated the sales in the amount of USD 10.7 billion, on the part of the Central Logistics unit overstated the amount inventory as much as Rp 23.9 billion. Errors in this presentation related to inventories arising from the value contained in the list of inventories prices has been increased. PT Kimia Farma, through the production director, publishes two inventories price lists on the 1st and February 3rd, 2002. The price list published on February 3rd has increased in value and have been used as the valuation of inventory for product distribution in PT

Kimia Farma on 31 December 2001. Furthermore, errors in the presentation related to sales by recording over and twice the sales. Double recording was happened on the units that accountant didn't sampled it, so it successfully passed the examination of the accountant. Based on the investigation of Bapepam, it was mentioned that public accounting firm who audited the financial reports of PT Kimia Farma already obey the applicable auditing standards, but the accounting firm still fails to detect the fraudulent financial report of PT. Kimia Farma. Other than that, the public accounting firm didn't proved in helping the management to perform the fraud.

Cases of fraudulent financial statements such as PT Kimia Farma often happens in the company circles. the management is one of the perpetrator behind the fraud. Management did this fraud with the purpose to enhance financial statement and attract the investor. The financial statements show the state of a company, a good financial statement can attract the interest of investor. With the existence of these things, the management companies often commit fraudulent financial statements. To detect fraudulent financial statements can be measured using financial ratios. Financial ratios consisted of several types of financial ratios such as liquidity, profitability, capital turnover, leverage and asset composition.

Leverage ratio is one of the ratios used in detecting fraudulent financial statements. Companies with high leverage indicates a high risk of bankruptcy because if the company can not pay their debts. The likelihood of manager to commit fraudulent financial statements will increase if the entity had a high debt that's because the entity transfers the risk from the founder and manager of equity to creditors. Additionally manager who faces pressure of economic circumstances often commit acts of fraud in financial statements through manipulating financial reports aimed at improving the company's prospects. To detect such fraud, financial ratio used is profitability ratios. Aside from leverage and financial profitability ratio there is also liquidity, capital turnover and asset composition ratio can be used to measure fraudulent financial statement.

Research on detecting the fraud in the fraudulent company through a variety of methods already been studied. However, the results obtained have not been entirely consistent. To get more consistent results, this study has the objective to test the methods that can be use in detecting the fraud in the fraudulent company.

Based on the background of this issue then I, as the authors propose a study entitled:
The Effect of Financial Ratios in Detecting Fraudulent Company Listed on The
Indonesia Stock Exchange

1.2 Research question

There are few questions that can help in the research process, as the follow:

1. Does the financial leverage has effect to the fraudulent company?
2. Does the profitability has effect to the fraudulent company?
3. Does the asset composition has effect to the fraudulent company?
4. Does the liquidity has effect to the fraudulent company?
5. Does the capital turnover has effect to the fraudulent company?

1.3 The purposes of research

The purposes of the study are stated as following:

1. To determine the effect of financial leverage to the fraudulent company.
2. To determine the effect of profitability to the fraudulent company.
3. To determine the effect of asset composition to the fraudulent company.
4. To determine the effect of liquidity to the fraudulent company.
5. To determine the effect of capital turnover to the fraudulent company.

1.4 Benefits of research

The following is a benefit in this research as follows:

1. For Investor

Through the information presented in the current study, it is expected that investors can use the information from these studies as a guide in making the right decision to invest their capital into a company.

2. For Auditor

With this study is expected the auditor can utilize the information obtained from these studies to detect fraudulent acts in an entity's financial statements.

3. For Management of companies

Through the information presented in the current study, it is expected that the management of companies to understand the consequences of acts of fraud in an entity's financial statements.

4. For Researchers

With the research, it is expected that researchers can use the knowledge and theory that obtained from the results of these studies in the college and the business world for solve the various problems that have related with the research topic.

5. For Readers

Through information on the results of these studies, it is expected to assist the reader in solving problems related to the research topic.

1.5 Systematic of the research

The report are consist of five chapters, the following are the parts of the fifth chapter:

CHAPTER 1: INTRODUCTION

This is the first part of this report, in this chapter will explain the background information, the formulation of the problem, objectives and benefits of the research and systematic discussion.

CHAPTER 2: THEORETICAL FRAMEWORK AND HYPOTHESIS DEVELOPMENT

In this section have content an explanation of the theoretical concepts that can be used as the cornerstone of the research problem and formulation of hypotheses.

CHAPTER 3: RESEARCH METHODOLOGY

In third chapter will explain the study design, the sample used in the study, the study variables and methods of analysis applied in the study.

CHAPTER 4: DISCUSSION AND ANALYSIS

In this section will explain outcome of the research, as well as other discussions such as hypothesis testing.

CHAPTER 5: CONCLUSIONS, LIMITATIONS & RECOMMENDATIONS

In this section will explain the conclusions of the study, the perceived limitations by the researchers during the study, as well as recommendations for the future of research.