CHAPTER II

THEORETICAL FRAMEWORK AND HYPOTHESIS DEVELOPMENT

2.1 Fraudulent Company

According to AICPA (2002), Fraudulent company are the companies have done by: (1) Falsification, Manipulation of the report, or change the accounting records, supporting documents that use for preparing the financial statement. (2) Negligence or deliberate error in the information which will effect to the financial statements. (3) To deliberate abuse of the principles that have related to the amounts, classification, method or disclosure.

According to Spathis (2002), Fraudulent company can do the various different types and consists of various elements of manipulation that is to raise the value of sales, profit and assets or lowering cost, losses and liabilities. The following describes the types of act that fraudulent company will do:

1. Revenue recognition that does not occur

Revenue recognition that does not occur is common action used in the fraudulent financial statement. This action involves recording sales to manipulate income.

2. Manipulating expenses or costs

The act of manipulating expenditures or the cost is a deliberate fraud by manipulating costs or expenses in the financial statements. Examples of manipulation costs is to take advantage of the operational costs. Manipulating costs can help increase a company's profit.

3. Overstating assets

Overstating current assets in the financial statements is a way used in the act of fraud in the financial statements. This action causes a significant impact in the financial statements. In addition these action also have an impact on the organization's employees, clients, investors and third parties.

According to ACFE (2014), fraudulent company is defined as the companies have do the act of fraud which is usually done by the management with the ways of material misstatement in the financial statement that could cause the losses to investors and creditor. The fraud can be financial or non-financial.

According to Manurung & Hardika (2015), Fraudulent financial statement is an act of deliberate or act of negligence in prepare the financial statements in which the reported financial statements does not meet the criteria of accounting principles. Acts of omission is a deliberate act that have an influence in the decision making for the parties concerned.

Fraudulent company is the companies have do a deliberate act of errors resulting misstatements in financial statements (Annisya, Lindrianasari, & Asmarianti, 2016). According to Sihombing dan Rahardjo (2014) as cited in Annisya *et al*., (2016), fraudulent financial statement is intentional acts or omissions in the reporting of financial statements that were reported did not meet the criteria of accounting principles. According to Septriani & Handayani (2018), the practice of earning management is an act of manipulation financial statement made by the management as a short-term solution in order to obtain the trust of investors on their performance. Earnings management is a phenomenon that can not be avoided because the phenomenon is the basis of accrual use which uses in preparing the financial statements. Even if in terms of rational and equitable in principle, if the accrual obtained has been modified the profit will also change. Earning management can change the performance of company become better than other companies, so as the investor who do not have the precautionary principle would be gullible by the management.

2.2 Literature Review

Research conducted by Skousen, Smith, & Wright (2008) aims to detect and predict fraud in the financial statements: effectiveness against fraud triangle and SAS no. 99. The variables used in this study are the nature of industry, ineffective monitoring, external pressure, personal financial need, financial targets, financial stability and organizational structure. The results obtained from the research showed that the financial targets, financial stability, organizational structure, nature of industry have a influence positive effect to the fraudulent financial statements. External pressure, ineffective monitoring, personal financial need have a influence negative effect to the fraudulent financial statements.

Research conducted by Firdaus & Suryandari (2008) aims to analyze the factors that influence the management strategy, finance, auditor, culture and government in accounting fraud. The variables used in the study are the founder of the company, a professional accountant, a special party transaction, CEO education, financial leverage, the age of the CEO, the size of the company, acquisition strategy, capital turnover, asset composition, the type of KAP, good corporate governance and the auditor's opinion. The results from the study showed that, the size of the company, the auditor's opinion, a special party transaction had the effect in the accounting fraud. While the age of the CEO, asset composition, CEO education, financial leverage, professional accountant, acquisition strategy, capital turnover, type of KAP, the company's founder and good corporate governance have no influence in the fraudulent financial statement.

Lou & Wang (2009) conduct research on the risk factors of fraud in the Fraud Triangle to assessing the possibility of fraud in the financial statements. The variables used in this study is the leverage, percentage of sales related party transaction, the analyst's forecast error, directors and supervisors' stock pledged ratio, the number of changes in auditor and restate historical times with the variable control firm size. The results from the research showed that the leverage, directors and supervisors' stock pledged ratio, the analyst's forecast error, percentage of sales related party transactions, restate historical times and the number of changes in auditor have a positively correlated to fraudulent financial statement while firm size has a negatively correlated to fraudulent financial statements.

Kusumawardhani (2013) conducting research with the purpose to detect fraudulent financial statement with fraud triangle analysis on banking companies listed in Indonesia Stock Exchange. The variables that used in the research is personal financial need with the proxy of percentage of ownership by insiders (oship), financial stability with the proxy of percentage change in total assets (achange), and ineffective monitoring with the proxy of the number of audit committee (bdout). The results from the study showed that the personal financial need with the proxy of percentage of ownership by insiders (oship), financial stability with the proxy of percentage change in total assets (achange), and

ineffective monitoring with the proxy of the number of audit committee (bdout) have effect to the fraudulent financial statement.

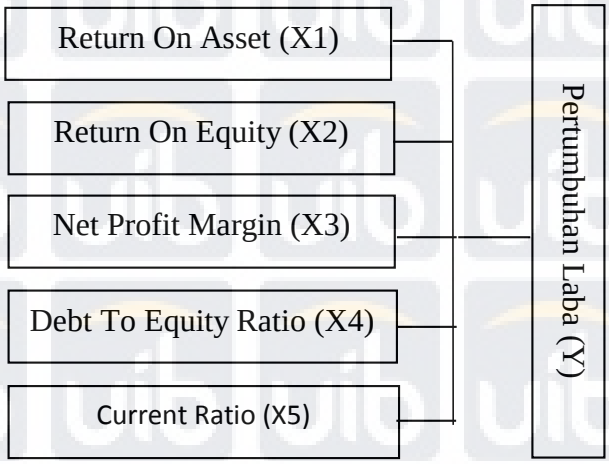

Figure 2.1 The effect of the ratio of Return on Assets, Return on Equity, Current Ratio, Debt to Equity Ratio and Net Profit against Corporate Profit Growth on the Indonesia Stock Exchange. Source: Heikal, Khaddafi, & Ummah (2014).

Figure 2.1 is a model of research has been conducted by Heikal *et al*., (2014) in this study using various ratio to show the effect to corporate profit growth. The ratio used are return on equity, debt to equity ratio, current ratio, net profit margin and return on asset. The results from the studies showed that the return on assets has a positive correlated effect to revenue growth. Net profit margin and return on equity have a positive correlated effect on profit growth. Debt to equity ratio has a high influence on the increase of income. Current ratio has no influence in determining the company's profit growth.

Boumediene (2014) conducting the research to detect and predict the fraud manager in the financial statement of bank Tunisia. In this study, the variables used are performance ratios, growth ratios, and capital ratios. The result from the studies showed that the low performance or high ratios growth ratios inflict the manager to do the fraudulent financial statement, while the low capital ratios does not cause the manager to do the fraudulent financial statement.

Widyashant (2015) conducting the research that aims to detect the effect of Fraud Diamond to the fraudulent financial statement. The variable used in this study are financial target, industry opportunity, director’s capability and auditor rationalization. The result of the research have showed financial target, auditor rationalization, and director’s capability have no effect to the fraudulent financial

statement while industry opportunity has significant influence to the fraudulent financial statement.

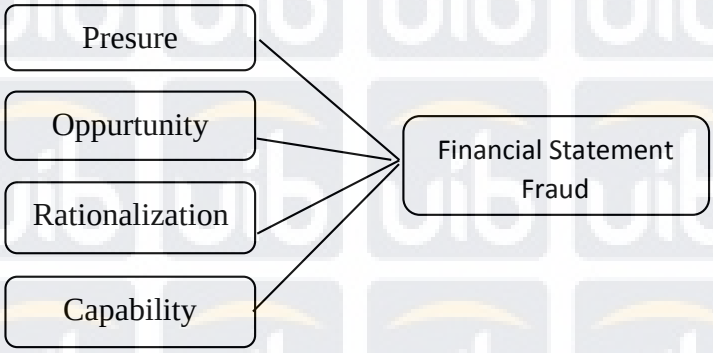

Figure 2.2 Effect of Fraud Diamond to the fraudulent financial statement. Source: Widyashant (2015).

Tiffani & Marfuah (2015) conduct research to detect fraudulent financial statement with the analysis fraud triangle in the manufactur companies listed in Indonesia Stock Exchange. The variable that use in this research are external pressure, financial stability, effective monitoring, nature of the industry, personal financial need, financial targets and rationalization. The result from research showed that the external pressure and financial stability have a positive correlated on fraud in the financial statements. While the variable effective monitoring has a significantly negative influence to fraud in the financial statements and nature of the industry, personal financial need, rationalization, financial targets had no influence on the fraudulent financial statements.

Research conducted Ahmed & Naima (2016) aims to detect and analyze potential earnings manipulation by the company in a developing country. The variable used in this research are sales growth index, days in sales in receivables index, total accruals to total assets, gross margin index, sales, general and administrative index, leverage index, asset quality index and depreciation index. The results from the study show days sales in receivables index is an indication of the increased income because that ratio is used for detect the increase of receivable thus concluded that the increase was due to inflation in income and inflation in income cause the earning manipulation. Total accruals to total assets, sales, general and administrative index and asset quality index showed a significant effect in detecting earnings manipulation. Other variable has no influence in detecting of earning manipulation.

In a research conducted Repousis (2016) using beneish model in detection fraudulent financial statement of companies in Greece. The variables used in this study as follows:

- GMI = Gross margin index
- DSRI = Days in sales in receivables index
- SGI = Sales growth index
- AQI = Asset quality index
- LVGI = Leverage index
- DEPI = Depreciation index
- TATA = Total accruals to total assets
- SGAI = Sales, general and administrative index

Results from the studies showed GMI, SGAI, DSRI, SGI and AQI have a significant relationship in earnings manipulation while DEPI, LVGI and TATA have no relation to earnings manipulation.

Husmawati, Septriani, Rosita, & Handayani (2017) conducting the research on the fraud pentagon analysis in assessing the likelihood of fraud in the financial statements. The variables that use in this research are financial stability, financial target, nature of industry, ineffective monitoring, external pressure, change in board of director, change in auditor, number of CEO's picture, rationalization. The result from the studies showed financial target has no affecting in detecting fraud in the financial statements. External pressure and Financial stability influential in detecting fraud in the financial statements. Ineffective monitoring and nature of industry have no influence to detect fraudulent financial statement. Change in board of director and change in auditor have an effect in detecting fraud in the financial statements. Number of CEO's picture dan rationalization have no influence in detecting fraudulent financial statement.

Akbar (2017) conduct research in order to identify fraudulent financial statement in manufacturing companies by using the theory of pentagon. In this research, the variables used are institutional ownership, financial target, the number of audit committee members, external pressure, nature of industry, financial stability, the change of directors, CEO duality, proportion of the independent commissioners, the number of CEO's picture, the change of auditors and auditor's

opinion. The results obtained from the studies showed that financial target, institutional ownership, financial stability and external pressure have a influence in the fraudulent financial statement. The change of directors, the number of audit committee members, nature of industry, the change of auditors, proportion of the independent commissioners, the number of CEO's picture, auditor's opinion, CEO duality have no effect in the fraudulent financial statement.

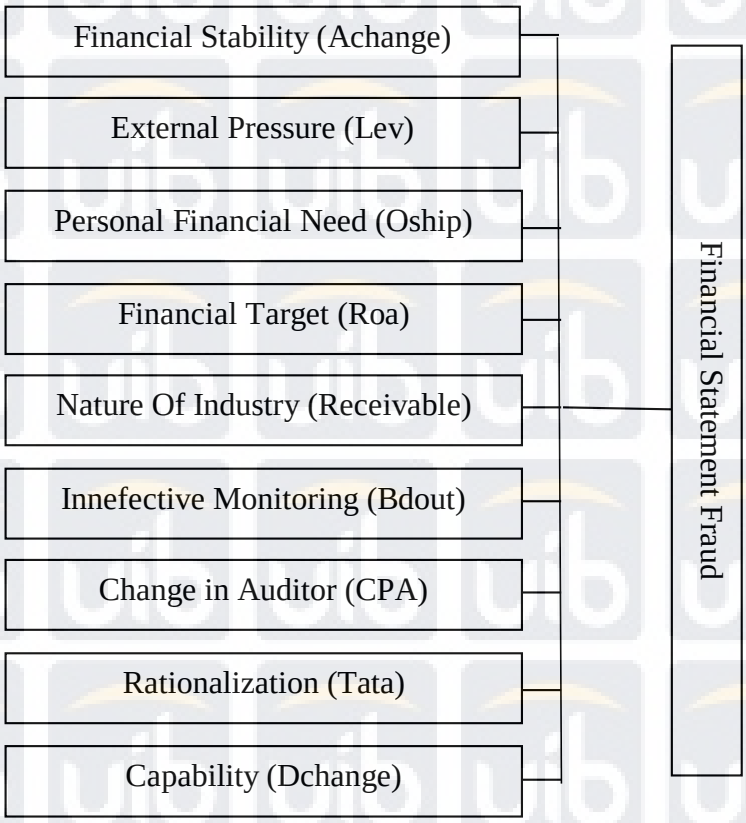

Figure 2.3 Detection of fraudulent financial statement: Tests using fraud diamond. Source: Yesiariani & Rahayu (2017).

Figure 2.3 is a model of research used by Yesiariani & Rahayu (2017) in the detection of fraudulent financial statement: Testing using fraud diamond. The variable used in the studies are personal financial need, external pressure, rationalization, financial stability, nature of industry, financial targets, ineffective monitoring, capability and change of auditors. The results obtained from the study showed that the variable rationalization and variable external pressure have a positive correlated to the fraudulent financial statements. Variable financial targets and variable financial stability have a negative correlated to the fraudulent financial statements. While the variable nature of industry, personal financial need, capability,

ineffective monitoring and change of auditors have no effect to the fraudulent financial statement.

Ratmono, Diany, & Purwanto (2017) conduct the research that aim to analyze whether the fraud triangle theory explains the fraudulent financial statement. The variable used in this study are net profit margin ratio, asset turnover ratio, ROA ratio, negative operating cash flow and financial expertise possessed by audit committee. The results obtained in the study showed that ROA ratio, negative operating cash flow, net profit margin ratio have no influence to the fraudulent financial statement. Variable financial expertise possessed by audit committee and asset turnover ratio have significant influence to the fraudulent financial statement.

Septriani & Handayani (2018) conducting research aimed to detecting fraudulent financial statements by fraud pentagon analysis. Variable that used in the research are external pressure, picture of CEO, ineffective monitoring, financial stability, rationalization, change of auditors, change of board of directors, nature of industry and financial target. The result from the studies showed that variable external pressure and financial stability have influence in the earning managements. Furthermore, variable rationalization, financial target and nature of industry proven have no influence to detecting fraudulent financial statement.

Ozcan (2018) conduct research about the use of beneish model in forensic accounting: Evidence from Turkey. The variable used in this research are Asset quality index, Gross margin index, Days in sales in receivables, Total accruals to total assets, Leverage index, Sales growth index, Depreciation index and Sales, general and administrative index. The variable of Asset quality index, Sales growth index, Leverage index, Gross margin index, Depreciation index and Days in sales in receivables have significant influence to detecting fraudulent financial statement otherwise Sales, general and administrative index and Total accruals to total assets have no influence to detecting fraudulent financial statement.

2.3 Relationship between variables independent and variable dependent

2.3.1 Relationship between leverage ratio 1 & 2 and fraudulent company

The leverage ratio is defined as the ratio used to measure the potency of companies or investors to utilize the borrowing money. Companies with high leverage tend to have high risk in bankruptcy problems if the company didn't have capability to pay the debts. The possibility of fraud in company will increase if the company has high debts because the owner and manager of the equity transfer the risk to the owner of the debt (Spathis, 2002). According to Dechow, Sloan, & Sweeney (1996), the company who has high debt the possibility of manipulate the income will increase. Research shows that the possibility of transferring wealth from creditors to managers has increased with increasing in the leverage (Chow & Rice, 1982). The management of the company will manipulate the financial report in order to fulfill the requirement of certain debts agreement. Therefore, it is proved that a high percentage of debt that may increase the possibility of fraud in the financial statements.

According to Martantya & Daljono (2013); Putra & Fitriany (2015); Kusuma, Perdana, & Suranta (2017); Sunardi & Amin (2018) have found that leverage ratio didn't has any effect to fraudulent company. Annisya *et al*., (2016) have found that external pressure which the calculation using the leverage ratio has no significant relation to fraudulent company.

Research conducted by Ata & Seyrek (2009) have shown opposite result from the previous research, they have found the leverage ratio which used in detecting the fraud in company has a positive relation. In the research conducted by Kara & Yereli (2013); Shih, Cheng, & Wang (2011) have found that leverage ratio has a significant positive relation in detecting the fraudulent company. According to study Aghghaleh, Iskandar, & Mohamed (2013) by using leverage ratio and sale to account receivable ratio have found that leverage ratio and sale to account receivable ratio has a significant positive relation in detecting the fraudulent company. Research conducted by Manurung & Hadian (2013) have found the same result from the previous research, the research using the external pressure variable with a proxy of leverage ratio indicate a positive relation to fraudulent company. In the study conducted by Nakashima (2017); Sihombing & Rahardjo (2014) have

found that leverage ratio which used to detecting the fraudulent company has a positive relation. The research conducted by Dani, Ismail, & Kamarudin (2013) have found that leverage ratio has a negative relation to fraudulent company. Research conducted by Nindito (2018) have found the same result from the previous research, the result indicate a significant negative relation to fraudulent company.

H_1 : There is a positive relation effect between leverage 1 ratio to fraudulent company.

H_2 : There is a positive relation effect between leverage 2 ratio to fraudulent company.

2.3.2 Relationship between profitability ratio and fraudulent company

Profitability ratio is defined as the ratio usually use by the entity to compare the net income with the income of the company. According to Nia (2015) profitability ratio usually used for measure the capability of company to generate the profit. According to Kreutzfeldt and Wallace (1996) as cited in Zainudin & Hashim (2016) the company with the low profit can distribute the incentives to management with the purpose to overstate the income or reduces the expenses, such reports indicate a significant error. According to Zainudin & Hashim (2016) in order to optimize the functionality of their shareholders, corporate executives will manipulate the profitability ratio and it result the fraudulent financial statements.

According to the research conducted by Skousen & Wright (2008) using the financial stability variable with a proxy of sales to total asset ratio and sales to account receivable ratio have found that profitability ratio has a positive relation in detecting the fraud in company. Furthermore, study conducted by Skousen, Smith, & Wright (2009); Prasmaulida (2016) have found that profitability ratio has a effect and positive relation in detecting the fraud of company. The outcome of research conducted by Abbas (2017); Inayanti (2016) have found the same result from the previous research, they have found the profitability ratio has a significant influence and positive relation to fraudulent company.

According to the research Norbarani & Rahardjo (2012); Manurung & Hardika (2015) have found that profitability ratio didn't has any effect in detecting the fraudulent company. According to the study of Darmawan & Saragih (2017)

have found opposite result from the previous research, the outcome of the study have showed that profitability ratio has a negative relation to fraudulent company.

H_3 : There is a positive relation effect between profitability ratio to fraudulent company.

2.3.3 Relationship between asset composition ratio 1, 2 & 3 and fraudulent company

Asset composition ratio is defined as the ratio used in the measurement of the percentage of current assets compared to total assets, the percentage of receivables compared to revenue and the percentage of inventory compared to the total assets. The management is more likely to manipulate the account such as sales, accounts receivable, allowance for doubtful and merchandise inventory (Schilit, 1993; Green, 1991; Loebbecke, 1989). Feroz, Park, & Pastena (1991) explained that the management will do manipulation receivables by recording fictitious sales aimed to increase receivables. On examination fraud in the financial statements by the company, Persons (1992) explained that the company assets currently has mostly consist of inventory and accounts receivable. Because of that the company management can utilize of these accounts as a way to commit fraud in the financial statements (Spathis, 2002).

According to Dalnial, Kamaluddin, Sanusi, & Khairuddin (2014) have found that asset composition ratio with a proxy of inventory to total asset has a positive relation effect to fraudulent company. The research conducted by Oktaviani, Karyawati, & Arsyad (2014) have found that asset composition ratio has a significant influence and positive relation to fraudulent company. According to the research conducted by Kanapickienė & Grundienė (2015); Putra & Fitriany (2015); Suyanto (2009) have found that asset composition ratio has a significant positive relation in detecting the fraud in the company. Research conducted by Nia (2015) have found that asset composition ratio which used to detecting the fraudulent company has a negative relation effect.

According to the study conducted by Dani *et al.*, (2013); Omoye & Eragbhe (2014) have found opposite results from the previous research, the results have shown that asset composition ratio has no effect to fraudulent company.

H_4 : There is a positive relation effect between asset composition 1 ratio to fraudulent company.

H_5 : There is a positive relation effect between asset composition 2 ratio to fraudulent company.

H_6 : There is a positive relation effect between asset composition 3 ratio to fraudulent company.

2.3.4 Relationship between liquidity ratio and fraudulent company

Liquidity ratio is the ratio used as a tool in the measurement the company potency to pay the short-term debt. According to Kreutzfeldt and Wallace (1996) as cited in Zainudin & Hashim (2016) states that the company which was considered have a problems with the liquidity are likely to have the potential for commit fraudulent actions in financial statements rather than the company with smoothly liquidity. Generally, the company which liquidity ratio is high then the company has a greater ability to pay short-term debt. The working capital to total assets ratio in the company is low indicate that the company has problems to settle their short-term debt. Dalnial *et al*., (2014) states the manager has a high possibility to commits fraud if the company has a low liquidity ratio.

According to the research Liou (2008) have found that liquidity ratio with a proxy of working capital to total asset has a positive relation to fraudulent company. According to the research Gaganis (2009) have found that liquidity ratio has a significant influence and positive relation to fraudulent company. According to the research Ujal, Amit, Hiral, & Rajen (2012) indicate that liquidity ratio has a positive relation in detecting the fraud in company. Furthermore, the outcome of research conducted Amara, Amar, & Jarboui (2013); Kanapickienė & Grundienė (2015) indicate that liquidity ratio has a positive relation in detecting the fraudulent company. In the outcome of research conducted by Ozcan (2016) have found that liquidity ratio has a negative relation in detecting the fraudulent company. Based on the result of research conducted by Nindito (2018) indicate the same result from the previous research, this research have found that liquidity ratio has a negative relation in detecting the fraud in the company.

Based on the results of research conducted by Astuti, Zuhrohtun, & Kusharyanti (2015); Hanifa & Laksito (2015); Kanapickienė & Grundienė (2015) indicate the opposite result from all previous research, result of the research have found that liquidity ratio has no relation to fraudulent company. Furthermore, research conducted Apriliana & Agustina (2017) have found that there is no influence between liquidity ratio to fraudulent company.

H_7 : There is a positive relation effect between liquidity ratio to fraudulent company.

2.3.5 Relationship between capital turnover ratio and fraudulent company

Capital turnover ratio is the ratio used as a tool in measurement the company capability to generate sales by utilizing the company assets. Asides this ratio is also used as a tool to measuring management capabilities in encounter the competitive situation. According to Persons (1992), the manager who commits in fraudulent financial statement are those not competitive in rivalry using the company asset in generating sales. It creates opportunities for manager to act in fraudulent financial statements (Dani *et al*., 2013). Furthermore, the management who can not to compete in utilizing the company's assets to generating sales, so in order to generate incentives for managers also possible to commit acts of fraud in financial statements (Nia, 2015). According to Dalnial *et al*. (2014) the company have a problem in generate the sales will be likely to commits in act of fraud in the financial statements.

According to the result of research conducted Suyanto (2009) have indicate that capital turnover ratio didn't has any influence in detecting the fraud in the company. Otherwise according to the research conducted Dimitropoulos & Asteriou (2009) have found that capital turnover ratio which used in detecting the fraud in the company has a positive relation. Research conducted Lenard & Alam (2009) have found opposite result from the previous research, the result have indicate that the company with lower capital turnover will increase the possibility of company to commit fraud in the company because of that capital turnover ratio in detecting the fraud in the company has a negative relation.

In the research conducted by Kamaluddin, Dalnial, Khairuddin, & Sanusi (2014) have indicate that capital turnover ratio in detecting the fraud in the company has a significant influence and negative relation. Furthermore, research conducted Persons (2011); Dani et al. (2013); Nia (2015) have indicate that the company will commit to fraud in the company if the capital turnover is low because of that capital turnover ratio in detecting the fraud in the company has a significant and negative relation.

H_8 : There is a negative relation effect between capital turnover ratio to fraudulent company.

2.4 Research model

From the results of the study above, we can make a research model that can provide the illustration about the variables that have influence to fraudulent financial statemets. The research model illustrate the influence of variables in detecting the fraudulent company. The following is the model of the research used in the research:

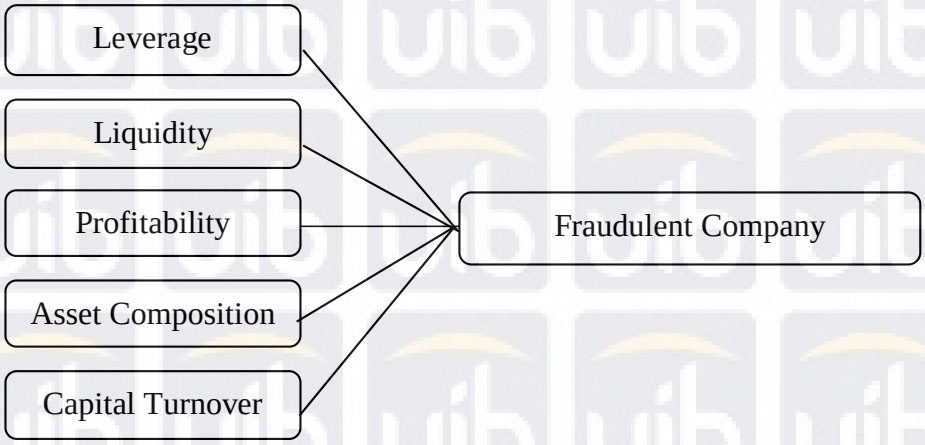

Figure 2.4 Detecting fraudulent financial statements using financial ratio. Source: Zainudin & Hashim, (2016).