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Factors that Influence Fraudulent Financial Statements in Retail Companies - Indonesia

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Abstract

Fraudulent financial statements is an intentionally misstatement of the financial statements. There are several factors affected the evidence of fraudulent financial statements report. The objective of this research is to investigate the influence of audit committee characteristics, managerial ownership, leverage, and liquidity toward the fraudulent financial statements report in retail companies listed on the Indonesia Stock Exchange in the period of 2012-2016. Using regression, the result shows that audit committee characteristic and leverage do not have significant effect on the fraudulent financial statements report, while managerial ownership and liquidity have. Simultaneously, audit committee characteristics, managerial ownership, *leverage* and liquidity have significant influence to the fraudulent financial statement report.

Keywords: Audit Committee Characteristic, Managerial Ownership, Leverage, Liquidity, Fraudulent Financial Statement

Abstrak

Fraudulent financial statements adalah tindakan yang secara disengaja untuk membuat salah saji pada laporan keuangan. Ada beberapa faktor yang mempengaruhi terjadinya fraudulent financial statements. Tujuan penelitian ini adalah untuk investigasi pengaruh karakteristik komite audit, kepemilikan manajerial, leverage dan likuiditas terhadap terjadinya fraudulent financial statements pada perusahaan sektor retail yang go public di Bursa Efek Indonesia pada periode 2012 – 2016. Sampel yang digunakan dalam penelitian ini adalah 12.. Dengan menggunakan regresi, hasil penelitian menunjukkan bahwa karakteristik komite audit dan leverage tidak memiliki pengaruh signifikan terhadap terjadinya fraudulent financial statements, sementara kepemilikan manajemen dan likuiditas ternyat memberikan pengaruh signifikan. Sedangkan karakteristik audit komite, kepemilikan manajemen, leverage, dan likuiditas secara simultan memiliki pengaruh signifikan terhadap terjadinya fraudulent financial statements.

Kata Kunci: Karakteristik Audit Komite, Kepemilikan Manajemen, *Leverage*, Likuiditas, *Fraudulent Financial Statements*

INTRODUCTION

As part of their accountability, public companies have an obligation to report their financial statements to the society. The information provided in the financial statements reflects their performance in the certain accounting period and reveals the companies' value. For that reason, the companies will put their best efforts to increase their performance so that they can present reliable information on their financial statements. However, sometimes their effort in improving performance needs a great concern, they still have interest in publishing good financial statements to retain or even increase their company's value.

A negative performance appears to bring higher risks to the company since it might motivate company to do manipulation in their financial information. Manipulated data in the presentation of financial information does not represent the actual condition of the company. If these data is used as basis for decision making, then the quality of decision making will be questionable. It will inflict a financial loss to public users of financial information, either directly or indirectly. Manipulation and the alike that have been intentionally committed by the company are considered as fraud. The fraud committed by companies to manipulate financial statements is called fraudulent financial statement (Zainudin & Hashim, 2016) or financial statement fraud (ACFE, 2017).

There were many fraud cases throughout the world such as Enron, Worldcom, etc. The practice of fraudulent financial statemement also occurred in Indonesia, such as financial statements manipulation conducted by PT Kimia Farma Tbk (Sulistiawan *et al.,* 2011). The company manipulates its financial statement by overstating the net income and doubled sales in two business units that are not exposed to external auditor sampling. Other financial statement fraud has done by PT Indofarma, Tbk (Armein, 2005). The company presented a misleading information by doing mark up to increase its profit.

To mitigate fraudulent financial statement, Sarbanes-Oxley Act required that the audit committee has to be fully independent and has at least one person skilled in finance or accounting (Hoag *et al.*, 2017). The existence of audit committee will reduce the chance for the fraudulent financial statement. Besides, managerial ownership can be used as management control to reduce the occurrence of fraudulent financial statements (Owen-Jackson *et al.,* 2009).

Looking through the detail, financial ratios can be used by the companies for evaluating their reporting performance in order to reduce the occurrence of fraudulent financial statement. Research on the effectiveness of financial ratios in detecting the fraudulent financial statement was done previously by some authors (Zainudin & Hashim, 2016; Dalnial *et al.,* 2014; Dani *et al.*, 2013). The financial ratios associated with the detection of the fraudulent financial statement are leverage ratio and liquidity ratio. Leverage ratio shows the company debt over the assets while liquidity shows the ability to pay its obligation (Goel *et al.,* 2015; Nia, 2015).

There are some issues about the bankruptcy of some retail companies which were caused by poor internal control. Based on the survey done by Deloitte India (2015) the retailers have high risk of manipulation within the retail business. Therefore, retail companies are an interesting object for testing the occurrence of fraudulent financial statement (Deloitte-India, 2015) This research will explore the factors that influence the occurrence of fraudulent statement in retail industry. Factors that are analysed consist of the audit committee characteristic, managerial ownership, leverage, and liquidity.

LITERATURE REVIEW

The Association of Certified Fraud Examiners (ACFE) describes the fraudulent financial statement as the misrepresentation of the financial statement that leads the users to receive false information (ACFE, 2017). Fraudulent financial statements are misstatement or ignorance of deliberate amounts or disclosures intended to deceive the users of financial statements for the purpose of misleading the reader and creating a false impression of firm performance (Arens *et al.,* 2012). Fraudulent financial statement is intended to secure investor's interest and associated with bonuses or increased salaries or to meet expectations of shareholders. Higher management board is usually at the center of fraudulent financial statement because financial statements are created at the management level.

Beneish did a research in using the accounting data, such as receivables, sales, asset, depreciation, leverage, total accrual, etc. to detect the financial statement distortion that resulted from manipulation. Beneish developed a model which is called Beneish M-Score (Beneish, 1999). This model can be used to detect companies with a tendency to commit fraud on their financial statements (Tarjo & Herawati, 2015).

Agency theory said that firms can be seen as contractual relation between agent and principal. The agency relationship arises when one or more individuals (agents) are employed and delegated the decision making authority by the owner to perform certain company's services (Jensen & Meckling, 1976). In some cases, the relationship between the principal and the agent is not in line with the company goals because the principal and agents have their own interests. With attachment to the contract, the principal wants to gain more profit and the agent wants to get a high compensation in return for his work in fulfilling the principal's expectation. This difference sometimes creates conflict of interest between the two parties.

According to Arens *et al*. (2012), audit committee consists of three or more members that are selected by company's board of directors in order to help them to do their responsibilities and help auditor to remain independent as part of company management (Arens *et al.*, 2012). The Financial Services Authority of Indonesia (OJK) Decree No. 55/PJOK.04/2015 stated that the membership requirements regarding the character of the audit committee in Indonesia, are having financial education background, understanding the financial statement laws and regulations, and being independent (OJK, 2015).

Jensen and Meckling (1976) said that agency issues will arise if there is separation ownership and control of a company between managers and shareholders. The separation is the reason for the difference between managers and shareholders (Omoye & Eragbhe, 2014). Managerial ownership is the ownership of shares by the company management. It means that the managers now become the shareholders or the owners of the company. In this case, managerial ownership appears to unify the interests of managers and shareholders.

Leverage is the amount of debt the company uses to finance its operations (Goel *et al.*, 2015). Instead of using the debt issuance, another alternative for sources of corporate funds is selling shares (offering) in the capital market. The greater the level of leverage in the company, the greater the source of funds obtained through debt so that the level of risk in debt and interest expense repayment is also greater. Increased interest charges to be paid resulted in a decrease in the dividend distribution so that it can cause concern to public or investors (Dalnial *et al.,* 2014). Investor might consider this as a negative performance of the company. This situation can be one possible motivation for the management to do the fraud.

Company's liquidity is companies' ability to pay its financial obligations. It can be measured by a liquidity ratio.The ratios illustrate companies' ability to fulfill their short-term debt. One of the most common ways is to compare the company's most liquid assets, which are easily convertible into cash, with short-term liabilities (Nia, 2015).

The greater value of current assets than its obligation shows the better the company ability to meet its obligations (Dalnial *et al.,* 2014). Conversely, firms with low coverage rates have low capabilities. For investors, it is a sign that the company has difficulty in fulfilling its financial obligations. Companies with insufficient liquidity are most likely forced to sell their assets to meet their obligations including discharging their productive assets, selling inventory or business units. If this step is taken, the company will incur losses for short-term survival of the company and their long-term financial health (Zainudin & Hashim, 2016).
Based on all this evidence, the followings are the hypotheses:

Hypothesis 1: Audit committee characteristics has relationship to the fraudulent financial statements report.

Audit committee has to remain independent and transparent in their work. Being independent and transparent means the audit committee has more focus on the quality of financial statement (Ozcan, 2016). Kent et al. (2010) found a significant negative relationship between audit committee to finance or accounting background and fraudulent financial statement (Kent, *et al*., 2010). The existence of proper background of audit committes will contribute more to the qualified financial statements since the have proper compentency to the audit works. The more committees with finance or accounting background appointed to the audit committee, the less the fraudulent financial statements that will be happen (Arens, *et al.,* 2012; Kent *et al.,* 2010; Ozcan, 2016; Vlaminck & Sarens, 2013).

Hypothesis 2: Managerial ownership has relationship to the fraudulent financial statements report.

Managerial ownership is considered to reduce the problems of the agency. Managerial ownership means that manager has a role as either a shareholder or an owner. Therefore manager (agent) will work in accordance with the interests of the shareholder (principal). Having both roles as the agent and principal in the same time, there will be a decreased level of conflict of interest. In turn, it will reduce the motivation of manager to do the fraudulent financial statements. Due to managerial ownership, managers will be more intended in increasing the value of the company and motivate managers to work in accordance with the interests of the principal. A research conducted by (Omoye & Eragbhe, 2014) shows that managerial ownership negatively affects fraudulent financial statement. The greater the level of ownership of shares by the managers, the possibility of fraud becomes smaller. The other study conducted also support that managerial ownership has a significant negative effect on fraudulent financial statements (Owen-Jackson *et al.*, 2009; Kent *et al.,* 2010; Siahaan, 2013).

Hypothesis 3: Leverage has relationship tothe fraudulent financial statement report.

Leverage is how much loan or debt the company has. The higher the level of leverage, the company will tend to report high profitability as well to cover their debt (Zainudin & Hashim, 2016). According to Jensen and Meckling (1976), there is the potential for transferring wealth from debtholders to shareholders and managers in companies that have high levels of debt dependence as the leverage increases. A company management may manipulate its financial statement if there is a need to meet certain debt agreement. Furthermore, higher leverage associated with a higher potential for violation of the debt agreement and a reduced ability to obtain additional capital through debts (Nia, 2015). Thus, this suggests that a higher level of leverage may increase the occurence of fraudulent financial reporting.

Hypothesis 4: Liquidity has relationship tothe fraudulent financial statement report.

Liquidity is used to determine a company's ability to fulfill their short-term debts. Many users analyze company liquidity before the investment. A study by Kreutzfeldt and Wallace in (Dalnial *et al.*, 2014) found that firms with liquidity problems had more potential of fraud in their financial statements as compared with firms without liquidity issues. In addition to investor, creditor also concern if the company is unable to meet the debt agreement. To overcome these concerns, the manager will strive to manipulate their financial statement (Zamri, *et al.*, 2013). Research showed that company with liquidity issues is associated with lower probability of the company to fulfill their short-term debts (Zainudin & Hashim, 2016; Omoye & Eragbhe, 2014). A study by (Dalnial *et al.*, 2014) resulted that the company with liquidity issues, the more likely it is for the manager to manipulate their financial statement. This research will use company size a control variable measured with total assets (Martantya & Daljono, 2013)

RESEARCH METHOD

Research model is a picture or graph that give causal explanation about the research key concept (Smith, 2017).

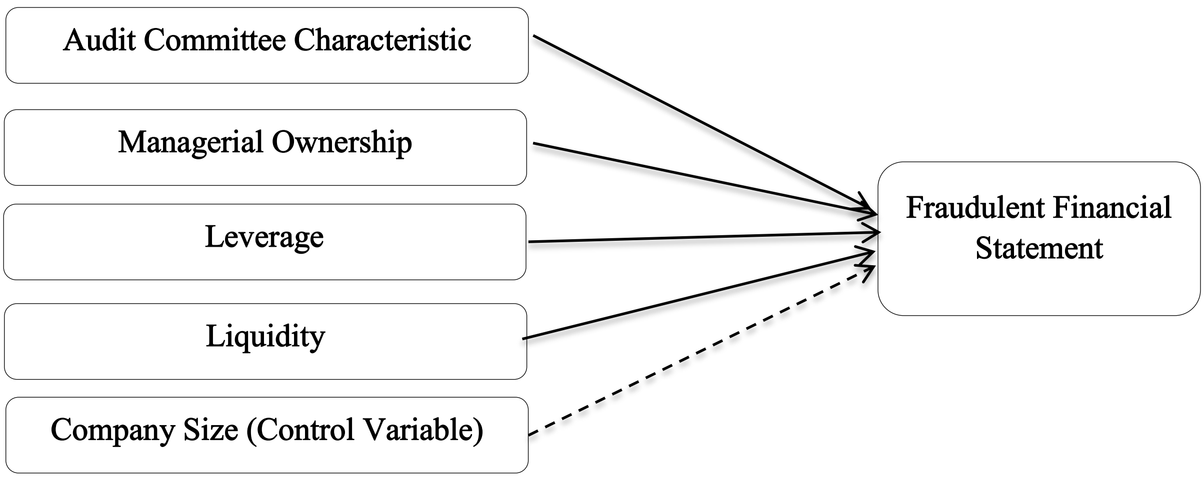

Figure 1. Research Model
Source: author

This research uses secondary data, which is companies' financial statement taken from Indonesia Stock Exchange and companies official website for the year ended 2012 to 2016. The samples are retail companies which has the complete data for this research. Multiple regression analysis is conducted in this research because this research has four independent variables. The dependent variable is fraudulent financial statement while the independent variables are audit committee characteristic, managerial ownership, leverage and liquidity.

$$Y = \beta 0 + \beta 1\,ACC + \beta 2\,MO + \beta 3\,LEV + \beta 4\,LIQ + \beta 5 SIZE + e \qquad (1)$$

Where

- ACC is audit committee characteristic calculated by the member of audit committee who have accounting or financial discipline/background divided by the total audit committee's members (Hoag, Myring, & Schroeder, 2017).

- MO or managerial ownership is a dummy variable. If the management owned the shares in the company, then it will be assigned 1 otherwise will be assigned 0.
- LEV is total liabilities divided by total assets (Nia, 2015).
- LIQ or liquidity is calculated using the percentage of cash conversion cycle per year that describes the amount of time to sell, collect and pay their operation. The formula is the number of days it takes to sell an entire inventory (DOI) added by the number of days needed to collect on sales or account receivable less the company's payment of its own bills or account payable in a year divided by number of days in a year, which is 365 (Nobanee, Abdullatif, & AlHajjar, 2011; Wang, 2002).
- SIZE or company size, used as control variable and calculated using ln total assets.
- *Y* is fraudulent financial statement using the following formula: (Beneish, 1999; Tarjo & Herawati, 2015).

$$FRAUD = -4.84 + (0.920\times DSR) + (0.528\times GMI) + (0.404\times AQI) + (0.892\times SGI) + (0.115\times DEPI) - (0.172\times SGAI) + (4.679\times ACCRUALS) - (0.327\times LEVI) \qquad (2)$$

Where the variable definition of fraud factors are shown in Table 1 below:

Table 1. Operational Definition of Variables

Fraud Factors:	Formula
DSR (Days' Sales Receivables index) =	(Current Year Receivables ÷ Sales) ÷ (Prior Year Receivables ÷ Sales)
GMI (Gross Margin Index) =	(Prior Year Gross Margin) ÷ (Current Year Gross Margin]
AQI (Asset Quality Index) =	(Current Year Noncurrent Assets except PPE ÷ Total Assets) ÷ (Prior Year Noncurrent Assets except PPE ÷ Total Assets)
SGI (Sales Growth Index) =	Current Year Sales ÷ Prior Year Sales
DEPI (Depreciation Index) =	[Prior Year Depreciation ÷ (Depreciation + PPE)] ÷ [Current Year Depreciation ÷ (Depreciation + PPE)]
SGAI (Sales, General, and Administrative expenses Index) =	(Current Year SGA ÷ Sales) ÷ (Prior Year SGA ÷ Sales)
ACCRUALS (Accruals Index) =	(Income Before Extraordinary Items - Cash from Operations) ÷ Total Assets
LEVI (Leverage Index) =	[(Current Year Long-Term Debt + Current Liabilities) ÷ Total Assets] ÷ [(Prior Year Long-Term Debt + Current Liabilities) ÷ Total Assets]

Source: (Beneish, 1999; Tarjo & Herawati, 2015)

RESULTS AND DISCUSSION

Table 2 reveals the result of the descriptive statistics. From this table, it can be concluded that the sample companies mostly has 3 members of audit committee, while 2 among them are those members who has education background in accounting and /or finance.

Table 2. Descriptive Statistics

	N	Minimum	Maximum	Mean
ACC	60	0,33	1,00	0,6694
LEV	60	0,16	1,66	0,5856
LIQ	60	-0,31	0,58	0,0839
FRAUD	60	-3,51	-0,91	-2,4022
SIZE	60	14,12	29,69	20,8037

Based on Table 3, there are 57% sample year with the manager having a managerial ownership.

Table 3. Frequency of Managerial Ownership

	Number of sample	Percentage
Have managerial ownership	34	57%
No managerial ownership	26	39%
Total	60	100%

Regression analysis result is shown below:

Table 4. Regression Result

Model		Unstandardized Coefficients			
		B	Std. Error	t	Sig.
1	(Constant)	-2,099	0,359	-5,854	0,000
	ACC	0,052	0,322	0,161	0,872
	MO	-0,310	0,134	-2,304	0,025
	LEV	-0,149	0,291	-0,514	0,609
	LIQ	1,472	0,512	2,873	0,006
	SIZE	-0,010	0,013	-0,727	0,471

According to Table 4, the multiple regression equation model is as follow:
Y = -2,099 + 0,052*ACC - 0,310*MO - 0,149*LEV + 1,47*LIQ - 0,010* SIZE + e

Coefficient of determination is used to predict the contribution of the model in influencing the dependent variables and shows how the dependent variable can be influenced by the independent variables.

Table 5. Coefficient of Determination Result

Model	R	R Square	Adjusted R Square
1	0,521	0,272	0,204

Coefficient of determination can be seen from the adjusted R square. Based on Table 5, the coefficient is 0,204. It means that the independent variable can explain the dependent variables by 20,40%, and the the rest, 79,60% is explained by another factors that are not in this research model.

Table 6. F test Result

Model		F	Sig.
1	Regression	4,028	,004

From the Table 6, the significant of F is 0,004 which is below the significant rate of 0,05. It means that the regression model can be used to explain the dependent variable. In other words, all the independent variables simultaneously give significant influence the dependent variable.

a. The Influence of Audit Committee Characteristics towards Fraudulent Financial Statement

Based on the test, the ACC has t value of 0,161 < 2,000 (t value less than t table) with significant value is 0,872 which the significant value is greater than 0,05. So, the H1 is rejected or the audit committee characteristic, the ACC does not have any influence to the fraudulent financial statement. This result contradict with the act regarding establishment and guidance of audit committee. The reason of this result can be associated with Indonesia culture where most company in Indonesia still dominated by family companies. The committee also comes from the management that result the audit committee cannot fulfill their duty to be independent or might be the existance of the committee just for formality (Prajanto & Pertiwi, 2016). This result can also be caused by the sampling data where some of the annual report does not give the audit committee educational background in detail. Thus, the audit commitee characteristic does not significantly influence the occurence of fraudulent financial statement.

b. The Influence of Managerial Ownership towards Fraudulent Financial Statement

For the MO, managerial ownership, the absolute t value is 2,304 > 2,000 (t value higher than t table) and the significant values is 0,025 which has significant level below 0,05. The Beta value is -0,310 shows a negative relationship of MO towards the occurrence of fraudulent financial statement. So, H2 is accepted or MO has negative and significant influences the fraudulent financial statement. MO tends to reduce the problems of the agency and motivate managers to work in accordance with the interests of the principal. Company with managerial ownership shows that the company can deal with their internal problem where the company generate a positive performance and seen to be a good prospect for investor. This is in accordance with the research of (Jensen & Meckling, 1976; Siahaan, 2013; Omoye & Eragbhe, 2014) that the higher the managerial ownership of a company the less the occurrence of fraudulent financial statement.

c. The Influence of Leverage towards Fraudulent Financial Statement

For LEV or leverage, the absolute t value is 0,514 < 2,000 (t value less than t table) and the significant values is 0,544 which has higher significant value than significant level of 0,05. So, H3 is rejected or the LEV does not have significant influence to the fraudulent financial statement. It might be because manipulating their financial statement is not the only way to fulfill its obligations. On the other hand, the restatement of financial statement that found within the research sample may lead to the improper information of the financial statement including the leverage. In addition, the creditors are no longer considered the amount of leverage but there are other considerations such as the trust and good relationships between the company and the creditors (Martantya & Daljono, 2013), thus the company does not fully under pressure to meet its obligations. The results of this study are consistent with research conducted by Tarjo and Herawati (2015) and Prajanto and Pratiwi (2017) where the leverage does not significantly influence the fraudulent financial statement.

d. The Influence of Liquidity towards Fraudulent Financial Statement

For LIQ, liquidity, the t value is 2,873 > 2,000 (t value higher than t table) and the significant values of 0,006 which has lower value than the significant level of 0,05. The Beta value of 1,472 shows a positive relationship towards the fraudulent financial statement. So, H4 is accepted or the liquidity LIQ has a significant positive influence toward the fraudulent financial statement. It is in accordance with the research conducted by (Bardos, 2011; Dalnial, Kamaluddin, Sanusi, & Khairuddin, 2014; Nia, 2015) that the liquidity firms with liquidity problems had more potential of fraud in their financial statements as compared with firms without liquidity issues. Despite of liquidity shows company performance, liquidity also refers to the liquid assets. Among assets, the high liquid firms have a higher price, and have a lower occurence of fraud. But among inliquid assets, there are more opportunities of fraud as the assets are more resalable (Li, Rocheteau, & Weill, 2011). High liquid company also tends to have high profit and a good prospect for investor. Conversely, the illiquid company also give a signal to the investor before their made any investment decision.

CONCLUSION

Based on the result and discussion before, the conclusion of this research shows both managerial ownership and liquidity has significant influence the fraudulent financial statement in different way. For managerial ownership, it negatively influences the occurrence of fraudulent financial statement. This is because by having the higher the shares owned by management means the management also responsible to the company as an owner. For liquidity, it is a positive relationship where the higher the liquidity of the company the higher the occurrence of fraudulent financial statement. It means the increasing liquidity rate may indicate the presence of manipulation from lower liquidity company in order to be free from liquidity issue.

Lastly, the results of audit committee characteristic and leverage do not have significant influence to fraudulent financial statement. This might be because the company management usually dominated by family relationship. Then, the leverage does not have influence to the fraudulent financial statement. This might be because trust and good relationship between the company and creditor cause the management is not fully under pressure to fulfill their debt. Thus, manipulating the financial statement is not necessarily a way to overcome the debt issues.

In this research only uses the Beneish M Score model to measure fraud variable. The next researchers can use more than one model or try to improve the model with current fraud issues especially in Indonesia. The use of more variables or other variables that used in this research and use bigger scope of samples.

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