Nature of Industry and Financial Stability as Indications of Fraudulent Financial Statements

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Abstract
In this globalization era, the risk of fraudulent financial statements is increasing. Fraudulent financial statements were due to opportunities, pressures, and political relations from several ranks of the board of directors and commissioners. Countries often experience economic instability, so companies must maintain financial performance to remain in good condition. Economic instability and less than optimal supervision trigger companies to commit fraudulent actions in financial statements, like manipulation of financial statements, misappropriation of assets, or other matters that are not under applicable accounting standards. This study aims to examine the effect of the nature of industry, financial stability, and political connection on fraudulent financial statements. This study uses 58 manufacturing companies listed on the Indonesia Stock Exchange from 2018 to 2020. Fraudulent financial statements are measured using the fraud score model. This study finds that the nature of industry negatively affects fraudulent financial statements. Companies with a high ratio of changes in receivables need to be supported by strong supervision so that management does not have the opportunity to manipulate financial statements. This study also found that financial stability positively affects fraudulent financial statements. When a company experiences growth below the industry average, management manipulates financial statements to improve the company's prospects. However, this study did not find any influence of political connections on fraudulent financial statements.

Keywords
Financial stability, Fraudulent financial statements, Nature of the industry, and Political connection.

1. Introduction
The Association of Certified Fraud Examiners (2018) revealed that the most fraud cases in the Asia Pacific occurred in the manufacturing industry from 2017-2018, namely 38 cases with a loss of $500,000. In 2019-2020 cases of fraud in the manufacturing industry fell to 26 cases with a loss of $400,000, where this fraud is the most fraudulent compared to any other industry (Association of Certified Fraud Examiners 2020). According to the Association of Certified Fraud Examiners (2020), fraud has three main factors: the misappropriation of assets, manipulation of financial statements, and corruption. Data shows that cases of misappropriation of assets as much as 89% caused the lowest loss of $114,000, corruption cases were 38%, with an average loss of $250,000, and cases of manipulation of financial statements by 10% with an average loss of $800,000. The data shows that financial statement manipulation has the lowest percentage of cases but has the highest loss rate compared to the other two fraud factors.

One of the financial statement fraud cases occurred in a manufacturing company in Indonesia, namely PT. Tiga Pilar Sejahtera Food Tbk. (AISA). The company overstates receivables amounting to Rp1.4 trillion, and the alleged flow of funds from the company to management amounted to Rp1.78 trillion. The fraud causes losses for investors. The fraud is also contrary to the quality of faithful presentation as regulated in the Indonesian Financial Accounting Standard 1 – Presentation of Financial Statements (Institute of Indonesian Chartered Accountants 2019). This fraud case motivated this research.

Previous studies have investigated the nature of the industry, financial stability, political connection, and fraudulent financial statements with the inconsistent result. Novitasari and Chariri (2018) found that the nature of industry had a positive effect on fraudulent financial statements, while Setiawati and Baningrum (2018) did not find any effect of the nature of industry on fraudulent financial statements. Novitasari and Chariri (2018) found that financial stability positively affected fraudulent financial statements, while Setiawati and Baningrum (2018) did not find any effect of financial stability on fraudulent financial statements. Matangkin et al. (2018) found that political connection had a positive effect on fraudulent financial statements, while Rosida and Setyawan (2021) did not find any effect of political connection on fraudulent financial statements. These inconsistent findings also motivated the conduct of this study.

A country's economy is not always in good condition. Economic instability and less than optimal supervision cause opportunities and pressures for fraud in financial statements because management is required to always look good in the eyes of the public. Therefore, this study aims to examine the effect of the nature of the industry, financial stability, and political connection on fraudulent financial statements.

The following sections are organized as follows. Section 2 presents a review of the literature for hypothesis development. Sections 3, 4, and 5 present the methods, data collection, results, and discussion. Section 6 concludes with the main findings, contributions, limitations, and suggestions for next research.

2. Literature Review

2.1 Nature of Industry and Fraudulent Financial Statements

Ijudien (2018) reveals that the nature of the industry occurs due to the accounts in the financial statements whose calculations are based on an estimate, which can trigger an opportunity to commit fraud in the financial statements. The nature of the industry is one of the conditions that require monitoring the company's organizational structure (Iqbal and Murtanto 2016). Managers can use weak supervision to commit fraud in financial statements. The nature of the industry can show how much control the company has. One way to measure the nature of the industry is to use receivables (Skousen et al. 2009; Iqbal and Murtanto 2016; Sasongko and Wijayantika 2019). Receivables are closely related to the estimated bad debts included in the percentage of receivables. The higher the number of receivables obtained from the sale of goods or services, the manager can manipulate the amount. An increase in the number of receivables from year to year can indicate that the company's cash turnover is not good. The more receivables a company has, the less cash it can use for its operational activities. Management has the opportunity to commit fraud in the financial statements due to weak supervision, which results in the high value of receivables.
H1: Nature of industry positively affect fraudulent financial statements.

2.2 Financial Stability and Fraudulent Financial Statements

Wobowo and Putra (2021) explain that financial stability is a condition that shows the company's finances are stable, and this is one of the attractions for investors. In reality, the economy is not always in a steady state. Economic instability will put management under pressure to be able to stabilize the company's financial condition. According to the Statement on Auditing Standards (SAS) No. 99, financial stability is included as one of the conditions that can result in someone committing fraudulent acts due to pressure due to the instability of the economic situation at a particular time. Pressure is one of the things that can make a person or company commit fraud, for example, by covering up bad company performance (Rosida and Setyawan 2021). Financial stability is measured using changes in total assets yearly. The more significant changes in total company assets that are not normal from year to year will indicate that the company's financial condition is unstable, so it will pressure managers to abuse company assets.
H2: Financial stability positively affect fraudulent financial statements.

2.3 Political Connection and Fraudulent Financial Statements

Chaney et al. (2011) explain that political relations are measured by looking at the presence of directors or commissioners in a company as political people or politicians who have several advantages, such as easy access to bank loans or relationships with the government. The existence of political relations run by the board of commissioners or directors can help a company's business by taking advantage of their position when experiencing financial difficulties (Sasongko and Wijayantika 2019). Commissioners or directors with political relations tend to have power and are not afraid to commit fraud because they consider their contributions to help smooth the company's business and make perpetrators underestimate company policies, internal controls, and applicable procedures (Faradiza 2019). Arrogance is considered an element of political connection and can be one of the triggers for fraud to occur in financial statements.
H3: Political connection positively affect fraudulent financial statements.

3. Methods

The dependent variable of this study is fraudulent financial statements (FFS) as measured using the fraud score (F-Score) model. Measurement using the F-score is a method of assessing the risk of fraudulent financial reporting with the highest level of accuracy (Richardson et al. 2005). This model is measured by accrual quality plus financial performance. Accrual quality can be measured using RSST accruals, while financial performance can be calculated by changes in receivables, inventories, income, and equity (Wobowo and Putra 2021). RSST accruals are computed from the sum of working capital, non-current capital, and financial accruals divided by the average total assets. This study examines three independent variables: the nature of the industry, financial stability, and political connection. Nature of industry (NI) which is proxied as receivable, is calculated from trade receivables divided by the current year's sales (t) minus trade receivables divided by the previous year's sales (t-1) (Iqbal and Murtanto 2016). Financial stability (FS) is proxied as a change that is calculated from this year's assets (t) minus the previous year's assets (t-1) divided by this year's assets (t) (Setiawati and Baningrum 2018). Political connection (PC) is measured using a dummy with a score of 1 if the board of commissioners and the board of directors have political relations and a score of 0 otherwise (Ferdiawan and Firmansyah 2017). The data analysis technique used is panel data regression with the following equation.

$$FFSit = \alpha + \beta 1NIit + \beta 2FSit + \beta 3PCit + \varepsilon$$

FFSit = Fraudulent financial statements of firm i in year t; *NIit* = Nature of industry of firm i in year t; *FSit*= Financial stability of firm i in year t; *PCit* = Political connection of firm i in year t.

4. Data Collection

This study obtained data from the Indonesia Stock Exchange (IDX) website and companies' official website. Nature of the industry, financial stability, political connection, and fraudulent financial statement data are obtained from manufacturing companies' financial statements. Political connection data is obtained from manufacturing companies' annual reports by reading the profiles of the company's board of commissioners and directors, confirming information from the annual report of manufacturing companies listed on IDX. This study determines the sample based on three criteria. First, companies that are consistently listed and publish annual reports on the Indonesia Stock Exchange during the 2018-2020 period. Second, companies that have complete data to calculate research variables. Third, companies that use rupiah currency in the company's financial statements. This study obtained a sample of 42 companies or 126 observations after excluding outlier data.

5. Results and Discussion

5.1 Descriptive Statistic

Table 1. Descriptive Statistic

Variables	N	Mean	Std. Dev.	Minimum	Maximum	PC	Not PC
FFS	126	0.3785	0.3375	-0.4960	0.9855		
NI	126	0.0057	0.0380	-0.2008	0.1637		
FS	126	0.0726	0.1620	-0.6772	0.8360		
PC	126					28 (22%)	98 (78%)

Source: data processing results (2022)

The results of descriptive statistics are presented in Table 1. Fraudulent financial statements (FFS) as proxied by F-Score has a mean (standard deviation) of 0.3785 (0.3375). PT. Intanwijaya Internasional Tbk. (INCI) owned the maximum value of 0.9855. PT. Indofarma Tbk. (INAF) owned the minimum value of -0.4960. A high F-score indicates that the company is committing fraud in the financial statements. The nature of the industry as proxied by receivables has a mean (standard deviation) value of 0.0057 (0.0380). PT. Semen Indonesia (Persero) Tbk. (SMGR) has a minimum value of -0.2008. PT. Indofarma Tbk. (INAF) has a maximum value of 0.1637. The higher the receivable value indicates weak supervision, providing an opportunity for managers to manipulate financial statements. Financial stability (FS) as a proxy for change has a mean (standard deviation) value of 0.0727 (0.1620). PT. Intikeramik Alamasri Industri Tbk. (IKAI) has a maximum value of 0.8360. PT. Trisula International Tbk. (TRIS) has a minimum value of -0.6772. The higher the change, the higher the change in the company's total assets from year to year. This shows that the company's financial condition is unstable, which can pressure managers to misappropriate company assets. Political connection (PC) is measured by using the presence of directors or commissioners who have political connections. Companies that have political connections are 22%, and the remaining 78% did not have political connections. The number of companies with political connections is relatively low.

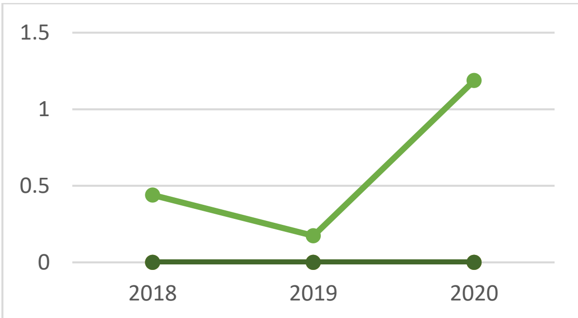

Figure 1. Mean of Fraudulent Financial Statements

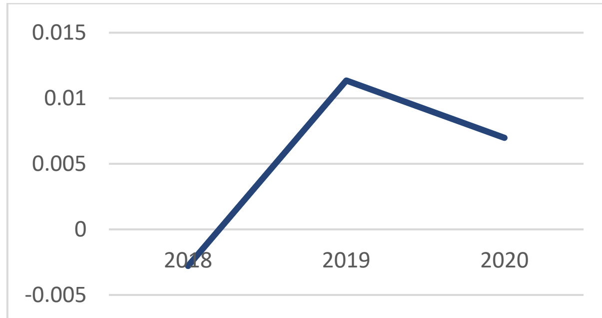

Figure 2. Mean of Nature of Industry

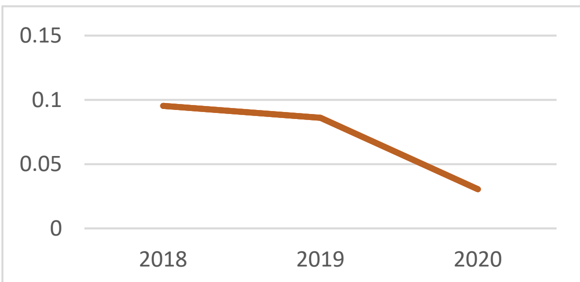

Figure 3. Mean of Financial Stability

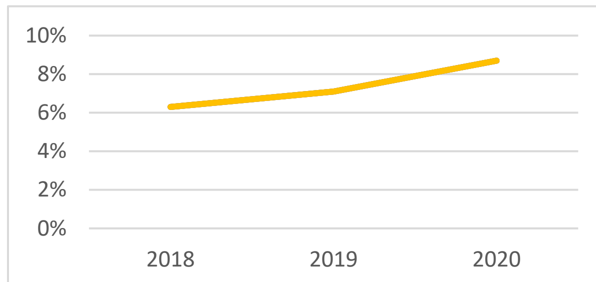

Figure 4. Frequency of Political Connection

Figure 1 shows that the mean fraudulent financial statement fluctuates, but in 2020, during the COVID-19 pandemic, indications of fraud in financial reporting increased. Fraud in financial statements is a deliberate act to eliminate material facts and omissions that result in misstatements in financial statement disclosures to mislead users of financial statements (Ijudien 2018; Novitasari and Chariri 2018). Fraud acts must be detected and prevented from the start so that the credibility and reputation of the company are maintained well. Companies must begin to analyze strategies to improve supervision and implement preventive measures to avoid or reduce the possibility of fraud (Sudarmanto and Utami 2021). Figure 2 shows the mean nature of the industry fluctuating, but in 2020 it established a decline. During the COVID-19 pandemic, transactions in the sale of goods or services decreased, so the number of receivables also decreased. A decrease in the number of receivables indicates a good cash turnover of the company. Figure 3 shows the mean financial stability that tends to decline, and a drastic decline occurred in 2020. This decline shows the lower changes in the company's total assets from year to year. This decline also shows the company's stable financial condition. Figure 4 shows that the number of companies with political connections has increased. The advantage of the company having political connections is that it tends to get easy access to bank loans or relations with the government.

5.2 Results

This study conducted hypothesis testing with panel data regression. Before the test was carried out, the researcher conducted a data feasibility test including normality, multicollinearity, heteroscedasticity, and autocorrelation tests. The test results show that all data feasibility tests are met, namely, the data are normally distributed and pass the multicollinearity, heteroscedasticity, and autocorrelation tests. After the data meets the feasibility test, the Chow, Hausman, and Lagrange Multiplier tests are carried out to determine the best regression model. The test results show that the random effect model is the best panel data regression model. The results of panel data regression testing are presented in Table 2.

Table 2. Regression Results

Variable	Coefficient	Std. Error	t-Statistic	Probability
C	0.4049	0.0444	9.1161	0.0000
NI	-3.1353	0.4396	-7.1322	0.0000
FS	0.2445	0.1142	2.1402	0.0344
PC	-0.1275	0.0825	-1.5440	0.1252
F-statistic	19.9821			
Adjusted R^2	0.3200			

Source: data processing results (2022)

Table 2 shows that nature of industry (NI) proxied by receivables is 0.0000 < 0.05 with a negative regression coefficient of -3.1353. These results indicate that the nature of the industry negatively affects fraudulent financial statements, thus indicating that H1 is rejected. This finding suggests that the high changes in receivables are also accompanied by solid supervision to minimize the opportunity for management to commit fraud in the financial statements. This result is consistent with Nabila (2020) finding. Financial stability (FS) is proxied by achange of 0.0344 < 0.05 with a positive regression coefficient of 0.2445. These results indicate that financial stability positively affects fraudulent financial statements, which means that H2 is accepted.

This finding is in line with our expectation which shows the higher the financial stability, the higher the change in the company's total assets from year to year. This condition happens because the company's finances are unstable, putting pressure on managers to abuse company assets. This result is consistent with Novitasari and Chariri (2018). Political connection (PC) has a probability of 0.1252 > 0.05 with a negative regression coefficient of -0.1275. These results indicate that political connection did not affect fraudulent financial statements, which suggests that H3 is rejected. This result is not in line with our expectations because the existence of a political connection in a company does not indicate that a company commits fraud in its financial statements. The greater political connection in this study only shows as an effort to support the company's business, not because of differences in interests between agents and principals or to provide opportunities for fraud. This finding follows Rosida and Setyawan (2021).

6. Conclusion

This study investigates the effect of the nature of the industry, financial stability, and political connection on fraudulent financial statements. This study found that the nature of the industry has a negative effect, whereas financial stability has a positive effect on fraudulent financial statements. Different results found that political connection does not affect fraudulent financial statements. The company's management is expected to carry out more substantial supervision and internal control to prevent fraud in the financial statements. The company is expected to be more intensive in socializing anti-fraud activities to minimize the risk of fraudulent financial statements. This study did not find any influence of political connections on fraudulent financial statements. The next researcher can investigate political connections by measuring political relations only for directors or commissioners. Further researchers can also measure political connections with other indicators, such as the presence of shareholders who control at least 10% of the total shares with voting rights and have ties to politicians or political parties.

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