# CHAPTER I

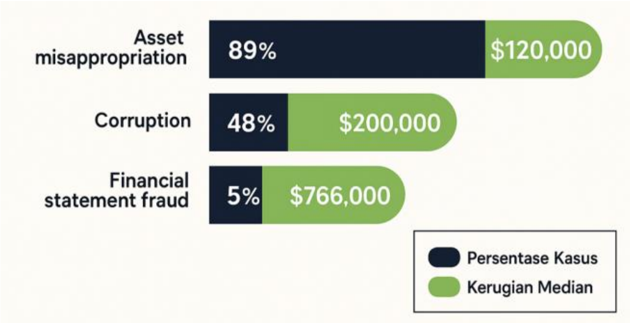
# INTRODUCTION

## 1.1 Background

In 2025, rising worries about the reliability and openness of corporate financial reporting have emerged across the global financial sector, driven by a series of major scandals and increasing findings from forensic audits and financial management (Ismail et al., 2024). Financial statements are the primary tool for communicating a company's financial health to stakeholders, including investors, creditors, and regulators, making the relevance of this data in business decision-making increasingly important (Ayem & Yuliana, 2019). The reliability of financial statements contributes to transparency and trust among investors and regulatory bodies, impacting investment decisions and market perceptions (Williams, 2024). Indonesia has a high incidence of financial statement fraud, with the Corruption Eradication Commission (KPK) reporting an increase in fraud cases in recent years (Handayati et al., 2022). International financial reporting fraud statistics from the Association of Certified Fraud Examiners (ACFE) in 2024 also reflect a concerning trend in financial reporting integrity in this country.

Inaccuracies in financial statements can lead to detrimental decisions for investors, creditors, and other stakeholders relying on this information. Therefore, studies related to financial reporting integrity are essential in identifying and preventing significantly impactful fraudulent practices (Figure 1.1). Transparency and honesty in preparing financial statements are fundamental steps to mitigate fraud risk and strengthen market trust.

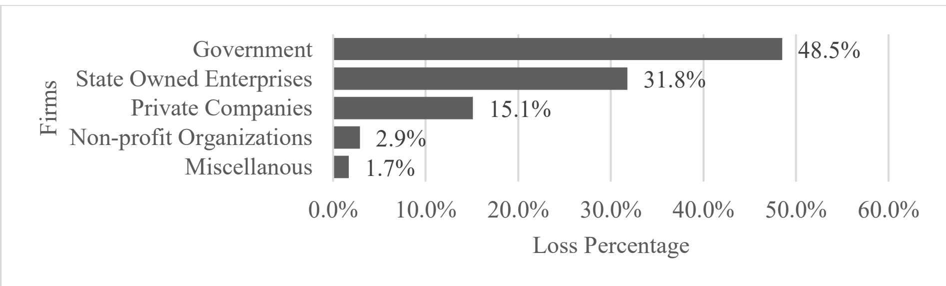
**Figure 1. 1 Percentage of Cases and Losses Due to Financial Reporting Integrity**




Source: Data processed (ACFE Report to The Nations, 2024)

Examining Figure 1.1, financial statement fraud is recorded as having the highest loss, amounting to $766,000, despite comprising only 5% of total cases. This finding confirms that although its frequency is low, financial statement manipulation causes highly significant loss impacts. This is because financial statement fraud generally involves systematic efforts to present misleading financial information to create a better performance image than the actual condition. This practice can influence investors', creditors', and regulators' economic decisions, so when fraud is uncovered, the consequences are not only financial but also reputational, legal, and systemic.

**Figure 1. 2 Types of Institutions/Organizations Most Harmed by Fraud**




Source: Data processed from AFCE (2019)

Based on the ACFE Indonesia survey (2019), government agencies and State-Owned Enterprises (SOEs) are the entities most harmed by fraud, at 48.5% and 31.8%, respectively. Sectorally, 58.8% of fraud cases occurred in companies with State-Owned Enterprise (SOEs) status (ACFE, 2019), indicating high risk in this sector. One of the most damaging forms of fraud is financial statement fraud, which often reflects weak financial reporting integrity. Various cases in the SOEs environment show that financial statement manipulation can involve internal and external parties, reflecting failures in control systems and accountability that should be maintained by state-owned companies.

In business practice, financial statement manipulation is often conducted to conceal actual financial conditions. One major case in Indonesia was the PT Jiwasraya case in 2018. The company initially reported a profit of Rp 2.4 trillion, but after re-audit by Public Accounting Firm (KAP) PWC, this figure was drastically corrected to approximately Rp 428 billion. This correction indicated significant financial statement engineering practices. Consequently, Jiwasraya defaulted on customer policy claims, with total liabilities reaching Rp 802 billion, reflecting the serious consequences of low financial reporting integrity (Kompas.id, 2020).

A case of financial statement manipulation also occurred at PT Garuda Indonesia in 2019. The 2018 financial statements showed a net profit of USD 809,850 (approximately Rp 11.33 billion), a drastic reversal from a loss of USD 216.5 million the previous year. However, two company commissioners, Chairal Tanjung and Dony Oskaria, stated that the profit recording did not comply with Financial Accounting Standards (PSAK) because it involved revenue recognition from PT Mahata Aero Teknologi, which was still in receivables and unrealized (Hartomo, 2019; Kompas.id, 2019). Due to this manipulation, Garuda was sanctioned by the Financial Services Authority (OJK) with a Rp100 million fine and an obligation to revise financial statements within 14 days. This case shows that dishonesty in reporting can impact the reputation and public trust in SOEs, causing systemic losses.

Based on these phenomena and cases, it is evident that financial statement manipulation, particularly within SOEs and government agencies, is a crucial and far-reaching issue. The high losses and involvement of various parties in fraud and financial statement manipulation practices reflect the importance of efforts to maintain the reliability of presented financial information. Therefore, this research focuses on financial reporting integrity as the main topic in preventing financial statement fraud and ensuring transparency. According to Scott (2003), financial reporting integrity is the principle ensuring financial statements reflect the actual and accurate financial condition without manipulation.

In line with the importance of maintaining financial information reliability, this research examines factors contributing to financial reporting integrity. Research by Ismail et al. (2024) and Arafah et al. (2023) identifies several key determinants of financial reporting integrity, including financial risk, profitability, investment opportunity set, foreign ownership, and earnings quality, which can encourage or suppress financial information manipulation practices. Financial risk is defined as the uncertainty faced by a company in meeting its financial obligations due to capital structure and market conditions (Popova et al., 2021). High financial risk indicated by a company's leverage drives managers to present favorable information to maintain funding access, potentially reducing financial reporting integrity. Supported by Jensen & Meckling's (1976) agency theory, financial risk can trigger conflicts of interest between managers and owners. Suzan and Iqbal (2024), Pratiwi and Nofryanti (2021), and Sayekti and Reschiwati (2024) prove that financial risk has a significant negative effect on financial reporting integrity. However, Yulinda (2022) found no significant effect, while Greenwood & Tao (2020) emphasize that regulatory oversight is more decisive than the level of financial risk.

Profitability reflects a company's ability to generate profits (Brigham & Houston, 2019). High profitability can reduce agency conflicts because managers are not driven to manipulate information when performance is already good (Jensen & Meckling, 1976). Safitri et al. (2023), Ibrahim et al. (2023), and Kumar & Singh (2024) support the positive effect of profitability on financial reporting integrity. Conversely, Widodo and Priyadi (2022) show that profitability does not always have a significant effect, as high profits do not guarantee that information reflects the actual condition.

Investment opportunity set is the set of investment opportunities available to a company for future growth and expansion (Myers, 1977).

Companies with high investment opportunity set have incentives to present accurate financial statements to build investor trust and lower capital costs (Jensen & Meckling, 1976). Pratiwi & Nofryanti (2021), Jamilah & Astuti (2023), and Chang & Wu (2024) prove that investment opportunity set positively affects financial reporting integrity. However, Rahman and Abdullah (2022) found no significant relationship, possibly due to weak corporate governance systems.

Foreign ownership brings expectations for higher reporting standards. Foreign ownership provides additional pressure on management to maintain financial reporting quality (Jensen & Meckling, 1976). Hartanto (2023), Afrilia & Surifah (2023), and Beuselinck et al. (2017) found that foreign ownership increases financial reporting integrity. However, Kao et al. (2019) show that foreign ownership effectiveness depends on local context, such as investor protection levels and governance structure.

Earnings quality moderates the relationship between financial risk and financial reporting integrity. Good earnings quality acts as a barrier to financial statement manipulation when companies face high financial risk (Jensen & Meckling, 1976). Nurjanah et al. (2023), Liu & Chen (2024), and Ismail et al. (2024) support this view, while Rahman & Widodo (2022) found no significant moderating effect.

In the relationship between profitability and financial reporting integrity, high earnings quality makes profit information more reliable. This strengthens management's motivation to present financial statement information honestly (Jensen & Meckling, 1976). Wang & Zhang (2023), Nguyen & Tran (2024), and Fonou-Dombeu et al. (2023) show that earnings quality strengthens the positive effect of profitability, although Rahman & Widodo (2022) found no significant moderating effect.

Earnings quality also moderates the relationship between investment opportunity set and financial reporting integrity. Companies with many future projects require investor trust, and good earnings quality is an important instrument in building that trust (Jensen & Meckling, 1976). Wang & Liu (2023), Patel & Sharma (2024), and Wijaya et al. (2022) support this view, while Lin & Chen (2022) found no significant moderating effect.

Lastly, earnings quality strengthens the relationship between foreign ownership and financial reporting integrity. In foreign ownership, high earnings quality gives foreign investors confidence in information reliability (Dechow et al., 1995; Jensen & Meckling, 1976). Lee & Kim (2023), Garcia & Martinez (2024), and Ismail et al. (2024) support this assumption, while Santoso & Pratama (2022) reported that earnings quality does not function significantly as a moderator.

Factors such as financial risk, profitability, investment opportunity set, and foreign ownership play crucial roles in influencing financial reporting integrity. Earnings quality functions as a moderating mechanism, ensuring the accuracy and credibility of financial statements despite managerial pressure to engineer data for specific interests. Considering this background and context, this research aims to examine "The Influence of Financial

Risk, Profitability, Investment Opportunity Set, and Foreign Ownership on Financial Reporting Integrity with Earnings Quality as Moderation", using data from SOEs companies listed on the Indonesia Stock Exchange for the 2021-2024 period.

## 1.2 Problem Statement

Based on the background described above, the research problems in this study are:

1. Does Financial Risk affect Financial Reporting Integrity?
2. Does Profitability affect Financial Reporting Integrity?
3. Does Investment Opportunity Set affect Financial Reporting Integrity?
4. Does Foreign Ownership affect Financial Reporting Integrity?
5. Can Earnings Quality moderate the relationship between Financial Risk and Financial Reporting Integrity?
6. Can Earnings Quality moderate the relationship between Profitability and Financial Reporting Integrity?
7. Can Earnings Quality moderate the relationship between Investment Opportunity Set and Financial Reporting Integrity?
8. Can Earnings Quality moderate the relationship between Foreign Ownership and Financial Reporting Integrity?

## 1.3 Research Objectives

Based on the stated research problems, the objectives of this research are as follows:

1. To analyze the effect of Financial Risk on Financial Reporting Integrity.

2. To analyze the effect of Profitability on Financial Reporting Integrity.
3. To analyze the effect of Investment Opportunity Set on Financial Reporting Integrity.
4. To analyze the effect of Foreign Ownership on Financial Reporting Integrity.
5. To analyze the moderating effect of Earnings Quality on the relationship between Financial Risk and Financial Reporting Integrity.
6. To analyze the moderating effect of Earnings Quality on the relationship between Profitability and Financial Reporting Integrity.
7. To analyze the moderating effect of Earnings Quality on the relationship between Investment Opportunity Set and Financial Reporting Integrity.
8. To analyze the moderating effect of Earnings Quality on the relationship between Foreign Ownership and Financial Reporting Integrity.

**1.4 Research Benefits**

1. Theoretical

This research is expected to contribute to the development of financial management science, particularly in understanding factors influencing financial reporting integrity. This study aims to enrich theories related to transparent and reliable financial reporting and avoid fraud risk in financial and management aspects.

2. Practical

A. For Companies

The results of this research can be used as a reference to improve the quality of company financial reporting. By understanding the influence of financial risk, profitability, investment opportunity set, and foreign ownership on financial reporting integrity, companies can be more cautious in managing resources and improving risk management. Additionally, understanding the role of earnings quality as a moderating variable helps companies enhance financial statement credibility, attract more investors, and reduce litigation risk due to statement manipulation.

B. For Universities

This research is expected to become a substantial reference source in financial management studies and related disciplines, for both researchers and academics at Universitas Pembangunan Nasional "Veteran" East Java, as well as national and international academic institutions. These findings can serve as a basis for further studies exploring topics relevant to the examined problems, contributing to academic insight development and innovation in this field.

C. Bagi Stakeholders dan Pemerintah

This research is expected to contribute to investment decision-making, credit risk assessment, and business strategies. Investors can be more selective in assessing company credibility, while creditors can evaluate credit risk more accurately. For auditors and regulators, these results provide guidance in assessing financial statement quality and adjusting regulations to enhance market transparency.