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Disclosure of corporate governance structure and the likelihood of fraudulent financial reporting

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Abstract

The purpose of this study is to examine the relationships between corporate governance structure and the likelihood of fraudulent financial reporting. Likelihood of fraudulent financial reporting is based on an integration of Beneish M-score model and Altman's Z-score model. These relationships are examined based on content analysis of annual reports of 227 Public Listed Companies in Malaysia for the year 2010-2011. Results of this study provide evidence that the effectiveness of corporate governance structure reduces the likelihood of fraudulent financial reporting. These results indicate that effective corporate governance structure is paramount in enhancing the credibility of financial reporting.

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Keywords: Corporate Governance; Board Size; International Experience; Audit Committee Effectiveness; Internal Audit Effectiveness; Independent Non-Executive Director Effectiveness; Fraudulent Financial Reporting.

1. Introduction

Increasing fraudulent financial reporting among public listed companies have increased concerns among the public as investors, auditors, creditors and other stakeholders. However, fraud is a crime that is rarely visible. In many occasions, the "warning signs", "red flags" or "indicators" which should have warned the relevant stakeholders of the fraud were ignored. Fraudulent financial reporting is one type of fraud with substantial negative impacts, loss of investor confidence, reputational damage, potential fines and criminal actions (Ernst and Young,

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2009). The dramatic collapse of giant corporations such as WorldCom, Enron and Global Crossing were due to incidences of financial statement fraud. These fraud cases had eroded confidence towards the financial markets, financial information and also the Accounting Profession Worldwide (Law, 2011). In Malaysia, some of the organizations that were alleged to have reported fraudulent financial information includes Megan Media Holding Berhad, Perwaja Steel Sdn. Bhd., OilcorpBerhad, Polymate Holdings Berhad, as well as Transmile Group Berhad (Norwani, Mohamad and Chek, 2011). These corporate failures have created doubts in the minds of various stakeholders on the financial report's credibility and reliability (Uadiale, 2012).

Past studies provide substantial evidence on the importance of effective corporate governance structure in reducing incidences of fraudulent financial reporting (e.g. Beasley, 1996; Dechow, Sloan and Sweeney, 1996; McMullen, 1996). However, Saleh, Iskandar and Rahmat (2005) argue that the current corporate governance mechanisms are not sufficiently effective in providing adequate control in reducing management incentives to engage in fraudulent financial reporting. Therefore, the aim of this study is to examine the impact of corporate governance structure as a tool in preventing and deterring fraudulent financial reporting practices in Public Listed Companies (PLCs) in Malaysia. The positive impact of the corporate governance structure examined in this study comprises of board size, board members international experience, independent non-executive directors' effectiveness, audit committee effectiveness and internal audit effectiveness. Findings from this study are expected to provide new evidence on the positive impact of corporate governance effectiveness in reducing the likelihood of fraudulent financial reporting.

This paper will proceed with the review of past literature from which hypotheses will be developed. The paper will then proceed to the empirical stage of variable measurement, sampling, data analysis and discussion of results. The final part of this paper presents conclusion, limitations and recommendation for future research.

2. Literature Review and Hypotheses Development

2.1 Corporate governance structure and fraudulent financial reporting

The growing incidences of corporate fraud indicates that ineffective emphasis on fraud prevention and deterrence mechanisms are being prioritized by organizations. In many recent corporate misconducts, failure of corporate governance structure as an effective monitoring tool has been highlighted to be one of the reasons to prevent fraudulent financial reporting financial. This infers that effective corporate governance structure has a positive impact in reducing such incidences. Nevertheless, prior studies provide mixed evidence (e.g. Law, 2012; Uadiale, 2012; Beasley, 1996). Hence, this study aims to add to the current literature on these relationships.

2.1.2 Board Size and likelihood of fraudulent financial reporting

In ensuring the success of organizations, Alzoubi and Selamat (2012) argue that board of director is an important catalyst. They argue that board members are responsible in setting organizational goals and strategies as well as aligning them with the shareholders' interest. In the context of financial information, they are responsible for the transparency and credibility of the financial statement. This is consistent with the argument suggested by Fama and Jensen (1983) where board of directors possesses the ultimate power in decision making as they have the highest level of control in an organization.

In relation to effective monitoring based on board size, mixed results were provided. Previous studies indicate that smaller boards are more effective because it is easy to manage and the directors can have effective communication among them and reduces potential misunderstandings (Alzoubi and Selamat, 2012; Abbot, Parker and Peters, 2004). Larger boards are claimed to be less effectives due to the coordination and process problems that can lead to less effective monitoring functions (Andres, Azofra and Lopez, 2005; Jensen, 1993). It has been recommended that the ideal board size should not be more than eight or nine directors (Lipton and Lorsch, 1992). In addition, Vafeas (2005) argues that too small and too large board sizes are expected to be ineffective. This is based on the argument that less responsibility is taken by the large board and too much obligations for the small board. Finally, Sukeechhep, Yarram and Al Faraqoue (2013) and Abbot, Park and Parker, (2000) find no significant relationship between board size and monitoring of the quality of financial reporting. Nevertheless, this study expects the various regulatory efforts in enhancing the effectiveness of the corporate governance structure in Malaysia to have a positive impact in enhancing the credibility of financial reporting. Hence, the following hypothesis is proposed:

H1: Board size is significantly negatively related to the likelihood of fraudulent financial reporting.

2.1.3 Board members with international experience and likelihood of fraudulent financial reporting

It is proposed by Carpenter and Feroz (2001) that board members with international experience have valuable, rare, and inimitable features characteristics that can contribute to the competitive advantage of companies who use their experiences. The international experience of board members can be obtained through international obligations in foreign companies. These individuals are exposed to the organization management of financial information and also the preparation of financial statement as well as exposed in the monitoring activities in the organizations by the foreign companies. The practices of these companies are likely to be influenced by the culture, rules, laws and regulations in the country where these companies operate. Such exposure and experience can assist board members of PLCs in managing the complexities associated in earnings management practices. Simultaneously, with the international experience that differ from local experience, it is also believed that these board members will help in promoting and implementing more proactive earnings management prevention and deterrence mechanism in organizations. Thus the following hypothesis is proposed:

H2: Board members with international experience are significantly negatively related to the likelihood of fraudulent financial reporting.

2.1.4 Audit committee effectiveness and likelihood of fraudulent financial reporting

As the audit committee is really important in an organization, section 301 of the Sarbanes-Oxley Act (SOX) requires public companies to establish independent audit committees in order to help organizations in enhancing the independence and integrity of the financial reporting (Law, 2011). Previous study by Coram, Ferguson and Moroney (2006) provides evidence that earning management can be prevented by having effective audit committee in organizations. According to past literature (e.g. Huang and Thiruvadi, 2010; Mohiduddin and Karbhari, 2010; Vafeas, 2005; Abbott et al., 2004), in strengthening the effectiveness of audit committee in enhancing the quality of financial reporting, such committee should comprise of not less than three members and majority of them must be appointed from a group of independent non-executive director. If the committee has insufficient directors, it might influence their effectiveness due to the shortage of directors in fulfilling their duties (Vafeas, 2005). In line with this, past studies also indicate that independent audit committees are more likely to be associated with lower earnings management (e.g. Agrawal and Chadha, 2005; Davidson, Goodwin-Stewart and Kent, 2005; Abbott et al., 2004; Bedard, Chtourou and Corteau, 2004; Xie, Davidson and DaDalt, 2003; Abbott et al., 2000; Klein, 2002). This is based on the argument that independent audit committee is able to provide unbiased assessment and judgment as well as effectively monitor management.

In addition to independence, the committee should ideally meet frequently and exercise professional care in their work. Previous studies provide evidence that organizations that have frequent meetings by their audit committees experience less earnings management incidences (e.g. Abbott et al., 2004; Xie et al., 2003; Abbott et al., 2000; Beasley, Carcello and Hermanson, 2000). Another valuable characteristic for effective monitoring by the audit committee members is related to financial expertise. Alzoubi and Selamat (2012) find that audit committees' financial expertise increase their monitoring capability and in turn increases the quality of financial reporting. Other studies also suggested comprehensive and effective monitoring by the audit committee reduces the likelihood of fraudulent financial reporting at an early stage (e.g. Law, 2011; Dyck, Morse and Zingales, 2007; Coram et al., 2005). Based on this argument, the following hypothesis is formulated:

H3: Audit committee effectiveness is significantly negatively related to the likelihood of fraudulent financial reporting.

2.1.5 Internal audit effectiveness and likelihood of fraudulent financial reporting

According to Belay (2007), internal audit function is one of the strongest mechanisms in monitoring and promoting good governance system in an organization. According to Coram et al. (2006), the origin of the internal audit function is a significant factor that would affect an organization to have effective internal audit. They find that in-house internal audit department is more effective in detecting and reporting fraud, rather than having the internal audit function to be fully outsourced. Besides, study by Hassan (2005) and Archambeault (2002) found that in-house internal audit would give extra advantages to an organization because these internal auditors would already have the knowledge of their organization. This would hence enable them to identify red flags whenever there is any potential occurrence of fraudulent financial reporting.

For an effective internal audit function, it is recommended that internal audit function should report directly to the audit committee and be appropriately positioned within an organization. This is because, in creating effective and efficient internal audit function, the organization must have established clear interaction or communication between both internal audits function and audit committee (e.g. Kevin, 2003; Oliverio and Newman, 1993). Other than that, the internal audit function needs to be independent with regards of activities that they audit and this further extends to a state that the board of the audit committee should be able to determine the needed aspect for the purpose of the internal audit function remittance.

As the responsibility of the internal audit department is to make regular reviews on the internal control system and ensure that effective and efficient operations are performed, the internal audit function is able to prevent fraudulent financial reporting in an organization by examining and assessing the sufficiency of their internal controls (Harden, 2010). This is done by asking several questions in the lookout for possible fraud schemes. Once the likelihood of fraud had been detected, the internal audit would inform both audit committee and management regarding any internal control that is being exposed to the risks. In line with these expectations, the previous literature (e.g. Law, 2011; Alleyne and Howard, 2005; Gramling and Myers, 2003) found that organization with effective internal audit tends to have less fraud occurences. Following these arguments, it is hypothesised that:

H4: Internal audit effectiveness is significantly negatively related to the likelihood of fraudulent financial reporting.

2.1.6 Independent non-executive directors effectiveness and likelihood of fraudulent financial reporting

In general, non-executive director is an individual outside of the organization and also known as an "independent director". Despite the fact that non-executive directors are independent and not involved in day to day operation, they still need to work closely with the executive team in order to get information and knowledge about the company (Siladi, 2006). As the independent director is not involved in day to day operation, it is believed that the independent director was not subjected to any pressure by the internal organization of the company. Therefore they are more likely to act independently and act in the shareholders' interest.

In strengthening the board effectiveness, it is recommended that organizations are required to have one-third or two independent non-executive directors from the board membership. It is really important for an organization to have a majority of independent non-executive directors on the board in order for them to scrutinize the management's role (Siladi, 2006). Besides that, there is also an empirical evidence by previous study (e.g. Sharma, 2004; Xie et al., 2003; Klein; 2002) that found the proportion of independent non-executive directors in the board is associated with the likelihood of earnings management. Apart from that, Siladi (2006) state a 'balanced' board creates an effective board. The balance of the board means that the board is comprised of directors with a mixture of skills and experiences. The integration of these broad ranges of skills and experiences is really important towards an effective operation and management. Furthermore, due to the wide range of background and their independence, these independent non-executive directors would also be able to have healthy discussions and debates with the executive directors in board meetings, which then would lead to an effective board that can help organizations in minimizing and deterring the fraud occurrence.

In line with the previous study (e.g. Alves, 2011; Crutchley, Jensen and Marshall, 2007; Beasley, 1996), the evidence provide that in order to prevent earnings management, the board of directors and its structure itself should come into view as one of the effective corporate governance mechanisms. The study also reported that board composition is one of the effective corporate governance mechanisms in reducing the agency problem, hence boosting financial information quality. Therefore, the following hypothesis is proposed.

H5: Independent non-executive directors' effectiveness is significantly negatively related to the likelihood of fraudulent financial reporting.

3. Methodology

3.1 Sample and data collection

The sample comprised of 227 Public Listed Companies in Malaysia for the year 2010 and 2011.The samples selected consisted of nine industries which are construction, consumer product, finance, industrial product, IPC, plantation, properties, technology and trading. The research approach involves the content analysis of public listed company annual reports. Content analysis has been widely employed in prior studies to measure CSR disclosure (e.g. Smith, Yahya and Amiruddin, 2007; Clemen and Douglas, 2006; O' Donovan, 2002; Hackston and Milne, 1996).

3.2 Measurement of variables

3.2.1 Likelihood of fraudulent financial reporting

In this study, the extent of likelihood of fraudulent financial reporting is measured by combining two models in measuring red flags for the likelihood earning management. The models are Z-score bankruptcy prediction model and Beneish M-score model. Both methods are combined to see whether there is an indication of fraud occurences. In the current study, the Z-score model that has been developed by Edward I. Altman (1986) is a proxy for financial distress risk or bankruptcy risk, where these risks could be an early warning sign for potential collapse that will lead to the occurrence of fraud or manipulation in an organization. The level of financial distress had been classified in three zones of discrimination. Z-scores that are less than 1.81 ($Z < 1.81$) is an indicator that the organization is in the "distress" zone, scores between 1.81 and 2.99 ($1.81 < Z < 2.99$) indicates that the organizations were in the "grey" zone, and for scores that are more than 2.99 ($Z > 2.99$), it is an indicator that the organization is in the "safe" zone. Meanwhile, Beneish M-score model that was developed by Beneish (1999) is similar to the Altman Z score, but it is optimized to estimate the probability of manipulation rather than bankruptcy (Beneish, 1999). For M-score, if the predictive score is greater than -2.22, it gives way to a red flag, indicating that there is a possibility of manipulation occurring in the organization, or it could also indicate a strong likelihood of the firm being a manipulator. Therefore, using these two models, the likelihood of fraudulent financial reporting in an organization could be determined. The score of "1" was given if the companies had red flags indicating that there was a possibility of fraudulent financial reporting and "0" if otherwise. The definition and measurement of variables used in this study are listed in table 1. In addition to the independent variables, this study also used two control variables in order to enhance the relationship between the independent and dependent variables. The control variables used are size and leverage of the organizations.

Table 1. Definition and measurement of variables

Variable Acronym	Definition	Measurement
EM	Earnings Management	Integration of Beneish M-score for detection of fraudulent financial reporting (1999) and Z-score bankruptcy prediction model (1968).
BOD_SIZE	Board Size	Total number of directors on the board
BOD_IE	Board members with international experience	Percentage of board members with international experience to total number of board members
INED_EFF	Effective independent non-executive directors	Self-constructed corporate governance index
AC_EFF	Effective audit committee	Self-constructed corporate governance index
IA_EFF	Effective internal audit	Self-constructed corporate governance index
SIZE	Size of an organization	Logarithm of the market value of equity
LEV	Leverage	Total debt / the total assets

In the above Table 1, self-constructed corporate governance index is adapted from Arshad, Razali and Bakar (2014). The extent of effectiveness is measured by comparing the contents of each annual report to the items in the corporate governance index and coded as "1" if the item is disclosed, "2" if the item disclosed is not in compliance with the Malaysian Code on Corporate Governance (MCCG) requirements and "3" if the item is not disclosed. The MCCG was issued in 2001 as an integral part of the Bursa Malaysia Listing Rules. It requires all listed companies to disclose the extent of compliance with the MCCG (Abdul Wahab, How and Verhoeven, 2008). As at 1 October 2007, some parts in the MCCG were revised to improve effective corporate governance practices, as well as to be in line with international best practices. The key amendments to the code were aimed at strengthening the roles and responsibilities of board of directors and audit committees.

4. Analysis and Results

4.1 Descriptive statistics

Table 2 presents the descriptive statistics on the dependent variable, likelihood of fraudulent financial reporting. The results of the descriptive statistics for continuous independent variables and control variable are presented in Table 3.

Table 2. Descriptive Statistic for Likelihood of Earnings Management

Likelihood of Fraudulent Financial Reporting	0	1	0.17

Table 3: Descriptive Statistics for Independent and Control Variables

	Min	Max	Mean
BOD_SIZE	4	14	7.89
BOD_IE	0	1	0.74
AC_EFF	1	1.86	1.2
IA_EFF	1	1.6	1.09
INED_EFF	1	1.33	1.01
SIZE (RM)	3.331	7.744	5.56
LEV (%)	6E-04	1.392	0.234

Results in Table 2 reported that the mean value for the likelihood of fraudulent financial reporting is 0.21. This indicates that the sample of companies selected in this study has low likelihood of fraud.

Table 3 reported that the minimum value for BOD_SIZE is 4 and the maximum value is 14. The mean value of 7.89 indicates the average number of board members in each organization. As for BOD_IE, the minimum value is 0.00% and the maximum value is 100.00%. The mean value of 74% indicates that there is a high representation of board members with international experience on the board. Table 3 also reported that the mean values for AC_EFF, IA_EFF and INED_EFF are 1.20, 1.09 and 1.01 respectively. Overall, these results indicate that the corporate governance mechanisms are highly effective. Finally, Table 3 reported that the mean value for firm size is 5.56 (RM 2,199,003,000) while the mean value for leverage is 23.37 per cent.

4.2 Multivariate analysis

In this study, linear multiple regression is used as the basis of analysis for testing H1 to H5. The hypothesized relationships for H1 to H5 respectively are modelled as follows:

$$FV = \beta o + \beta 1\ BOD\_SIZE + \beta 2\ BOARD\_IE + \beta 3\ AC\_EFF + \beta 4\ IA\_EFF + \beta 5\ INED\_EFF \quad (1)$$
$$+ B6\ SIZE + \beta 7\ LEV + \varepsilon$$

Where variable definitions are given in Table 1.

In the above regression models, multicollinearity was tested using the variance inflation factor and tolerance levels, and found to be well within the satisfactory range. The results of the regression analysis are presented in Table 4 and are now discussed in terms of tests of each of the hypotheses.

Results of the multiple regression analysis in Table 4 reported that the adjusted R^2 is 13.6 per cent, indicating that the possibility of earnings management practices of an organization can be explained by the model. The F value of 6.077 at a significant level of $P = 0.000$ provides evidence that the model in this study is valid.

With regards to HI which is board size (BOD_SIZE), the result in table 4 reveals an insignificant effect on fraudulent financial reporting. Hence, H1 is rejected. This indicates that board size does not reduce the likelihood of fraudulent financial reporting.

H2 predicts that BOD_IE is significantly negatively related to the likelihood of fraudulent financial reporting. Results in Table 4 reveal insignificant negative relationship. Hence H2 is rejected. These results indicate that board members with international experience do not increase their roles and responsibilities in enhancing the overall corporate governance effectiveness.

Table 4. Multiple regression results for factors affecting measure of financial vulnerability

DV	LIKELIHOOD OF EARNINGS MANAGEMENT		
R^2	0.163		
Adjusted R^2	0.136		
F statistic	6.077		
Significance	0.000		
	Beta	T	Sig.
Constant			0.161
BOD_SIZE	-0.007	-0.104	0.640
BOD_IE	-0.034	-0.540	0.579
AC_EFF	0.178	-2.811	0.030***
IA_EFF	-0.164	-2.477	0.023***
INED_EFF	-0.012	-0.194	0.016***
SIZE	-0.146	-2.149	0.013***
LEV	0.264	4.197	0.000***

*Significant at 10% level (1-tailed test) **Significant at 5% level (1-tailed test) ***Significant at 1% level (1-tailed test)

H3 predicts that AC_EFF is significantly negatively related to the likelihood of earnings management. Referring to the regression results, it indicates that audit committee effectiveness has negative significant influence to the likelihood of fraudulent financial reporting ($p < 0.05$). This means that the audit committee effectiveness has decreased the likelihood of fraudulent financial reporting in organizations. This result is consistent with past studies (e.g. Law, 2011; Dyck, Morse and Zingales, 2007; Coram et al., 2005). Therefore, H3 is accepted.

H4 predicts that IA_EFF is significantly negatively related to the likelihood of earnings management. Results in Table 4 indicate that internal audit effectiveness has negative significant influence to the likelihood of fraudulent financial reporting ($p < 0.05$). These results indicate that internal audit function have improved their roles and responsibilities in enhancing the overall corporate governance effectiveness. This result is consistent with the argument that internal audit effectiveness enhances the quality of financial reporting (e.g. Hassan, 2005; Archambeault, 2002). Therefore, H4 is accepted.

H5 predicts that INED_EFF is significantly negatively related to the likelihood of earnings management. Result in Table 4 reveals that independent non-executive directors' effectiveness has negative significant influence to the likelihood of fraudulent financial reporting ($p < 0.05$). Hence H5 is accepted. Consistent with recent studies (e.g. Alves, 2011; Crutchley, Jensen and Marshall, 2007;Beasley, 1996), independent non-executive directors effectiveness can be an effective corporate governance mechanism to improve the quality of financial reporting.

5. Conclusion and Limitation

This study examines the relationship between the corporate governance structures specifically board characteristic and the effectiveness of selected corporate governance mechanisms. The significant negative relationships between audit committee effectiveness, internal audit effectiveness and independent non-executives directors' effectiveness and the likelihood of fraudulent financial reporting indicate that effective board members is paramount in enhancing the overall corporate governance effectiveness. The insignificant influence of board size and board member with international experience further corroborates these results. This can be a signal to regulators to undertake more effective actions to encourage organizations in practicing enhanced corporate governance. Concurrently, this study also recommends further improvements in respect of the creation of effective boards of directors by organizations.

There are some limitations in this study. First, this study used the revised corporate governance mechanisms. Therefore, the results may not have been generalized for an overall perspective of corporate governance. Besides, this study used only two types of fraud indicator model, which were Z score (Altman, 2000) and Beneish M score

(Beneish, 1999). Future research may include other fraud indicator models. Despite these limitations, this study provides useful insights in understanding the relationship between various corporate governance structures and the likelihood of fraudulent financial reporting. Finally, this study provides a significant feedback to policymakers to improve and strengthen the current MCCG.

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