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MANAGEMENT FRAUD PROPENSITY FACTORS, GOVERNANCE INTERACTIONS AND EARNINGS MANIPULATION: A CASE OF MALAYSIAN PUBLIC LISTED COMPANIES

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ABSTRACT

Fraudulent financial reporting still persist despite corporate governance evolutions. Majority can be attributed to earnings manipulation as suggested by literatures. They were caused by management fraud propensity factors of pressure/incentives, opportunity and rationalisation/ attitudes in line with International Standards on Auditing no: 240 (ISA 240). Furthermore, formation of ASEAN Corporate Governance Score card (ACGSC) in 2011 and Malaysian Codes of Corporate Governance (MCCG) were expected to improve compliance and financial statements integrity. The sample consisted of 504 firm-years representing 252 earnings and non-earnings manipulating firms, selected using the M-score model. This study begins with measurement of corporate governance disclosure, utilising corporate governance index (CGI), replicated from ACGSC components subsequent to its issuance in 2012 and 2013. Next, management fraud propensity factors of pressure/ incentives, opportunity and rationalization/ attitude were examined using binary logistical regression to assess relationship with earnings manipulation. This study differs as it utilised CGI as proxy for opportunity, replacing limited governance attributes as the latter was argued for being insufficient in portraying complexity within corporate governance ecosystem. Furthermore, corporate governance performance as observed through disclosure shapes fraud opportunity that influences financial statements integrity. Later, CGI was adopted to assess potential interacting effect on the relationship between ISA 240's management fraud propensity factors and earnings manipulation. Results revealed pressure/incentives-related fraud propensity factors (recurring negative cash flows from operation, rapid growth, unusual profitability, need for financing), opportunity-related fraud propensity factors (CGI) and rationalisation/attitudes-related fraud propensity factors (management interest on earnings trend) were significantly related to earnings manipulation. Contradictory to expectation, CGI also showed significant positive interaction on strengthening the relationship between pressure-related fraud propensity factors due to recurring negative cash flows from operations and earnings manipulation. Possible explanation is firms with strong corporate governance but experiencing weak financial standings are constantly pressured by shareholders to meet their interests which driven management to manipulate profit. This study provides tools for regulators to stay vigilant of firms with characteristics of potential earnings manipulation and for shareholders to select stocks not prone to earnings manipulation.

Keywords: Earnings Manipulation; Fraudulent Financial Reporting; Corporate Governance Index; ASEAN Corporate Governance Scorecard; Fraud Propensity Factors