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Corporate Governance and Fraudulent Reporting in Indonesia and Malaysia

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Abstract

Purpose: This study analyses the effectiveness of corporate governance in mitigating Fraudulent Financial Reporting (FFR) in Indonesia and Malaysia. It examines whether governance mechanisms can reduce the risks of fraud, bankruptcy, and earnings manipulation in public companies experiencing financial distress.

Methodology: This study employs a quantitative approach using panel data from public companies in Indonesia and Malaysia during the period 2014–2023 that experienced financial problems or financial distress indicators. This study applies a bivariate probit model to analyze the relationship between corporate governance mechanisms and three key risks: fraudulent financial reporting, bankruptcy, and earnings manipulation.

Results: The findings revealed notable differences between the two countries. In Indonesia, potential fraud was identified in 49% of firms, bankruptcy risk in 88.67%, and earnings manipulation in 55% of the companies. In Malaysia, the potential for fraud was significantly higher at 82%, while bankruptcy risk was similar at 88.67%, and earnings manipulation was 88.15%. These results suggest that although both countries face substantial financial distress risks, Malaysian firms exhibit a stronger tendency toward financial reporting manipulation and committing fraud.

Conclusions: This study concludes that corporate governance mechanisms in Indonesia appear to be more effective in mitigating fraudulent financial reporting than those in Malaysia.

Limitations: This study focuses only on publicly listed companies experiencing financial distress in Indonesia and Malaysia, which may limit the generalizability of the findings.

Contributions: This study highlights that factor such as regulatory enforcement and ownership structure may play a more significant role than formal governance compliance in preventing fraudulent financial reporting.

Keywords: *Bankruptcy, Financial Reporting, Fraud, Governance, Manipulation*

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1. Introduction

Information asymmetry in the market can occur at two stages: prior to the release of information, which gives rise to adverse selection, or after the information has been disclosed, which may lead to moral hazards (Yan & Lee, 2023). According to Ghafoor, Zainudin, and Mahdzan (2019), one consequence of information asymmetry is fraud, which is often associated with unethical or illegal behavior. Ghafoor et al. (2019) note that this type of fraud is often complex to detect because it is covertly and intentionally carried out to pursue personal gain without regard for the potential negative impact on others. Toms (2019) states that fraud in financial reporting is generally triggered by several unrelated factors, with the most significant being the presence of opportunities. Toms (2019) asserts that company

management at the pinnacle of power often builds large technocratic hierarchies without adequate oversight from shareholders or the financial markets. Under certain conditions, such as during a takeover, managers often manipulate accounting to increase offer value or hide poor performance (Braun, 2021). In line with this, Camfferman and Wielhouwer (2019) note that the declining trust of market participants in the accuracy and credibility of financial statements is influenced by various financial reporting scandals that occurred in the early 21st century. The Enron scandal, deeply ingrained in collective memory, remains one of the most outstanding examples of all time and triggered massive reforms due to the crisis of confidence in global capital markets, further eroding the credibility of the accounting information presented by companies.

Regulation is one of the primary mechanisms for limiting opportunistic behavior in business (Cui, Liu, & Luo, 2023). An example is the Sarbanes-Oxley Act (SOX) in the United States, which was established in response to various financial scandals. It aims to enhance the reliability of financial statements and impose strict penalties on those who violate its provisions (Camfferman & Wielhouwer, 2019). In addition to regulations, effective corporate governance is also essential for maintaining the integrity and functionality of an organization (Maulani, Amalia, & Birton, 2024). Xucui (2020) states that corporate governance practices can improve company effectiveness by strengthening internal controls. Xucui (2020) further notes that these practices can help minimize information asymmetry and improve both the quality and quantity of information presented in financial statements.

In Indonesia, *Jiwasraya* and *Asabri* cases have drawn attention (Panuntun & Adristi, 2021). Panuntun and Adristi (2021) revealed that the *Jiwasraya* case involved financial reporting manipulation, where the state-owned insurance company reported investment values that did not accurately reflect the actual situation, misleading investors and policyholders. This scandal resulted in state financial losses in the case of *PT Asuransi Jiwasraya (Persero)* amounting to Rp 16,807,283,375,000, according to the *Badan Pemeriksa Keuangan Republik Indonesia (BPK-RI)*, and revealed weaknesses in the supervisory system and internal audit processes that failed to detect irregularities early (Panuntun & Adristi, 2021). Meanwhile, in Malaysia, the 1MDB scandal garnered international attention due to its involvement in large-scale corruption and embezzlement practices that eroded the credibility of the government and the country's financial institutions (Jones, 2020). Various cases have shown that effective governance is essential for preventing and detecting fraudulent financial reporting practices (Jones, 2020; Panuntun & Adristi, 2021).

Corporate governance plays a vital role in minimizing the risk of fraud in financial reporting (Sadique, Ismail, Roudaki, Alias, & Clark, 2019). Sadique et al. (2019) the characteristics of governance are significant in reducing the likelihood of fraudulent financial information. However, users of financial statements should not simply be passive; they must conduct a critical analysis to ensure that the information presented is accurate and reliable. Özer, Merter, and Balcıoğlu (2023) highlight that governance is a key factor in the timeliness of financial reporting. This perspective is supported by Esmailikia and Oshani (2022), who found that strengthening governance mechanisms can help reduce the likelihood of fraudulent financial reporting, especially during periods of financial instability. Additionally, Rostami and Rezaei (2022) point out that conflicts of interest and information asymmetry between owners and management, along with the company’s structural factors, can also contribute to fraud.

Detecting fraud in financial statements can be quite challenging because of its concealed nature and the absence of immediate visibility (Young, 2020). This risk increases when investors or external parties lack adequate control and oversight of the company, creating opportunities for unethical behaviors. Martins and Ventura Júnior (2020) assert that a robust corporate governance structure is essential for mitigating the risks associated with Fraudulent Financial Reporting (FFR). In particular, governance practices involving a well-functioning board are more effective in reducing the likelihood of bankruptcy. Meanwhile, auditing practices focus on minimizing earnings manipulation (Iqbal, Sharofiddin, Farooq, Khan, & Kamran, 2022). This suggests that companies with strong governance are better equipped to reduce the risks of fraud and bankruptcy while enhancing the quality of their financial reports (Martins & Ventura Júnior, 2020).

The research conducted by Rostami and Rezaei (2022) highlight the significant role of CEO competence within the industry in minimizing the risk of financial statement fraud. CEOs with a strong understanding and extensive experience in their field are generally more diligent in accurately identifying, assessing, and addressing reporting issues (Rostami & Rezaei, 2022). Additionally, Rostami and Rezaei (2022) emphasize that the financial expertise of the board of directors plays a crucial role in reducing fraudulent reporting practices. A board comprised of individuals with backgrounds in accounting or finance is better equipped to identify issues in financial statements, making its oversight of company management essential for protecting shareholder interests (Backhouse & Wickham, 2020).

This study demonstrates that various components of the corporate governance structure significantly reduce the risk of FFR. Some governance mechanisms have proven effective because of their negative correlation with the likelihood of bankruptcy, while others aim to minimize the potential for earnings manipulation (Rostami & Rezaei, 2022). Unlike previous studies, such as the one conducted by Martins and Ventura Júnior (2020), the findings of this study contribute to the literature by applying a bankruptcy prediction model specifically calibrated for the Brazilian market based on the Altman approach. Additionally, it updates the use of Z- and M-scores to better align with current market conditions. This study incorporates probabilistic models to estimate the likelihood of bankruptcy and earnings manipulation. Consequently, this comprehensive approach not only enhances the identification of potential fraud in financial reporting but also significantly improves the reliability of the results. This study makes methodological contributions and enriches the scientific literature. The application of a robust methodological approach, combined with the relevance of the findings, provides strategic value to this study, particularly for investors and market regulators. This study successfully identified the likelihood of financial statement fraud, bankruptcy, and earnings manipulation using the employed method. Additionally, the results confirm that a well-structured corporate governance framework is crucial for minimizing the chances of these issues occurring.

2. Literature Review and Hypothesis Development

2.1 Fraudulent Financial Reporting

Financial statements are a key source of information for investment decision-making (Shakespeare, 2020). However, in recent decades, several fraud cases involving financial reporting have raised doubts about the credibility of the accounting profession (Patel, 2022). Richardson, Obaydin, and Liu (2022) explain that accounting fraud harms capital markets and can disrupt investment decisions made by both shareholders and other stakeholders. This situation also has broader economic implications, as declining public trust has the potential to push companies toward bankruptcy and trigger a wave of layoffs, as occurred in the Enron case in the United States (Carberry & Zajac, 2021).

One form of this manipulation is known as creative accounting, a technique used to manipulate financial information to create an image of a table performance (Gupta & Kumar, 2020). According to Abed et al. (2022), this practice diminishes the overall quality and reliability of financial reports. Wen, Lin, Hu, He, and Cao (2023) also, argue that numerous instances of fraudulent financial reporting and their detrimental effects on the market have ignited significant debate about the processes involved in preparing and communicating financial information. This reflects the existence of dimensions of human behavior closely related to ethical values, morality, and integrity (Zahari, Said, & Arshad, 2022). Therefore, fraud in financial reporting can be viewed as a managerial deviation rooted in agency issues (Tekwani, 2023). Under conditions of moral hazard, companies must implement ongoing monitoring mechanisms to prevent deviant behavior and minimize the likelihood of FFR, as emphasized by (Rostami & Rezaei, 2022).

According to Timofeyev and Jakovljevic (2020), accounting fraud is typically committed by company managers or executives to obtain specific benefits, particularly by manipulating financial statements to enhance the company's performance in the public eye and positively impact stock prices in the capital market. This finding is supported by Almulhim (2022), who studied 108 observations covering all banks listed on the Saudi Stock Exchange (TASI) for the period 2010–2020 and showed that companies with indications of manipulation tend to face liquidity problems. Similarly, Jain and Lamba (2020)

revealed that companies in India involved in fraud not only exhibit manipulative characteristics but also face issues related to their business continuity. This study builds on Martins and Ventura Júnior (2020) to explore the possibility of FFR by assessing bankruptcy risk and the potential for earnings manipulation. To estimate bankruptcy probability and identify signs of earnings manipulation, we utilize the Z- and M-scores models developed by Altman (1968) and Beneish (1999), respectively. However, in the context of Indonesia, Budiman (2023) demonstrates that the Z-score has greater predictive power for bankruptcy in the Indonesian market. Therefore, this study adopts the Z-score model as the foundation for identifying the Z-score values.

The Z-score- and M-score models are widely recognized in the literature for predicting bankruptcy and identifying earnings manipulation practices. Budiman (2023) evaluated the accuracy of various bankruptcy prediction models using a sample of 31 construction companies in Indonesia that faced financial difficulties during the COVID-19 pandemic. Additionally, research by (Barboza, Basso, & Kimura, 2023) revealed that among the models tested, Altman, Baydia, and Dias's Z-score achieved the highest accuracy rate of 90% for predicting bankruptcy. Similarly, Srebro et al. (2021) analyze the predictive capabilities of the Z- and M-scores by examining financial information from 48 companies in Malaysia, including 24 that failed. Their findings indicated that the Altman Z-score model was quite reliable, successfully classifying approximately 65% of the samples into the safe zone, 20% into the gray zone, and 15% into the distress zone linked with a potential for bankruptcy. Furthermore, these results suggest that companies in the distress zone are more prone to business continuity issues and the risk of manipulating financial statements (Srebro et al., 2021).

Lumadi and Rusgowanto (2023) examined the reliability of the M-score model using data from 171 manufacturing companies in Indonesia from 2016 to 2018. Their regression analysis revealed that the M-score model could effectively classify companies that manipulated financial reports, with approximately 31% of manufacturing companies identified as engaging in financial reporting fraud. Conversely, 69% were not found to have committed any manipulation (Lumadi & Rusgowanto, 2023). Sutainim, Mohammed, and Kamaluddin (2021) tested the Beneish M-score on 140 non-financial public companies in Malaysia from 2015 to 2017. Their findings indicate that 22.9% of these companies were suspected of earnings manipulation, noting a decline in 2016, followed by a sharp increase in 2017. Therefore, predictive models such as the Z- and M-scores are widely used in research focused on the potential for fraudulent financial reporting. Several studies have also established a connection between corporate governance practices and bankruptcy prediction and earnings manipulation (Esmailikia & Oshani, 2022; Lumadi & Rusgowanto, 2023; Martins & Ventura Júnior, 2020; Srebro et al., 2021; Sutainim et al., 2021). Based on these findings, this study uses these two metrics to evaluate the effectiveness of corporate governance structures in preventing fraudulent financial reporting.

2.2 Corporate Governance as a Deterrent to Fraud

Al-Faryan (2024) argues that corporate governance acts as a mechanism to resolve conflicts of interest between principals and agents, primarily through the application of transparency principles, such as the open disclosure of financial information. Moreover, corporate governance is recognized as an essential practice for reducing information asymmetry in capital market trading activities and potentially preventing opportunistic behavior by internal parties (Ghafoor et al., 2019; Martins & Ventura Júnior, 2020; Rostami & Rezaei, 2022; Wen et al., 2023). In the context of corporate governance structures, this study highlights several practices that may influence the quality of financial reporting. These practices include the size of the board of directors (Kirana, Wibawaningsih, & Wijayanti, 2020; Martins & Ventura Júnior, 2020); the involvement of independent members (Agustin, Maharani, & Effendi, 2021); women on the board (Abiodun et al., 2023; Handoko & Olivia, 2022); the average compensation received by the board (Almarayeh, 2023); an audit committee (Trisanti, 2023); and the role of independent audit (Gerekan, Şendurur, & Yıldırım, 2024; Peng & Chau, 2023) which is important in detecting early signs (red flags) of potential fraud. Board size is considered a crucial factor in corporate governance (Martins & Ventura Júnior, 2020). According to Cho and Chung (2022), financial literature indicates that board characteristics, including size and oversight effectiveness, are closely related to efforts to reduce the information asymmetry.

Several studies have found that boards with relatively few members tend to be more effective in carrying out oversight functions because communication between members can occur more efficiently (Hasnan, Rahman, & Ali, 2019; Uddin Bhuiyan, Opare, & Ahmed, 2024). However, a board that is too small can potentially hinder effective reviews and decision-making. The ideal number of board members is suggested to be between eight and nine (Andayani & Wuryantoro, 2023). The independence of board members is a crucial aspect of corporate governance practices (Melón-Izco, Ruiz-Cabestre, & Ruiz-Olalla, 2020). According to Iqbal et al. (2022), having independent board members can enhance the effectiveness of management oversight while decreasing the risk of earnings manipulation. Similarly, Agustin et al. (2021) argue that board independence is reflected in the board's lack of direct involvement in day-to-day operational activities while maintaining close ties with the executive team to gain a thorough understanding of the company's situation. highlight that this separation from daily operations allows independent members to avoid internal pressures, enabling them to make decisions that are more aligned with investors' interests.

The involvement of women on boards of directors is a crucial element of corporate governance structures (Dar & Shairgojri, 2022). According to Abiodun et al. (2023), the presence of women on boards tends to improve company performance. In Indonesia, the principles of equal opportunity and diversity are also emphasized in POJK No. 21/POJK.April 2015: Governance of issuers and public companies. This diversity has implications for enhancing board performance, as differences in background and perspective among members can lead to more in-depth discussions and more informed, prudent, and high-quality decisions. Therefore, the presence of women on boards of directors can be seen as good corporate governance practice (Almarayeh, 2023).

The audit committee plays a crucial role in the corporate governance structure by ensuring the independence and integrity of financial reporting (Rostami & Rezaei, 2022). This committee not only helps prevent earnings manipulation (Alquhaif and Alobaid (2024) but also serves as an objective monitor of management performance, thereby reducing the risk of fraud in reporting (Martins & Ventura Júnior, 2020)**.** The size of the audit committee is important; a larger number of members brings greater diversity of expertise, which ultimately enhances the analytical capacity and oversight efficiency (Endrawes, Feng, Lu, & Shan, 2020)**.** Additionally, external or independent audits are vital control mechanisms that companies use to improve the quality of their financial reports. These audits are important because they involve unbiased external parties that provide impartial opinions, thus lowering the risk of fraud (Marzuki, Haji-Abdullah, Othman, Wahab, & Harymawan, 2019; Trisanti, 2023). Audit quality can be measured by audit fees, among other factors. In-depth and professional audits, which typically command higher fees, tend to deliver better-quality services (Chen, Elemes, & Lobo, 2023). This is further supported by the fact that premium-quality audit services often command higher rates in competitive markets (Ramdin, 2021).

Table 1. Corporate governance variables

Variable	Code: Measurement	Reference
Board Size	DD: Measured by the number of board members in the board.	(Cho & Chung, 2022; Ibrahim & Yahaya, 2024; Martins & Ventura Júnior, 2020)
Board Independence	DK: Measured by the number of independent directors divided by the total number of board members	(Agustin et al., 2021; Iqbal et al., 2022)
Women on the Board	Dwom: Measured by the number of women on the board divided by the total of board members	(Abiodun et al., 2023; Almarayeh, 2023)
Board Compensation (GD)	GD: Measured by total compensation of directors in logarithm value	(Aljughaiman, Almulhim, & Al Naim, 2024; Almarayeh, 2023; Elnahass, Salama, & Trinh, 2022)

Audit Committee Size (AC)	AC: Measured by the number of audit committee	(Martins & Ventura Júnior, 2020; Marzuki et al., 2019; Ruchiatna, Midiastuty, & Suranta, 2020; Trisanti, 2023)

3. Research methodology

This study uses a sample of public companies listed on the Indonesia Stock Exchange (IDX) and Bursa Malaysia (BM) to analyze corporate governance practices. We obtained financial data from the Refinitiv database for 45 companies between 2014 and 2023. Information on corporate governance was obtained directly from each company's internal report and database. The sample selection criteria focused on companies with indications of financial problems such as bankruptcy or earnings manipulation. Companies with incomplete or unavailable data on the analyzed variables were excluded from the sample. Overall, this study yielded 450 observations, as shown in Table 2

Table 2. Sample composition

	Indonesia	**Malaysia**	**Total**
Initial Sample	126	189	315
Missing data and value	96	174	270
Final sample	30	15	45
Observation across the sample period	300	150	450

3.1 Identifying the Possibility of Fraud

This study examines the relationship between corporate governance structure and the likelihood of fraud in financial reporting using a bivariate probit regression model with pooled panel data.

$$P(Y_{it} = 1) = \beta_0 + \beta_1 DD_{it} + \beta_2 DK_{it} + \beta_3 Dwom_{it} + \beta_4 GD_{it} + \beta_5 AC_{it} + \delta t + \gamma s \qquad (1)$$

For each company i in period t, Yit is a binary variable used for three analytical purposes. In the first model, this variable represents the likelihood of financial statement fraud. In the second model, Y_{it} is used to estimate the potential for bankruptcy with a probability threshold of $P(Z_i) > 0.80$. In the third model, this variable is used to detect indications of earnings manipulation with a probability of $P(M_i) > 0.80$. This study measures financial reporting fraud as a binary variable (Martins & Ventura Júnior, 2020; Maryadi, Midiastuty, Suranta, & Robiansyah, 2020). Martins and Ventura Júnior (2020) added that the determination of the fraudulent financial reporting (FFR) is based on the match between the company's Z-score and M-score values with the characteristics of the troubled company. Companies experiencing business continuity difficulties or that have revised and reissued their financial statements are used as references. The Z-score and M-score values are calculated and expressed as $P(Z_i = 1)$ and $P(M_i = 1)$. $P(Z_i = 1)$ indicates the probability of bankruptcy, and $P(M_i = 1)$ indicates the potential for earnings manipulation.

As illustrated in Figure 1, this approach enables the identification of FFR based on probability similarities with groups of troubled companies, both operationally and in terms of their reporting. By combining these two scores, the method used predicts the likelihood of bankruptcy or earnings manipulation separately and identifies the potential for FFR more comprehensively. Furthermore, the integration of both probabilities enhances the model's ability to capture complex financial conditions that may not be detected when each indicator is analyzed independently. This is because financial reporting fraud often arises from a combination of financial distress and managerial incentives to manipulate earnings (Sabrina, Midiastuty, & Suranta, 2020). Therefore, the joint use of the Z-score- and M-scores provides a more holistic perspective for identifying firms that are more likely to engage in fraudulent reporting practices (Falasifah, Titisari, & Istiatin, 2025). In addition, the probabilistic approach applied in this study allows for greater flexibility in classification, as it does not rely solely on rigid cut-off values but considers the degree of risk faced by each firm. Consequently, this method contributes to a more nuanced and reliable detection of fraudulent financial reporting.

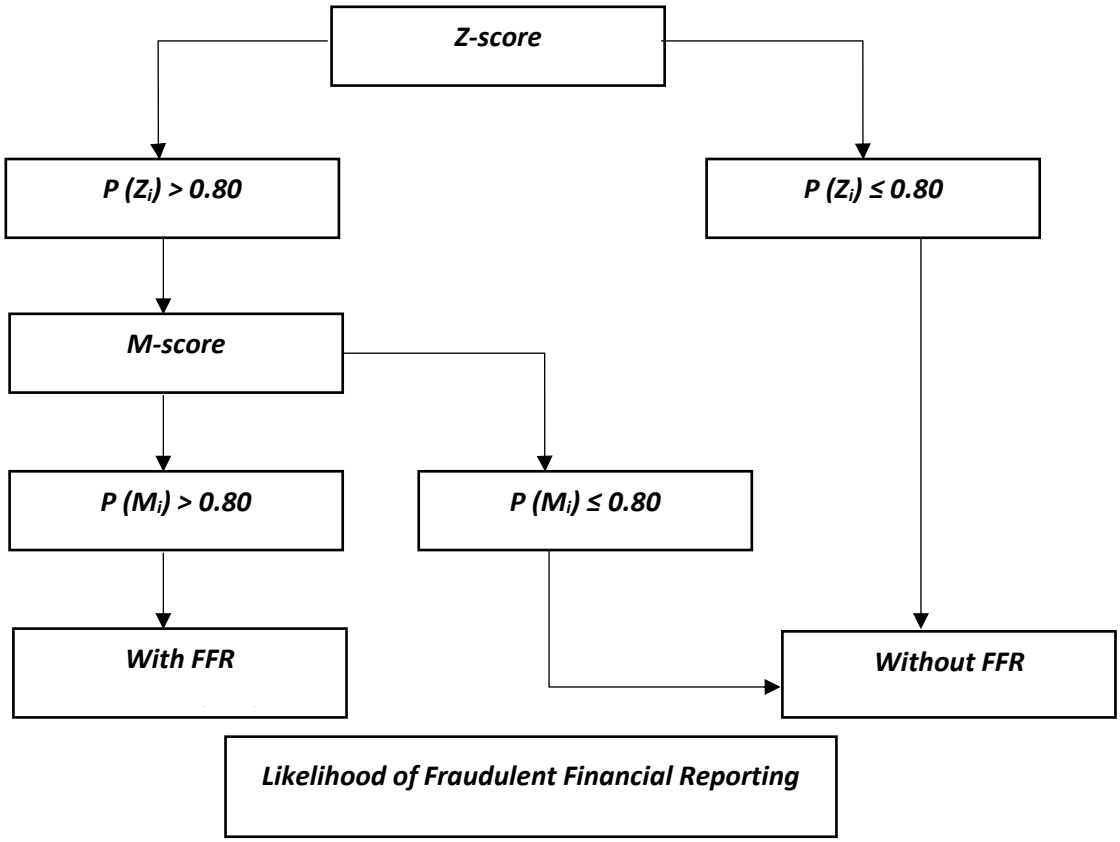

Figure 1. Identification of the possibility of fraudulent financial reporting

3.2 Identification of Bankruptcy Prediction and Earnings Manipulation

To assess the likelihood of bankruptcy, this study employs a Z-score model that has been modified to suit the market conditions of developing countries such as Indonesia and Malaysia. By regressing bankruptcy or legal restructuring indicators on various firm financial characteristics, the model generates a formula that estimates the probability of a company encountering financial distress or potential bankruptcy. The detailed computation of each variable incorporated into this model is presented in Table 2.

Table 3. Model parameters of Altman, Baydia, and Dias

$X_1 = \frac{(\text{Current Assets}_{it} - \text{Current Liabilities}_{it})}{\text{Total Assetsx}_{it}}$	$X_3 = \frac{\text{Market Value}_{it}}{\text{Total Liabilities}_{it}}$
$X_2 = \frac{\text{Earnings Before Interest and Taxes}_{it}}{\text{Total Assetsx}_{it}}$	$X_4 = \frac{Sales}{TotalAsset_{it}}$

To enhance prediction accuracy, this study recalibrated the Z-score model by re-estimating its coefficients. Although widely used, prior research Knežević et al. (2021) shows that the model's coefficients are sample- and period-specific, making them unsuitable for direct application to this dataset. To prevent misclassification, a probit model was re-estimated using firms in the sample that filed for bankruptcy or legal restructuring. This process generated updated coefficients for variables X_1, X_2, X_3, and X_4, which better reflected the Indonesian and Malaysian contexts. These coefficients are then incorporated into Equation 2 to compute bankruptcy probability, $P(Z_i = 1)$.

$$P_i = p(Z_i = 1) = \frac{1}{1+e-(-0{,}854-1{,}555X_{1i}-2{,}278X_{2i}+0{,}0002X_{3i}-0{,}234X_{4i})} \quad (2)$$

A company is considered to have problematic characteristics, as described by Altman, if its $P(Z_i)$ value is in the top quintile of the sample, that is, $P(Z_i) > 0.80$. Conversely, companies exhibiting a sustainable operational profile have a value $P(Z_i) \leq 0{,}80$. For the model analysis, this indicator was converted into a dummy variable, with a value of 1 assigned to companies with $P(Z_i) > 0.80$ and a value of 0 assigned to companies with $P(Z_i) \leq 0.80$. The Beneish model approach is used to estimate the M-score, which measures a company's propensity to manipulate its financial statements. The complete formulas and calculation methods are outlined in Table 3.

Tabel 4. Model parameters of Beneish

$ARSI = \frac{(\text{Receivable}_{it}/\text{sales}_{it})}{(\text{Receivable}_{it-1}/\text{sales}_{it-1})}$
$\text{AQI} = \frac{1 - (\text{Current}_{it}\ \text{Asset}_{it} + \text{PP\&E}_{it})\ \text{Total Assets}_{it}}{1 - (\text{Current Asset}_{it-1} + \text{PP\&E}_{it-1})\ \text{Assets}_{it-1}}$
$\text{TATA} = \frac{(\text{Net} - \text{Income}_{it}\ \text{Operational Cash Flow}_{it}\ \text{Assets}_{it}}{(\text{Net} - \text{Income}_{it-1}\ \text{Operational Cash Flow}_{it-1}\text{Assets}_{it-1}}$
$\text{SGAI} = \frac{(\text{Sales, general, and administrative expense}_{it}/\text{Sales}_{it})}{(\text{Sales, general, and administrative expense}_{it-1}/\text{Sales}_{it-1})}$
$\text{DEPI} = \frac{(\text{Depreciation}_{it}\ /(\text{Depreciation}_{it} + \text{PP\&E}_{\mathbf{it}})}{(\text{Depreciation}_{it-1}\ /(\text{Depreciation}_{it-1} + \text{PP\&E}_{\mathbf{it-1}})}$
$\text{LVGI} = \frac{\text{Total Liabilities Assets}_{it}}{\text{Total Liabilities Assets}_{it-1}}$
$\text{GMI} = \frac{\text{Gross Margin}_{it}}{\text{Gross margin}_{it-1}}$
$\text{SGI} = \frac{\text{Sales}_{it}}{\text{Sales}_{it-1}}$

Similar to the Altman model, the Beneish model requires recalibration because its original coefficients were derived from a specific sample and period. Thus, this study re-estimates the model's coefficients through probity regression using firms in Indonesia and Malaysia that have documented indications or cases of earnings manipulation. The updated coefficients are then applied to Equation to calculate the probability of earnings manipulation, expressed as $P(M_i = 1)$.

$$P(M_i = 1) = \frac{1}{1+e-(-1{,}1{,}635+0{,}251DSRI+0{,}462GMI-0{,}231AQI+0{,}114SGI-1{,}075DEPI+0{,}139SGAI+0{,}014LVGI+0{,}058TATA)} \quad (3)$$

When the value of $P(M_i)$ falls within the highest quintile of the sample ($P(M_i) > 0.80$), the firm is categorized as having a high likelihood of engaging in earnings manipulation, consistent with Martins & Júnior (2020). For the second regression, this indicator was transformed into a dummy variable, coded 1 if $P(M_i) > 0.80$, and 0 if $P(M_i) \leq 0.80$. After obtaining the probability values $P(Z_i)$ and $P(M_i)$, the potential for fraudulent financial reporting (FFR) is identified. Following the FFR approach, a firm is assigned a value of 1 if it simultaneously exhibits a high probability of bankruptcy ($P(Z_i) > 0.80$) and a high probability of earnings manipulation ($P(M_i) > 0.80$). If one or both conditions were not met, the variable was coded as zero. This constructed variable is then used to assess how corporate governance structures influence FFR tendencies and their association with bankruptcy risk and earnings manipulation.

4. Results and Discussion

4.1 Results

The analysis begins by estimating the main research variables: bankruptcy prediction (Z-score), earnings manipulation (M-score), and the probability of FFR. As shown in Table 4, potential fraud was detected in 49% of the annual observations for Indonesia and 82% for Malaysia. This indicates a high level of vulnerability in the Malaysian market, while the 49% figure in Indonesia, although lower, still reflects a substantial risk that warrants further attention. These percentages are considerably higher than the 5.5% reported by Martins and Ventura Júnior (2020) for Brazil. This difference partly stems from methodological variations, as their study applied the Beneish model for the M-score and a different model for the Z-score. A key strength of this study is the recalibrated Z- and M-models tailored to the characteristics of the Indonesian and Malaysian samples, which enhances the robustness and reliability of bankruptcy and earnings manipulation estimates. The probability of fraudulent financial reporting during the study period is determined by combining the likelihood of bankruptcy and earnings manipulation. In the Indonesian sample, 88.67% of the observations showed a high bankruptcy probability ($P(Z_i) > 0.80$), while 55% showed indications of earnings manipulation ($P(M_i) > 0.80$). In Malaysia, the corresponding figures were 88.67% for bankruptcy probability and 88.15% for earnings manipulation. It is important to note that these numbers reflect the frequency of detected symptoms, not the average Z- or M-scores. Moreover, the analysis is probabilistic, meaning that it measures the likelihood of an event occurring rather than confirming the presence of fraud.

Table 5. Descriptive statistics of variables in Indonesia

Variable	Mean	Modus	Std. Deviation	Minimum	Maximum
FFR	0.49	-	-	-	-
Z-Score	0.88	-	-	-	-
M-Score	0.55	-	-	-	-
DD	5.20	6.00	1.78	2.00	9.00
DK	4.39	3.00	1.77	1.00	13.00
Dwon	0.67	0.00	0.79	0.00	3.00
GD	23.53	19.30	1.38	19.00	26.00
AC	3.01	3.00	0.96	0.00	9.00

Table 6. Descriptive statistics of variables in Malaysia

Variable	Mean	Modus	Std. Deviation	Minimum	Maximum
FFR	0.82	-	-	-	-
Z-Score	0.87	-	-	-	-
M-Score	0.88	-	-	-	-
DD	3.73	4.00	1.32	1.00	6.00
DK	1.66	1.00	1.17	0.00	4.00
Dwom	0.44	0.00	0.66	0.00	2.00
GD	22.75	22.64	0.96	20.00	26.00
AC	2.30	3.00	1.16	0.00	4.00

In Tables 4 and 5, the descriptive statistics show that the average board of directors for the sample companies in Indonesia and Malaysia has approximately five and three members, respectively. Although there are no binding global rules, various international governance codes and regulations provide general guidance on the size and composition of boards. In Indonesia, the *Otoritas Jasa Keuangan (OJK)* through POJK No. 33/POJK.04/2014, states that the board of directors must consist of at least two members, reflecting the country's effort to formalize minimum governance standards. Meanwhile, in Malaysia, the Malaysian Code on Corporate Governance (MCCG 2021) does not prescribe a specific number of board members. However, it emphasizes that the size and composition should be appropriate for the company's complexity. Furthermore, under the Companies Act 2016, every private company in Malaysia is required to have at least one director, whereas public companies must have a minimum of two directors. In the Indonesian sample, the level of board independence (X2) averages around four independent members, while in Malaysia, it is only about one.

This indicates a weaker governance structure in Malaysia, as limited board independence can create a higher risk of misaligned interests between the management and shareholders. According to Martins and Ventura Júnior (2020), weak monitoring mechanisms may increase the likelihood of earnings manipulation, thereby reducing the quality of accounting information (Sadique et al., 2019). These differences are largely driven by the regulatory frameworks. Indonesia, through POJK No. 33/POJK.04/2014, requires a higher proportion of independent commissioners to strengthen the oversight. Meanwhile, Malaysia adopts a single-tier board structure under the Malaysian Code on Corporate Governance (MCCG 2021), in which executive and non-executive directors share the monitoring responsibilities (Sheehy, Yu, & Lie, 2021). Consequently, Malaysia places greater reliance on independent directors within a unified board rather than on a separate supervisory body, which contributes to the lower number of independent board members observed in the sample.

In Malaysia, the Bursa Malaysia Listing Requirements mandate at least one female director (X3), resulting in a 44% female representation in the sample. Indonesia has no similar quota; however, the average share of women in executive positions reaches 67%. Malaysia's MCCG 2021 also stresses independent-dominated remuneration committees with transparent compensation, while Indonesia's POJK No. 17/2023 requires banks to establish written remuneration policies and allows for malus clawback mechanisms. The study also finds notable differences in the audit committee size. Indonesia's audit committees average 3.02 members, aligning with the minimum recommended standard, whereas Malaysia's average is only 2.3 members. This gap suggests stronger adherence to governance practices in Indonesia, particularly in financial reporting oversight, despite both countries sharing similar governance objectives.

4.2 Influence of Corporate Governance

This study examines how corporate governance structures influence FFR, along with related factors such as bankruptcy prediction and earnings manipulation, using three bivariate probit regression models on a panel data. The first model examines the direct relationship between corporate governance and FFR, while the other two models separately assess the effects of governance on bankruptcy prediction and earnings manipulation to enhance robustness. The estimation results, summarized in Table 6, indicate that all models meet the econometric validity requirements. Although time and sector dummy variables are included as controls, they are not displayed in the table because the analysis focuses on corporate governance practices.

Table 7. Probit regression estimation results for FFR, bankruptcy, and manipulation in Indonesia

Variable	FFR		Bankruptcy		Manipulation	
	Coefficient	Z statistic	Coefficient	Z statistic	Coefficient	Z statistic
Constant	-3.123	-1.925	-9.240	-3.924	-0.445	-0.276
DD	-0.118	-2.163	-0.206	-2.283	-0.109	-1.998
DK	0.073	1.622	0.089	1.143	0.071	1.579
Dwom	0.035	0.363	0.039	0.300	-0.040	-0.420
GD	0.001	1.665	0.004	3.779	0.000	0.378
AC	0.128	1.583	0.380	3.432	-0.059	0.752
R2	0.029		0.214		0.018	
Log Likelihood	-201.864		-83.289		-202.592	
Chi square	0.669		0.059		0.362	
Nº Firms	30		30		30	
Nº Observations	300		300		300	

In Indonesia, the findings show that only board size has a negative and significant effect on fraudulent financial reporting, with a coefficient of –0.118. This supports the results of Rostami and Rezaei (2022) and Kusumawardani, Soediro, Adhitama, and Farhan (2023) who argue that an appropriately sized board strengthens oversight and reduces opportunities for manipulation. Other governance variables, such as female board representation, total board compensation, and audit committee size, do not exhibit

a significant relationship with FFR. These results differ from several prior studies Andayani and Wuryantoro (2023); Martins and Ventura Júnior (2020); Ogoun and Perelayefa (2019), which generally find that higher director compensation lowers incentives for financial statement fraud. Despite using comparable analytical techniques, the effect of governance mechanisms on FFR in Indonesia appears to follow a distinct pattern relative to global evidence.

The analysis of corporate governance and bankruptcy prediction shows that board size has a negative and significant effect on bankruptcy risk, with a coefficient of –0.206. Meanwhile, total director compensation (0.009) and audit committee size (0.155) have positive and significant effects. These results imply that larger boards help reduce the likelihood of bankruptcy through stronger oversight and better strategic decision-making. In contrast, excessively high compensation and oversized audit committees may increase bankruptcy risk owing to potential inefficiencies or coordination issues that weaken financial stability (Trisanti, 2023). The findings from the earnings manipulation model further confirm the negative and significant impact of board size (–0.109). This indicates that companies with more board members are less likely to engage in earnings manipulation, as larger boards tend to offer stronger monitoring, broader viewpoints, and a more balanced division of responsibilities, which collectively help constrain managerial opportunism (Hoseinalinezhad, Hashemi Kucheksarai, & Jafari, 2024).

Table 8. Probit regression estimation results for FFR, bankruptcy, and manipulation in Malaysia

Variable	FFR		Bankruptcy		Manipulation	
	Coefficient	Z statistic	Coefficient	Z statistic	Coefficient	Z statistic
Constant	-11.275	-2.293	-20.910	-2.744	-2.668	-0.552
X1	0.333	2.220	0.266	1.580	0.381	2.279
X2	0.119	0.534	-0.288	-0.870	0.178	0.740
X3	0.631	1.806	0.840	1.910	0.436	1.058
X4	0.004	2.196	0.009	2.737	0.001	0.515
X5	-0.117	-0.586	0.155	0.580	-0.193	-0.842
R2	0.188		0.280		0.133	
Log Likelihood	-51.299		-38.158		-42.560	
Chi square	0.050		0.185		0.185	
Nº Firms	15		15		15	
Nº Observations	135		135		135	

In contrast to the Indonesian results, the Malaysian findings show that board size (0.333) and total director compensation (0.004) have a positive and significant effect on FFR. This suggests that larger boards and higher compensation levels increase the fraud risk in Malaysia. Oversized boards may face coordination challenges that weaken oversight, while high compensation without strong control mechanisms may invite opportunistic behaviors. These results align with Iqbal et al. (2022), who argue that large boards tend to be less effective and more prone to independence issues, although they differ from studies such as (Esmailikia & Oshani, 2022), which report the opposite effect. The bankruptcy prediction results for Malaysian firms indicate that only total board compensation has a positive and significant impact ($p = 0.009$), implying that higher compensation is associated with a greater bankruptcy risk. This may occur when generous pay is not supported by sound financial performance or strict monitoring, thereby encouraging risk-taking and opportunistic decisions (Carberry & Zajac, 2021). In the Malaysian earnings manipulation model, board size emerges as the only significant variable with a positive coefficient (0.381). This implies that larger boards are associated with a higher tendency for earnings manipulation. This finding is noteworthy because it contradicts the common expectation that larger boards enhance firm monitoring (Aljughaiman et al., 2024). Potential explanations include dispersed responsibilities, weak cohesion and communication, and heightened chances of managerial dominance, all of which may dilute oversight and enable manipulation.

5. Conclusion

5.1 Conclusion

This study examines the role of corporate governance in mitigating Fraudulent Financial Reporting (FFR). Fraudulent financial reporting refers to the intentional manipulation or misstatement of financial information to mislead stakeholders regarding a company's financial performance or position. The results indicate that the influence of corporate governance mechanisms on FFR differs between Indonesia and Malaysia. In Indonesia, most governance variables show a negative relationship with FFR, suggesting that stronger governance reduces the likelihood of financial manipulation. In particular, board size has a significantly negative effect on FFR. Boards that are too small may lack effective monitoring capacity, whereas excessively large boards may face coordination problems that weaken oversight. Therefore, maintaining a proportional board size can enhance monitoring effectiveness and reduce earnings manipulation opportunities. Furthermore, governance variables, such as commissioner independence and the presence of female directors, have no significant effect in either Indonesia or Malaysia. This indicates that the existence of formal governance structures alone is insufficient to ensure effective monitoring. The effectiveness of governance largely depends on the quality of implementation and the broader institutional environment in which firms operate. Differences in corporate culture, ownership structures, and managerial incentives may influence the functioning of governance mechanisms. Overall, the findings demonstrate that corporate governance plays an important role in reducing fraudulent financial reporting; however, its effectiveness is strongly influenced by the institutional context. In Indonesia, proportional board structures, balanced compensation systems, and strong internal auditing mechanisms can reduce the likelihood of earnings manipulation. In contrast, in Malaysia, formal governance mechanisms appear to be less effective in preventing fraud among financially distressed firms. These results suggest that improving governance effectiveness requires not only formal structures but also stronger implementation of integrity, transparency, and accountability within the organization.

5.2 Research Limitations

This study had several limitations. First, the sample focuses only on companies that experience financial distress or financial reporting issues. Although this approach allows for a deeper analysis of fraud-related behavior, it may limit the generalizability of the findings to all publicly listed companies. Second, this study only examines several corporate governance variables, including board size, managerial compensation, commissioner independence, gender diversity, and internal auditing. Other governance mechanisms, such as ownership concentration, audit committee expertise, and external audit quality, were not included in the analysis. Third, institutional and cultural factors that may influence governance effectiveness were discussed conceptually rather than being measured directly in the empirical model. Consequently, some contextual factors affecting governance practices may not be fully captured.

5.3 Suggestions and Directions for Future Research

Future research can extend this study in several ways. First, future studies could include a broader sample of firms, including both financially distressed and non-distressed companies, to provide a more comprehensive understanding of the effectiveness of governance in preventing fraudulent financial reporting. Second, additional governance variables, such as ownership structure, audit committee expertise, board experience, and external audit quality, could be incorporated to provide a more comprehensive analysis of governance mechanisms. Third, future research should adopt mixed-method approaches that combine quantitative analysis with qualitative methods, such as interviews or case studies, to better understand how governance mechanisms operate in practice. Finally, comparative studies involving more Southeast Asian countries may provide deeper insights into how institutional environments influence the effectiveness of corporate governance in mitigating fraudulent financial reporting.

Author Contributions

Conceptualization, formal analysis, writing review and editing, supervision, and final approval of the manuscript were conducted by BN Meanwhile, the methodology, data collection, and writing original draft preparation were conducted by IAN.

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