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DO BOARD ATTRIBUTES MATTER? INVESTIGATING THEIR INFLUENCE ON FRAUDULENT FINANCIAL REPORTING: A STUDY OF NON-FINANCIAL FIRMS IN PAKISTAN

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ABSTRACT
Financial reporting is important, as it provides information about the company upon which investors rely and make investment decisions. The accuracy of such reporting is mandatory to protect investors and keep the firm away from fraudulent practices. This study aims to unveil the influence of board attributes on fraudulent financial reporting in non-financial firms in Pakistan. The study considers board attributes like board size, independence, and diversity as independent variables while fraudulent financial reporting proxied by the Beinish model as a dependent variable. Using various tests, the study findings proclaim that board attributes (board size, board independence, board diversity) significantly influence fraudulent financial reporting in non-financial firms. A well-structured board with diverse perspectives, independent oversight, and an appropriate size can act as a strong deterrent to fraudulent activities. Larger boards provide comprehensive and effective monitoring, while board independence ensures that decisions are made impartially, reducing the likelihood of manipulation. Furthermore, diversity in the boardroom also encourages varied viewpoints, resulting in more appropriate and accurate decisions. For investors, this insight is crucial as it highlights that strong governance structures specifically board attributes can protect their investments by minimizing risks associated with fraudulent practices.
Keywords: Board size, Board Independence, Board Diversity, Fraudulent practices, Non-Financial Firms

Introduction

Financial reporting serves as a tool for managers to justify the decisions they make for the company in front of shareholders and owners while also serving as a source of appropriate information for external and internal entities concerning determining their choices. Financial statements' core meaning and significance become worthless When managers merely pay attention to the numbers included in them. This is because the ultimate objective of managers is to present the company's financial statements excellently to owners and investors (Fathmaningrum & Anggarani, 2021). Aside from the company's stakeholders, such as the government, creditors, vendors, and

employees, its shareholders also examined its financial statements. It is very crucial to have an accurate and trustworthy financial report to satisfy them (Utami, 2023). The deliberate manipulation, misrepresentation, hiding, or underestimating of financial data to deceive financial reports constitutes fraudulent financial reporting. It is an illegal act that violates rules and regulations for personal benefit by deliberately manipulating financial data. According to the Association of Certified Fraud Examiners (ACFE), financial figure manipulation is considered fraudulent (ACFE releases 2018 Report to the Nations, 2024). Although fraudulent financial reporting is a rare type of deceit to attract investors and creditors, it will create a huge loss to companies, compromised reputations, and a decline in investors' confidence once it is detected and exposed (Dzaki & Suryani, 2020). An important requirement for both economic growth and to attract investors and shareholders into beneficial economic activities, it is essential to have access to relevant information and data that supports financial, economic, and business decision-making (Wang, 2019). However, fraud is currently one of the elements undermining the reliability and accuracy of financial statements (Purba & Syafruddin, 2023). Organizations that dealt with and experienced fraud, such as Bank Muscat, Enron, Satyam, Oman National Gas, and WorldCom, suggested a great emphasis on anti-fraud measures, essentially fraudulent risk assessment (Rehman & Hashim, 2020; Bhasin, 2013; Singleton & Singleton, 2010). "SAS No. 99 about Consideration of Fraud in Financial Statement Audit" states that one kind of financial fraud is fraudulent financial reporting. Second, the presentation of inappropriate assets. These two misstatements of the financial statements violated generally accepted accounting principles (GAAP) and were therefore inappropriate for presentation. The current study will concentrate on the misstatements resulting from fraudulent financial reporting, which is the first category of fraud (Syamsuddin et al., 2023). The majority of large companies' failures have been characterized by cases of corporate fraud as well as some other notable cases, such as Enron, WorldCom, and the most recent Wirecard case. These cases have also highlighted the significance of effectively operating corporate governance models that would prevent these types of incidents.

Several studies have demonstrated the critical role that corporate governance plays a vital role in enhancing the accuracy and reliability of financial reporting and combating fraudulent financial reporting (Rostami & Rezaei, 2022; Shah, 2020). Corporation governance can be defined as the arrangements used for guiding and monitoring businesses. It encompasses the creation of a structure by which the investors, managers, and board members, among other people, exert effort toward the common goal. To sum up, effective corporate governance can concentrate on the betterment and improvement of the organizations' indicators, such as transparency and accountability, and prevent fraudulent activities. Promoting the reliability and accuracy of financial reporting on the allocation of resources is a prevalent factor of an effective corporate governance mechanism (Habib & Jiang, 2015; Purba & Syafruddin, 2023; Alim et al., 2024). Using various structures of corporate governance, this study aims to

establish how the different measures that exist to check fraudulent financial reporting affect the probability of the act being committed.

Over the last decade, several countries' regulatory authorities and international standard-setting organizations have introduced different measures that aim at improving corporate governance standards and minimizing occurrences of fraud. These acts include the Sarbanes-Oxley Act (SOX) in the United States and the UK Corporate Governance Code which has been devised to rectify such corporate governance and improve the financial reporting standards. These regulations stress on issues such as directors' independence, audit committee, and corporate disclosure. However, instances of fraud in financial reporting are still being reported, which means that much more should still be done to improve corporate governance principles.

One important component of corporate governance which addresses the effectiveness of the business' operations is the board of directors. Another function is to monitor the management of the company and provide proper and reliable financial statements (Indrati et al., 2021). Board independence concentrates on the boards that are engaged in monitoring the operations and procedures of the company in the absence of executives and serves to enhance the board's monitoring ability. Additionally, the board's financial and sector knowledge endowment may lead to better decision-making and monitoring of business operations, minimizing the chance of fraudulent financial reporting. Corporate governance reforms focus on the board's independence, but the performance of the board ultimately depends on each director (Dalton & Dalton, 2005).

The number of boards of directors is a key instrument for internal corporate governance; they hold a special place in corporate business organizations. The performance of a business depends significantly on the diversity and size of its board, board activity, and shareholder ownership. The ultimate target of the board's members is to govern all organization operations. All incorporated entities are legally required by statute to have a board of directors (Garg, 2007). To maximize effectiveness in the policy-making process, the sizes of boards are adjusted following the complexity of the companies' business operations. The complexity of a business may require an even higher number of board members. However, the growth and development of the company are dependent on the number of board members, but it also leads towards complexity within the organization (Krisnadewi et al., 2020).

Scholars have given significant attention to board diversity as one of the corporate governance methods (Luoma & Goodstein, 1999; Mallin et al., 2013). larger boards primarily responsible for promoting stakeholder involvement and participation in corporate decision-making, which in turn motivates and encourages firms to make sustainable contributions. Board diversity strengthens the relationship between corporate governance structures such as outside directors, the size of the board, and the operating performance of the company (Alabede, 2016). Companies with diverse and larger directors on board certainly have the depth of ability and knowledge needed to improve corporate performance (De Villiers et al., 2011). Some scholars suggest that diversification of the boards can boost the corporate financial and social

efficiency of the company, regarded as an integral corporate governance variable (Cuadrado Ballesteros et al., 2015; Post et al., 2011).

Audit committees, employees, and internal and external auditors are also important elements of the framework of corporate governance, expected to monitor the process of preparation of financial statements, comply with the standards for the preparation of reports, and be responsible for the accuracy of the statements. Financial fraud can be prevented by an efficient audit committee because, after the implementation of the new law, the committee is responsible for financial reporting and shells out any problems and shortcomings from the work of other committees.

It is the responsibility of the internal auditors to assess and enhance the efficacy of the company's risk management, internal control systems, and governance framework. In contrast, external auditors try to ensure that the accounts are created and presented accurately, most importantly, and they provide an unbiased assessment of the financial status of the company. Therefore, audit services significantly affect the possibility of fraudulent reporting.

Fraudulent financial reporting effectively argues for the utilization of efficient mechanisms and policies in corporate governance to prevent financial crimes. In this paper, an attempt will be made to add knowledge on how, and to what extent, this system of corporate governance influences the propensity of financial fraud, in the hope that it will allow investors, regulators, and policymakers enough information so that they can make informed decisions on the subject. Consequently, by dissecting different aspects of governance and the impact of every aspect concerning financial reporting, the study seeks to provide pragmatic solutions to the variables affecting the corporate governance structures and integrity of the financial reporting process.

Literature Review and Proposed Hypothesis

Corporate governance is a policy and procedure that must be implemented by a company. For the implementation of effective good corporate governance, companies must be able to protect the goals and objectives of owners and other participants at all levels of the organization (Wahyudi et al., 2019). The objectives of the stakeholders can be shielded from irresponsible company managers through the execution of good corporate governance (Devi, 2024; Hemdan et al., 2021). Excellent corporate governance can influence greatly financial integrity. Numerous studies have shown that these improvements significantly lower risk and boost the credibility of financial reports. For instance, Malaysia, Italy, and Japan have strong governance structures that are efficient in preventing financial fraud and involve some essential governance factors, including audit committees and independent directors. Uwuigbe et al. (2019), examined the relationship between financial statements and corporate governance of Italian registered companies, using a sample size of 26 companies spanning through the period of 2001-2011. According to the findings, an audit committee operating under Italian corporate governance is more likely to mitigate risk and fraud incidents. Additionally, fraudulent activities are linked to a weak governance structure (Beasley et al., 2000; Beasley & Salterio, 2001). According to Wahyudi et al. (2019), corporate

governance mechanisms simultaneously have a great influence on fraud in financial reporting.

For ensuring the success of organizations, the board of directors serves as a crucial catalyst. They are liable for establishing company objectives, plans, and policies and coordinating them with the shareholders' interests. Regarding financial information, they are also accountable for the transparency, integrity, and reliability of the financial statement (Alzoubi & Selamat, 2012). A board must have eight or nine board directors to monitor and regulate managers efficiently (Lipton & Lorsch, 1992; Petra, 2005). According to Fama and Jensen (1983), the board of directors holds the highest level of authority in an organization, so all the decisions are made under their supervision. Xiang, Li, and Li (2014) examined that board size has also an exceptionally significant influence on the standard of information disclosure. Kim et al. (2009) investigated that a company's ability to monitor and regulate its operation (unrelated corporate diversification) was enhanced if there was a great knowledge of institutional shareholdings, especially when it related to a dual CEO. A large number of directors on the board will enable the supervisory function to be effectively promoted successfully with full authority, bringing the opinions and experiences of numerous managers (Asmar et al., 2018). Large boards reduce the probability of fraud in financial statements and are related to outstanding performance on the reputation of the company (Kalbuana et al., 2022; Orozco et al., 2018). Companies with a higher number of board members have a positive correlation with corporate voluntary disclosure; as a result of the presence of a diversity of opinions and skills, companies with larger boards typically share more information (Al-Janadi et al., 2013; Allegrini & Greco, 2013; Esther & Henry, 2018). However, several other studies predicted that board size has no significant impact on financial statement fraud (Lin & Nguyen, 2022; Salleh & Othman, 2016; Shan, 2013).

H1: Board Size has a significant negative relationship with fraudulent financial reporting

Carpenter and Feroz (2001) argued the relationship between board diversity and financial statement fraud in 75 companies in North Carolina. The findings of this study showed that boards with international expertise have unique, special, and incomparable qualities that increase the organization's competitive edge. Board members having international expertise in multinational corporations can easily control and monitor activities within organizations. Board members can manage the complicated aspects of earnings management with the help of such experiences. However, global experience differs from local experience, so it is also expected that board members with international experience will help in encouraging and executing more enhanced earnings management prevention procedures (Razali & Arshad, 2014). An improvement in the quality of financial reporting might result from supervisory boards with foreign experience (Dobija & Puławska, 2022). The board's independence was strengthened by the addition of foreign directors, enabling them to merge their diverse professional experiences to fully explore and utilize the resources of the organization (Gregorič et al., 2017; Oehmichen et al., 2017). According to Nielsen and

Nielsen (2013), foreign experts have distinct cognitive schemas, which can influence how information is gathered, analyzed, organized, and utilized as well as provide wide networks and business awareness.

H2: Board Diversity has a significant negative relationship with fraudulent financial reporting

Board independence is frequently suggested for better corporate governance; it can exert a great influence on company performance but remains debated (Kiran & Ibrahim, 2021). More independent board members in the company have contributed to improving governance by reducing the management's motives for earning and profit. The efficacy of board independence can be evaluated by using a variety of conceptual frameworks, such as agency theory, resource dependency theory, and stewardship theory. Institutional context is a key factor in explaining inconsistent results among many studies and different nations (Kiran & Ibrahim, 2021; Neville et al., 2019). Corporate governance is strengthened by the presence of independent and external directors. Generally, board independence improves corporate social performance in civil law countries, and when self-reported data is utilized, their impact is more significant (Ortas et al., 2017). Farber (2005) examined the study of corporate governance and financial reporting reliability and concluded that fraudulent companies had worse corporate governance than control firms. According to Xie et al. (2003), board independence reduces the probability of earnings management while simultaneously increasing the efficiency of management regulations. Companies that are not fraudulent have a greater percentage of external and independent directors than fraudulent ones (Carcello & Nagy, 2004; Saksena, 2003). According to Siladi (2006), board independence should not involve regular operations of the firm but should reflect advisors' intimacy with the company's executive team; as a result, more knowledge, awareness and exposure can be achieved. Achieving greater independence is a beneficial approach to governance.

H3: Board independence has a significant negative relationship with fraudulent financial reporting

Methodology

In this study, the overall index of the probability of fraudulent financial reporting is determined by using the Beneish M-Score Model to assess the red flags related to the probability of earning management. This model is designed to determine whether any forms or integrated systems contain any indications of fraud incidents. In 1999, Professor Messod Beneish developed the Beneish M-score model for detecting financial fraud, a mathematical model that predicts the possibility of earnings manipulations instead of bankruptcy (Ramírez-Orellana et al., 2017; Omar et al., 2015). It is crucial to determine if a company has engaged in earnings manipulation or not. The accuracy of the Beinish model has been verified by numerous literatures (Warshavsky, 2012; Repousis, 2016), but there are still issues and limitations with full transparency because institutions vary throughout the country. Therefore, to accurately detect financial fraud, the accuracy remains controversial; more model modifications need to be performed (Lu & Zhao, 2021). Recent studies, such as those

in China (Lu & Zhao, 2021) and Indonesia (Narsa et al., 2023), also examined and modified the model to precisely detect financial fraud.

Earnings Management (EM) is regarded as a dependent variable in the current study. Previous research has demonstrated that financial fraud can be accurately detected by using the Beinish model. Beinish model includes Board Size (BOD_SIZE), Board members with international experience (BOD_IE), and Effective independent non-executive directors (INED_EFF), treated as independent variables. Whereas the size of an organization (SIZE) also serves as a control variable in this study. The formula used for calculating Beinish M-score is

$$M = -4.84 + 0.92DSRI + 0.58GMI + 0.404AQI + 0.892SGI + 0.115DEPI - 0.172SGAI + 4.679TATA - 0.327LVGIM$$

Observing Results:

· M-score < -2. 22: It responds that this company cannot be a manipulator.

· M-score > -2. 22: Specifies that there is a possibility of management's earnings manipulation.

Table 1: Description of variables

Variable	Definition	Measurement
EM	**Earnings Management**	**Beneish M-score.**
BS	**Board Size**	**Total number of directors on the board**
BD	**Board diversity**	**Number of female directors/ total board size**
BIND	**Board Independence**	**Number of independent directors/ total board size**
FS	**Firm's Size**	**Natural Log firm's asset**

Result and Discussion

Table 1: Descriptive Statistics

Variable	Obs	Mean	Std. Dev.	Min	Max
EM	**400**	**-0.1577848**	**5.442555**	**-21.06426**	**77.79602**
BIND	**400**	**0.1784266**	**0.1176548**	**0.01**	**0.9166667**
BS	**400**	**8.315**	**1.630159**	**7**	**17**
BD	**400**	**0.1030003**	**0.129528**	**0**	**0.5714286**
FS	**400**	**15.51651**	**1.899371**	**8.615227**	**18.91931**

Table 1 exhibits the statistical information of all variables which are being used in this study:

Earning Management's variability is still significant, ranging from a minimum value of -21.06426 to 77.79602, with a mean of -0.158 and a variance of 5.443. Board Independence has a mean of 0.1784, with the highest and lowest values of (0.01 and 0.9166). The standard deviation of board independence is 0.1177. Board size has and average value of 8.315, with minimum and maximum values of (7 and 17) carrying a standard deviation of 1.630159. Board diversity has an average of 0.103, while the

standard deviation is 0. Firm Size has a mean of 15. 5165 and the standard deviation is 1.8994.

Table 2: Correlation Matrix

	EM	BIND	BS	BD	FS
EM	1.0000				
BIND	-0.0174	1.0000			
BS	-0.0171	-0.0518	1.0000		
BD	0.1785	0.0398	-0.1255	1.0000	
FS	0.0763	0.0578	0.1873	0.0601	1.0000

The correlation matrix presented in Table 2 of the current study highlights the absence of multicollinearity. It is mandatory to obey the basic assumptions of the classical linear regression model and among all assumptions, one is the absence of perfect correlation among explanatory variables. Findings unveil that none of the relationships between explanatory variables exceed 0.8 or 80 percent which denote the presence of multicollinearity. Hence, the findings confirm that data is free from multicollinearity issues

Table: 3: Variance Inflation factor

Variable	VIF	1/VIF
BS	1.06	0.942668
FS	1.05	0.953676
BD	1.03	0.975389
BIND	1.01	0.991430
Mean VIF	1.04	

The current study also uses the variance inflation factor (VIF) to detect multicollinearity. Table 3, highlights the finding of the variance inflation factor confirming the absence of multicollinearity. According to the rule of thumb, if the VIF value of all variables and the mean value are equal or greater than 5, then there will be a multicollinearity issue in the data. tables highlight that none of the values is greater than 5, so confirming the absence of a multicollinearity issue.

Table 4: Ordinary Least Square (OLS):

EM	Coef.	Std. Err.	t	P>|t|	[95% Conf. Interval]	
BIND	-1.436184	2.309734	-0.62	0.053	-5.977271	3.104903
BS	-0.033814	0.1707765	-0.20	0.843	-0.3695727	0.3019429
BD	7.649214	2.14163	3.57	0.000	3.438629	11.8598
FS	0.2430254	0.1481635	1.64	0.102	-0.0482714	0.5343223
_cons	-0.930246	0.3426916	-2.71	0.007	-1.603958	-.2565341

Table 5: Random Effect Model

EM	Coef.	Std. Err.	z	P>|z|	[95% Conf. Interval]	
BS	-0.0338149	0.1707765	-0.20	0.843	-0.3685307	0.300901
BIND	-1.436184	2.309734	-0.62	0.052	-5.963179	3.090811
BD	7.603503	2.085112	3.65	0.000	3.516759	11.69025
FS	0.2372789	0.1434821	1.65	0.098	-0.0439409	0.5184987
_cons	-3.820463	2.29443	-1.67	0.096	-8.317463	0.6765362

The current study proceeds with the ordinary least square (OLS) and random effect model to uncover the influential role of board attributes on financial fraud. Tables 4, and 5 highlight the finding, confirming that board attributes significantly impact financial fraud. Board independence has a negative (-1.436184) and statistically significant (0.053) (0.052) impact on financial fraud revealing that more independent boards reduce fraudulent practices within firms. The negative nexus between board independence and financial fraud is due to enhanced monitoring and oversight provided by independent directors. Independent board members are less likely to have conflicts of interest, allowing them to scrutinize financial statements more effectively and detect financial fraud. Independent directors are also more inclined to question aggressive accounting practices, thereby reducing the likelihood of earnings manipulation. Moreover, board independence fosters a culture, and discourages fraudulent practices aimed at misrepresenting a company's financial position. Findings are aligned with Xie et al., 2003; Carcello & Nagy, 2004; Saksena, 2003; According to Siladi 2006). In addition, the board size has also a negative (-0.033814) and insignificant (0.843) relationship with the fraudulent practice in both ordinary least square and random effect models. The findings of the study suggest that larger boards maximize monitoring of the firms and reduce fraud occurrence. A larger board has more expertise and perspectives, which can lead to more checks and balances in management activities. The diversity in viewpoints can improve decision-making and accountability, making it harder for fraudulent behavior to go unnoticed. Furthermore, larger boards may bring a greater sense of collective responsibility, discouraging illegal and unethical practices. The findings of the study are aligned with those (Al-Janadi et al., 2013; Allegrini & Greco, 2013; Esther & Henry, 2018; Asmar et al., 2018).

Moreover, board diversity was found to have a negative (-7.6492) and statistically significant (0.000) association with financial fraud in non-financial firms. The study's findings also proclaimed that a positive relationship between board diversity and fraudulent practices may be due to the complexity and potential challenges in decision-making within diverse boards. Diverse boards usually have members with diverse perspectives, like cultural differences, and expertise, which can create complexity. This diversity, while beneficial for fostering innovation, may also result in slower consensus-building and potential conflicts, consequently, less effective monitoring and internal control might emerge, increasing opportunities for fraudulent practices. The findings of the study are aligned with the previous studies of (Razali & Arshad, 2014; Gregorič et al., 2017; Oehmichen et al., 2017 Widyaningsih et al., 2023), while opposing the findings of (Sanad et al., 2020)

Conclusion

The main purpose of the study is to examine the nexus between board attributes and fraudulent practices in non-financial firms in Pakistan. The study used fraudulent practice as a dependent variable measure through modified Beinish score while board attributes (board independence, board size, and board diversity) as independent variables. Using various ordinary least squares and random effect models, the findings of the study uncovered that board attributes (board independence, board diversity)

have a significant impact on fraudulent practices in non-financial firms. Results of the study reveal that board independence significantly impacts fraudulent practices, suggesting that increasing independent board members within the board can significantly reduce the risk of fraudulent practices. The findings support the agency theory, which states that independent directors, who are not actively involved, are more likely to effectively monitor and control managerial actions, thereby curbing fraudulent practices. Independent board members bring objectivity and oversight, ensuring that financial reporting is accurate and ethical. To mitigate fraudulent practices, firms should prioritize enhancing board independence by appointing more non-executive, independent directors.

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