






“Corporate governance and financial statement fraud: Evidence on the moderating influence of financial distress”

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CORPORATE GOVERNANCE AND FINANCIAL STATEMENT FRAUD: EVIDENCE ON THE MODERATING INFLUENCE OF FINANCIAL DISTRESS

Abstract

This study examines the impact of corporate governance on the probability of financial statement fraud and evaluates the moderating role of financial distress in this relationship. This issue remains highly relevant given the persistence of fraudulent financial practices despite evolving governance regulations. The analysis is conducted on a sample of 330 non-financial companies listed on the Indonesia Stock Exchange from 2021 to 2022. Using purposive sampling and secondary data, the study measures financial statement fraud with the F-score, corporate governance through institutional ownership, ineffective monitoring, regulatory compliance, and financial distress using the Zmijewski model. The study applies moderated regression analysis across three models. The results from Model 1 show that corporate governance has a significant negative effect on the likelihood of financial statement fraud ($\beta = -0.085$; $p < 0.05$). Model 2 finds that financial distress alone has a significant positive effect ($\beta = 0.315$; $p < 0.05$). Model 3 confirms a significant moderation effect, where financial distress strengthens the relationship between governance and fraud (interaction $\beta = 0.353$; $p < 0.05$). These findings indicate that while effective governance can reduce fraudulent financial reporting, this effect is influenced by a company's financial state. Therefore, robust governance structures are vital, particularly in times of financial hardship. Future studies should consider external institutional mechanisms to further understand these dynamics.

Keywords governance, distress, fraud, reporting

JEL Classification M42, G01, G34

INTRODUCTION

The phenomenon of financial statement fraud represents a critical issue that reflects the lack of integrity in financial reporting within the modern business environment. This fraudulent behavior involves the deliberate manipulation of accounting information by management to present a financial state that does not reflect the actual state of the company, thereby potentially harming investors, creditors, and other stakeholders. Numerous financial scandals reported globally, including in Indonesia, underscore the persistence of such practices and their potential to threaten business continuity and the stability of financial markets.

A fundamental scientific problem that emerges in this context is the extent to which corporate governance mechanisms are capable of mitigating the risk of financial statement fraud. Weak governance structures often provide opportunities for managerial opportunism, whereas robust oversight systems are theoretically expected to limit incentives for fraudulent behavior. However, empirical evidence has shown that the implementation of sound governance principles does

not always ensure the prevention of fraudulent financial reporting. This inconsistency invites deeper scientific inquiry into the actual effectiveness of corporate governance in constraining opportunistic managerial actions.

Moreover, the condition of financial distress adds another layer of complexity to the discourse surrounding financial statement fraud. On the one hand, financial pressure may serve as a driver for management to manipulate financial reports in order to maintain the firm's external image. On the other hand, such a condition may also incentivize more prudent and transparent behavior in order to retain market trust and access to capital. This duality reveals a scientific gap in the literature regarding the role of financial distress as a potential moderating variable in the relationship between corporate governance and financial fraud.

Accordingly, the scientific problem addressed in this study concerns how the relationship between corporate governance and financial statement fraud is formed and influenced by the presence of financial distress. The complexity and inconsistency of prior empirical findings emphasize the need for a more context-specific examination – particularly within non-financial sector firms in Indonesia. This study is grounded in the academic imperative to clarify these uncertainties and contribute to a deeper understanding of the mechanisms through which governance practices and financial pressure interact in either enabling or deterring financial reporting misconduct.

1. LITERATURE REVIEW AND HYPOTHESES

Financial statement fraud is characterized by deliberate noncompliance with relevant accounting standards in the reporting of financial information, leading to substantial omissions or distortions of facts (Cheng et al., 2021). Financial statement fraud transpires when a corporation distorts its financial reporting by fabricating non-existent income, overstating inventories, and intentionally misrepresenting profits (Sari & Nugroho, 2021). It is also considered a form of fraud committed by the company's management, involving material misstatements that harm investors and other stakeholders (Wang et al., 2023a).

The financial statement fraud case in 2021 occurred at PT Asabri (Persero). Furthermore, in 2023, a publicly traded property and real estate corporation was found to have perpetrated financial statement fraud (Fajri et al., 2023). Other fraudulent activities continue to occur and have a detrimental impact on corporate development (Wicaksono et al., 2023). Corruption is the predominant kind of fraud, comprising 64.4%, followed by asset theft at 28.9%, and financial statement fraud at 6.7% (ACFE, 2020).

The phenomenon of financial statement fraud occurring in several companies reveals a strong con-

nection with corporate governance. The matter of corporate governance is based on agency theory (Jensen & Meckling, 1976). Agency difficulties emerge from the division between ownership and management inside a corporation. From a financial perspective, managers can control financial information and the reporting processes provided to investors or shareholders (Annan, 2022). A well-functioning corporate governance system is expected to address both financial and non-financial crises within a company, thereby enhancing the efficiency of business management (Harinuridin & Safitri, 2023).

The changes in corporate governance across countries and companies create opportunities for improvement through mergers and acquisitions (Hussain & Loureiro, 2022). Research demonstrates that corporate governance, evaluated through criteria such as management ownership, institutional ownership, and board size, significantly negatively impacts the incidence of financial statement fraud in Indonesian manufacturing enterprises (Tanjaya & Kwarto, 2022). Velte (2023) reveals that effective corporate governance can mitigate the risk of financial statement fraud in enterprises across diverse nations. In addition, poor corporate governance can trigger financial statement fraud (Cole et al., 2021; Wu et al., 2023; Wang et al., 2023b; Xing et al., 2022; Luo et al., 2023).

Enhanced corporate governance procedures have been shown to contribute positively to the quality of financial reporting, providing better information for investor decision-making. This improvement is partly driven by regulatory additions that require stronger oversight mechanisms, such as the involvement of audit committees and broader disclosure practices, which can reduce the likelihood of reporting manipulation (Sheveleva, 2022). A lower probability of financial statement fraud is associated with a larger representation of the audit committee. The board of commissioners, a key component of corporate governance, can adversely impact financial statement fraud (Challen & Noermansyah, 2023).

Several studies suggest that corporate governance may not always be a decisive factor in reducing financial statement fraud. In some contexts, external elements such as the availability of information and the strength of external monitoring mechanisms play a more crucial role in mitigating agency-related issues than internal governance structures. Regulatory oversight, media scrutiny, and transparency to the public often serve as stronger deterrents to fraudulent behavior than board composition or audit committee activity. The absence of conclusive empirical evidence supporting the impact of corporate governance on fraud further reinforces the notion that internal governance alone may be insufficient to prevent reporting misconduct (Andres et al., 2022; Pham & Nguyen, 2023; Garanina & Kim, 2023).

Reliable and relevant information plays a crucial role in corporate decision-making, particularly during periods of financial pressure. It not only supports effective risk assessment but also helps preserve a firm's reputation and access to capital markets. Within this context, positive accounting theory highlights the tendency of firms to adopt conservative reporting strategies when under financial distress, aiming to reduce uncertainty and maintain stakeholder confidence (Watts & Zimmerman, 1978). This approach is further supported by empirical findings suggesting that transparent and accurate financial disclosures serve as practical tools for managing financial risk (Guggenmos & Bennett, 2021; Li et al., 2021).

In situations where a company is facing financial difficulties, it can reduce the incentive to engage in manipulation by ensuring that accurate and transparent information is made available to all stakeholders. There may be no substantial correlation between financial distress and the occurrence of financial statement fraud (Sanjayana & Urumsah, 2021), while others report a significant effect (Pratama & Pupitasari, 2022; Nugroho et al., 2018; Truong, 2022). Upon analyzing the indicators of financial distress, it was shown that liquidity ratios and sales growth exerted no significant effect. However, leverage ratios exhibited a positive and substantial impact on financial distress circumstances (Tron et al., 2023). This study's results highlight the complex relationship between financial difficulty and false reporting, underscoring the need for more research to better understand the underlying causes and potential remedies.

Financial statement fraud is the intentional manipulation of financial information by an entity, frequently motivated by financial pressures and inadequate corporate governance. By encouraging transparent and accountable supervision, effective corporate governance has been demonstrated to mitigate the risk of financial statement fraud. Additionally, financial difficulties can serve as a natural control mechanism, as companies facing financial strain recognize that manipulation will only exacerbate the situation and increase the risk of losses, both in terms of reputation and business sustainability. Therefore, financial difficulties motivate companies to adhere more strictly to honest and responsible reporting principles.

In summary, the literature reveals a complex interaction between corporate governance and financial distress in shaping the likelihood of financial statement fraud. This study, therefore, seeks to explore how financial distress moderates the effect of governance on fraud, offering deeper insights into internal control systems and ethical financial reporting practices.

Therefore, the study hypotheses are as follows:

H1: The better the corporate governance practices implemented, the lower the likelihood of fraudulent activities in financial reporting.

H2: *In situations of financial distress, effective corporate governance is expected to be more efficient in mitigating the risk of financial reporting fraud.*

2. METHOD

The paper employs a quantitative analysis of financial statement fraud, financial crisis, and company governance. The secondary data were sourced from the Indonesian Stock Exchange. All non-financial sector enterprises that were listed on the Indonesia Stock Exchange (IDX) from 2021 to 2022 are included in the study's population.

The selection of data from 2021–2022 for the research was made as this timeframe encapsulates the post-COVID-19 pandemic environment, marked by economic strain and significant uncertainty in the corporate sector. The pandemic's impact has led several organizations to face financial challenges, hence heightening the danger of financial statement fraud and evaluating the efficacy of corporate governance. Consequently, such

data are deemed pertinent and abundant in actual phenomena that may be employed to evaluate diverse ideas in finance and accounting. Data from 2023–2024 are deemed less appropriate for assessing the direct impact of the pandemic since this era has transitioned into recovery and economic normality. Consequently, research on post-COVID-19 effects is better accurately conducted within the 2021–2022 timeframe.

This study focuses on non-financial sector companies due to the more uniform regulations and accounting principles compared to the financial sector, which is governed by Bank Indonesia Regulations (PBI). Non-financial companies are also more vulnerable to financial distress, such as revenue decline or liquidity problems, which can affect management decisions. The sample was obtained by purposive sampling, focusing on enterprises that routinely publish annual reports and supply the requisite data, culminating in a total of 330 companies.

This study identifies financial statement fraud as the dependent variable, assessed using the *F*-score

Table 1. Variable description

Variable	Type	Explanation
Financial Statement Fraud (FSF)	Dependent	This variable calculates the fraud score by summing the quality of accruals and financial performance. $F - Score = Accrual\ Quality + Financial\ performance.$
		Average F-Score Value
		F-Score > 2.45
		F-Score > 1.85
		F-Score > 1
Corporate Governance (CG)	Independent	F-Score < 1
		Low Risk
		The Circular Letter of the Financial Services Authority, number 32/SEOJK.04/2015 $\frac{Total\ number\ of\ the\ applied\ principles}{number\ of\ principles\ based\ on\ circular\ letter\ number\ 32 / SEOJK.04 / 2015} \cdot 100\%.$
		Institutional Ownership $\frac{\sum Institutional\ share}{\sum Outstanding\ share} \cdot 100\%$
		Ineffective monitoring $\frac{The\ Number\ of\ Independent\ Commissioners}{The\ Total\ Number\ of\ Commissioners}$
Financial Distress (FD)	Moderating	The calculation that results in a value greater than 0 indicates that the company belongs to the group experiencing financial distress, and the company is assigned a score of 0. Conversely, if the result of the calculation is less than 0 or negative, the company is categorized as not experiencing financial distress and is assigned a score of 1. $X = 0.534 + 4.703X1 - 1.087X2 + 0.009X3.$

(Indiraswari et al., 2020). The independent variables are corporate governance, measured by three proxies: The Financial Services Authority Circular (SEOJK) 2015 (POJK, 2015), institutional ownership (Papatungan et al., 2020), and ineffective monitoring (Kuntadi & Putri, 2023). Financial distress is used as a moderating variable, measured using the Zmijewski model (Seto & Trisnaningsih, 2021). The study follows a systematic and logical procedure, starting with data collection, computation of variable scores, testing of classical assumptions, and concluding with moderated regression analysis (Table 1). All analysis steps were designed to be transparent and reproducible for future researchers.

3. RESULTS AND DISCUSSION

The hypotheses test was performed with moderated regression analysis (MRA) method, with the testing stages based on Izzalqurny et al. (2019). The following are the regression equations used in this study:

$$FSF = \alpha + \beta_1 \cdot CG + \varepsilon, \quad (1)$$

$$FSF = \alpha + \beta_1 \cdot CG + \beta_2 \cdot FD + \varepsilon, \quad (2)$$

$$FSF = \alpha + \beta_1 \cdot CG + \beta_2 \cdot FD + \beta_3 \cdot CG \cdot FD + \varepsilon, \quad (3)$$

where FSF = Financial Statement Fraud, CG = Corporate Governance, FD = Financial Distress, α = Constant, β_1 , β_2 , β_3 = Regression coefficient, ε = Error.

Table 2 displays the descriptive data for the three factors examined in this study: corporate governance, financial distress, and financial statement fraud. It presents the lowest, maximum, mean, and standard deviation for each variable, offering an overview of the data's distribution and variability.

Table 2. Descriptive statistics

Variable	Minimum	Maximum	Average	Standard Deviation
Corporate Governance	-8.616	9.795	-0.00624	1.874220
Financial Distress	-4.851	10.164	0.26972	0.942250
Financial Statement Fraud	-3.514	9.253	0.74955	1.129908

The average corporate governance, as evaluated by three proxies (SEOJK 2015, ineffective monitoring, and institutional ownership), is -0.0062 , with a maximum value of 9.795 , a minimum value of -8.616 , and a standard deviation of 1.87422 , according to the data. Since the mean value is less than the standard deviation, this indicates that the corporate governance standard is insufficient.

The Zmijewski model has produced a mean financial distress score of 0.26972 , with a standard deviation of 0.942250 , a maximum of 10.164 , and a minimum of -4.851 . Since the mean value is less than the standard deviation, this indicates that the financial hardship data are insufficient. Thus, non-financial sector enterprises are, on average, experiencing financial difficulties, as evidenced by the average financial distress score of 0.26972 , which is greater than zero.

The F -score assesses the mean financial statement fraud score at 0.74955 , with a standard deviation of 1.129908 , a maximum of 9.253 , and a minimum of -3.514 . Since the mean value is less than the standard deviation, this suggests that the financial statement fraud data are suboptimal. The fact that the average fraud score of 0.74955 is less than 1 suggests that non-financial sector enterprises are generally at a low risk of committing financial statement fraud.

This analysis undertakes a stepwise regression analysis. Model 1 is utilized to evaluate Hypothesis 1, whereas Models 2 and 3 are applied to assess Hypothesis 2, which has been modified to a one-tailed test due to the SPSS output indicating a two-tailed result. The findings from the regression analysis, along with the coefficient of determination, are displayed in Table 3.

Hypothesis 1, as expressed in Model 1, is supported by a t -value of -2.584 and a significance value of 0.005 , which is less than 0.05 . This implies that financial statement fraud is negatively

Table 3. Hypotheses testing

Model	Variable	Beta Coefficient	T-Value	Significance
Model 1	Constant	0.749	–	–
	Corporate Governance	–0.085	–2.584	0.005
	Value of F	6.676	–	–
	Significance	0.005	–	–
	Adjusted R Squared	0.017	–	–
	Model 2	Constant	0.270	–
Corporate Governance		0.085	3.120	0.001
Financial Distress		0.315	4.923	0.000
Value of F		24.232	–	–
Significance		0.000	–	–
Adjusted R Squared		0.066	–	–
Model 3	Constant	0.653	–	–
	Corporate Governance	–0.115	–3.602	0.000
	Financial Distress	0.353	5.550	0.000
	Value of F	19.045	–	–
	Significance	0.000	–	–
	Adjusted R Squared	0.099	–	–

impacted by company governance. This suggests that the acceptance of Hypothesis 1 is supported by the fact that effective company governance can decrease the prevalence of financial statement falsification. The corporate governance variable is responsible for 1.7% of the variation in financial statement fraud, as indicated by the corrected R^2 value of 0.017. The remaining variance is attributed to factors that were excluded from the study model.

Models 2 and 3 elucidate Hypothesis 2. The financial distress variable can be considered an independent variable, as evidenced by the t -value of 4.923 and the significance level of 0.000 in Model 2. Furthermore, Model 3 has a t -value of 5.550 and a coefficient of 0.353, with a significance level of 0.000 (< 0.05 , indicating statistical significance). The moderating coefficient of 0.353, which is greater than the corporate governance coefficient without moderation (–0.085 in Model 1), suggests that the intensity of the negative relationship has increased. This suggests that the adverse correlation between corporate governance and financial statement falsification may be further exacerbated by a financial crisis, thereby validating Hypothesis 2. The Adjusted R^2 value of 0.017 in Model 3 indicates that corporate governance and financial hardship account for 9.9% of the variance in financial statement fraud, with the remaining 90.1% attributable to factors that were excluded from the study model.

Classical assumption tests are utilized to evaluate the regression model, as an effective regression model should not exhibit any issues related to classical assumptions. This paper includes many conventional assumption tests, such as those for normality, multicollinearity, heteroscedasticity, and autocorrelation. Table 4 outlines the findings from these classical assumption tests. To assess normality, histogram graphs, and Normal P-P plots were employed to ascertain whether the developed regression model adheres to a normal distribution.

The classical assumption test reveals that the normality assessment, determined by the Kolmogorov–Smirnov significance value of 0.952, suggests that the normality criterion has been satisfied, given that this value exceeds the threshold of 0.05 (5%). Consequently, the residual distribution adheres to a normal distribution, indicating that the regression model fulfills the normality requirement.

The Durbin–Watson statistic is employed in this investigation to conduct the autocorrelation test. The Durbin–Watson (DW) statistic is indicative of the absence of autocorrelation, with a value of 2 indicating a midpoint between 0 and 4. The interpretation of DW values is generally as follows. A DW number nearing 0 signifies substantial positive autocorrelation; a DW value nearing 4 denotes considerable negative autocorrelation; and a DW value approaching 2 implies little to no autocorrelation. The classical assumption test indi-

Table 4. Classical assumption test

Type	Testing	Testing Results	Remarks
Normality	Kolmogorov-Smirnov value	0.952	valid
Autocorrelation	Durbin-Watson Values	2.076	valid
Multicollinearity	Corporate Governance Tolerance	0.997	valid
	Tolerance of Financial Distress	0.997	
Multicollinearity	VIF Governance Tolerance	1.003	valid
	VIF Financial Distress	1.003	
Heteroscedasticity	Gleicher Test of Corporate Governance	0.814	valid
	Gleicher Test of Financial Distress	0.171	

cates a Durbin–Watson score of 2.076, which approximates 2. This signifies that the model or its residuals demonstrate minimal to no substantial autocorrelation.

The multicollinearity test findings, derived from the tolerance value in the classical assumption test, demonstrate that no variables exhibit a tolerance value below 0.10, indicating an absence of correlation among the independent variables, with values surpassing 95%. The computation of the variance inflation factor (VIF) indicates that no independent variable exceeds a value of 10. It may thus be concluded that the independent variables show no evidence of multicollinearity.

This study employs heteroscedasticity testing to investigate the presence of unequal variance in the residuals of the regression model across various observations. If the variance is the same, this is referred to as homoscedasticity, whereas if a difference in variance occurs, it is referred to as heteroscedasticity. A regression model is considered good if it exhibits homoscedasticity, meaning it does not suffer from heteroscedasticity. The classical assumption test reveals that the significance values for all equations are above 0.05, indicating no evidence of heteroscedasticity.

This paper indicates that corporate governance negatively impacts financial statement fraud. The SEOJK 2015, institutional ownership, and ineffectual supervision are employed as proxy indicators for corporate governance in this investigation. The interdependence of the three elements may increase the probability of financial statement falsification. This risk can be mitigated through proactive engagement of institutional shareholders, the implementation of corporate governance standards, and robust monitoring. The findings

suggest that when corporate governance is strong, financial statement fraud is reduced.

Agency theory also supports this conclusion, as it demonstrates that corporate governance is a solution to agency issues within corporations. Fraudulent financial reporting undermines data quality, thereby reducing the profitability of the company and harming its primary shareholders. Corporate governance is considered an appropriate mechanism to reduce the risk of fraud (Mousavi et al., 2022).

Superior financial reporting quality is correlated with an improvement in corporate governance quality, which in turn reduces the likelihood of financial infractions within a corporation. The disclosure of corporate governance structure is negatively correlated with financial reporting fraud (Dara et al., 2019; Popa et al., 2024). While some studies indicate that corporate governance can prevent financial reporting fraud by creating effective internal control processes and ensuring accurate financial reporting procedures, others suggest that corporate governance does not have a significant impact on financial reporting fraud (Harinurdin & Safitri, 2023; Arum et al., 2023).

The findings of this study suggest that financial difficulty serves as a moderating factor that affects the negative correlation between financial reporting fraud and corporate governance. The financial crisis further exacerbates company governance and the prevalence of financial reporting deception. The quality and reliability of financial information are prioritized in the positive accounting theory approach.

This investigation demonstrates that the adverse correlation between financial statement fraud and

effective corporate governance is influenced by financial duress. This discovery contradicts other studies indicating that financially distressed organizations are more likely to engage in fraudulent activities (Andrew et al., 2022; Michira et al., 2021; Christian, 2022). This study aligns with the findings of Gan et al. (2020), which suggest that financial instability may mitigate fraud risk by improving supervision and transparency. Darmiasih et al. (2022) contend that company governance does not consistently exert a direct influence on financial hardship. This study presents a novel perspective, indicating that although financial hardships may intensify pressure, effective governance continues to mitigate the likelihood of financial statement fraud, with financial difficulty amplifying the beneficial impact of governance on reporting transparency.

The principal-agent theory is substantiated by the results of this study, which underscore the importance of the interaction between the principal (shareholders) and the agent (management) in preventing adverse agent conduct, particularly in the context of financial statement fraud. Positive accounting theory highlights the significance of accurate financial information in addressing financial difficulties and maintaining the reliability of financial reports. The theoretical implications of these findings indicate that corporate governance serves both as

a protection against fraud and as a mechanism to safeguard the integrity of financial information in compliance with relevant accounting standards.

This study implies that companies should enhance governance by improving transparency, accountability, and internal monitoring from a practical standpoint, such as by implementing real-time financial reporting systems accessible to the audit committee and establishing anonymous whistleblowing platforms. Elevated institutional ownership may mitigate the likelihood of financial statement falsification. Identifying, assessing, and managing financial risks that could lead to financial statement manipulation in order to develop prudent risk management strategies for companies that are experiencing financial distress.

Future research should examine the potential for external factors, such as the impact of organizational culture, broader market conditions, and stronger regulations, to mitigate the correlation between financial statement fraud, financial crisis, and corporate governance. Additionally, further studies could focus on adjustments to corporate governance in financial distress situations to improve its effectiveness in mitigating fraud risks, thereby providing practical insights that may benefit companies and regulators in the future.

CONCLUSION

This study aimed to examine the impact of corporate governance on financial statement fraud, with financial distress as a moderating variable. The findings indicate that strong corporate governance practices reduce the likelihood of fraudulent financial reporting. Moreover, financial distress enhances the negative relationship between governance and fraud.

Based on these results, effective governance mechanisms are essential in safeguarding the integrity of financial information. Even under financial pressure, well-established governance helps companies maintain transparency and accountability. These findings align with the principles of positive accounting theory and agency theory in mitigating opportunistic behavior.

Future research may explore external influences such as organizational culture, regulatory enforcement, or market dynamics. A longitudinal research design can provide deeper insights into the evolving interaction among the studied variables. Cross-national comparisons could further assess the generalizability of these conclusions across different institutional settings.

AUTHOR CONTRIBUTIONS

Conceptualization: Susmita Dian Indiraswari, Bambang Subroto, Rosidi, Imam Subekti.

Data curation: Susmita Dian Indiraswari.

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Investigation: Bambang Subroto.

Methodology: Rosidi, Imam Subekti.

Project administration: Bambang Subroto.

Resources: Rosidi.

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Supervision: Bambang Subroto, Imam Subekti.

Validation: Rosidi.

Visualization: Imam Subekti.

Writing – original draft: Susmita Dian Indiraswari, Bambang Subroto.

Writing – review & editing: Rosidi, Imam Subekti.

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