ABSTRACT

Accounting rules exist to ensure that financial statements are useful to their end users in their financial decision-making. Financial statements are useful provided the information presented therein must be exact, faithful to the financial circumstances and be produced in time to help the decision-making process. However, poor ethics in accounting have increased both, the incidences of criminal activities as well as bear the business through harming its reputation and rendering their financial statements untrustworthy and therefore useless. Poor ethics in accounting have resulted in accounting frauds in recent years that have gained momentum all around over the world. The rate of financial and accounting frauds committing by corporate entities have nowadays signaled a red alarm to all. The fear is now widespread that the increasing wave of fraud in the recent years might pose certain threats to economy, political stability, and the survival of financial institution and the frauds of the industry as a whole. It has found that big corporates and even multinationals are engaged in window dressing their operating revenues and profits or applying income smoothening in reporting their operating fraud is quite disappointing. These financial corporate frauds involve huge amounts of money and are geared towards maintaining or increasing the share price of the perpetrating companies in the stock exchange market. These financial frauds not only mar the sentiments of investors but also give jolt to the economy. The recent financial scandals of one of the major leading accounting firms in the United States Arthur Andersen coupled with alleged unethical acts committed by Enron, Adelphia Communications, Dynegy, WorldCom, and Tyco have aroused the awareness of the public and stakeholders as to the moral decline and unethical posture of public accountants unveiled a decline in moral reasoning and ethical standards of public accountants. The consequence of unethical conduct among public accountants has necessitated a variety in the manner of responsibility for ameliorating the quality of teaching in the accounting curriculum.

The existence of corporate fraud and its devastating effect on both the reporting entity and various stakeholders requires an immediate and active intervention in order to curtail the menace and to ensure that the reports presented by corporate entities are accurate, reliable, and free from any accounting fraud.
Researchers and practitioners have made mild attempts in both developed and non-developed economies to identify fraud indicators and to build fraud prediction procedures. Although few surveys have been conducted in past that try to find the prevalent fraudulent practices in both profit and non-profit organizations. However in general an investigation on the subject-matter brought out that little research has been carried out as of now. The importance of accounting information to investors, government and public at large has motivated the researcher to undertake this topic. Hence, the present study has been gestated and pursued to analyze the unethical accounting practices in multinational companies and the impact of corporate governance on financial frauds. The study is based on three broad objectives which are as follows:

i. Identify the prominent global corporates involved in fraudulent financial reporting practices and the nature of accounting irregularities they committed.

ii. Exposing the true perpetrators behind these scandals.

iii. To gain insight into the unethical accounting practices of selected corporate entities.

Based on prior theoretical and empirical evidences, the present study identifies four important corporate governance variables (independent variables) and two financial frauds variables (dependent variables). The corporate governance variables include Board Size, Board Composition, Directors Equity Interest and Corporate Governance Disclosure Index, while as return on assets and return on equity have been used to measure financial performance of firms. The study covers a span of 13 financial years, starting from 1999-00 to 2012-13. For the purpose of empirical analysis, following hypotheses have been formulated.

i. (H₀): There is no significant relationship between Board size and fiscal operations of depository financial institutions.

ii. (H₀): There is no significant variation in the financial frauds of sample corporations with foreign directors and corporations without foreign directors.

iii. (H₀): There is no significant relationship between the ratio of non-executive directors and the financial frauds of sample corporations.
iv. \( (H_0): \) The relationship between directors' equity holding and the financial functioning of sample corporations is not significant.

v. \( (H_0): \) The relationship between the governance disclosures of sample corporations and their operations is not significant.

vi. \( (H_0): \) There is no significant difference between the profitability of the healthy and the rescued sample corporations.

The purposive sampling technique has been used in the study and the sample of 21 American and European multinational companies has been selected for final analysis. The entire study is exclusively based on the secondary sources of data. The financial data of companies related to financial frauds and corporate governance have been extracted from COMPSTAT database and the official websites of the respective companies. The corporate governance index has been developed which are based on 45 items falling under five heads i.e. financial disclosure, non-financial disclosure, annual general meeting, timing and means of disclosure and best practices for compliance with corporate governance. A corporate governance disclosure index (CGDI) has been figured by applying the following formula:

\[
\text{CGDI} = \frac{\text{Total Score of the Individual Company}}{\text{Maximum Possible Score Obtainable by Company}} \times 100
\]

The study incorporates multi-regression techniques to analyze the impact of hypothesized explanatory variables on different measures of financial frauds (dependent variables) i.e. return on assets and return on equity. The Pearson correlation technique has been also used to measure the degree of association between variables under consideration. Panel data analysis has been used to investigate the impact of corporate governance on different measures of financial frauds of sample firms. The panel data has been estimated through pooled OLS, fixed effects and random effects techniques. As there is no substantial correlation between the unobserved units of observation, specific random effects and the regressors the Random effect model may be more appropriate. Nevertheless, based on fluctuations in the capital base and the share capital of the sample companies, the intercept of each company is supposed to be a random factor. Therefore random effect technique has been adopted to analyze the impact of the corporate governance proxies on the
financial frauds proxies of sample companies. SPSS-19 and Eviews-8 software have been used to run the regression models.

The results of Pearson correlation technique revealed significant negative relationship between board size and return on equity at 1% and 5% level of significance. This means that an increase in the board size will lead to a reduction in profitability (ROE) of sample companies. A similar result has been also observed between board size and return on asset (ROA), however the results are statistically significant at 1% level of significance. The result of the two proxies i.e. ROE and ROA for board size is consistent with earlier studies like Lipton and Lorsch (1992); Jensen (1993); Yermack (1996); Bennedsen et al (2006); and Harris and Raviv (2005).

Proportion of outside directors also revealed significant negative correlation coefficient (r) of -0.486 and -0.447 with ROE and ROA respectively. As far as corporate governance disclosure index is considered it depicted positive correlation of 0.539 and 0.528 with ROE and ROA respectively and is statistically significant at 1% and 5% level of significance. This means companies that discloses more on corporate governance issues are likely to execute safer than those that disclose less. This results are consistent with earlier studies like Makhija & Patton (2000), O’Sullivan and Diacon (2003) and Cheng (2008). The results also showed that equity interest is positively correlated with return on directors’ equity and return on assets at 1% level of significance.

The regression results revealed the two models i.e. ROE and ROA are statistically significant at 1 % level thus indicating that the models do not suffer from specification bias. The coefficient of determination (R2) in model (ROE) indicates that about 66% of change in return on equity is accounted for by the explanatory variables while the adjusted R-squared of 63.5% further justifies this effect. Similarly for the second model (ROA), 58% of change in ROA is accounted for by the independent variables.

Based on regression results the null hypothesis i.e. no significant relationship between Board size and financial frauds of sample companies has been rejected as there is statistically significant negative impact of board size on financial frauds as measured by ROE and ROA. This invariably has in mind that the board size must be taken while taking financial decisions. The results, therefore supports the agency theory as
the large panel members being the agents, tend to look after their own pastimes. The
second null hypothesis which states that there is no significant variation in the
financial frauds of sample corporations with foreign directors and the same without
foreign directors has been accepted. This non-significant difference could be found on
the fact that foreign directors tend to conform to the corporate social, organizational
culture of the surroundings in which they work.

Based on regression results, the third null hypothesis i.e. no significant relationship
between the ratio of non-executive directors and the financial frauds of sample
corporations has been accepted. The result shows that the negative association
observed between the variables is significant at only 10% with a p-value of 0.066.
This confirms that outside directors have significant but negative impact upon the
occurrence of financial frauds committed by sample multinational companies. Thus
negative correlation entails that the more the number of outside directors, the lower
the occurrence of financial frauds.

Furthermore, the fourth hypothesis i.e. the relationship between directors’ equity
holding and the financial functioning of sample corporations is not significant has
been rejected. The correlation result of this hypothesis revealed strong significant
positive correlation of 0.716 between the directors’ equity holding and the fraud of
companies. The regression results also indicate that the positive correlation observed
between the studied variables is significant at 1%, 5% and 10% respectively. The
result depicts that the more companies’ equity owned by the directors, the better the
financial frauds of companies. This means that the equity ownership creates better
management, monitoring on the portion of the table and hence improved results.

The fifth hypothesis i.e. no significant relationship between the governance
disclosures of corporations and their operations has been rejected. A positive
correlation of 0.539 is observed between the degree of governance items disclosed by
the sample companies and ROE and ROA which are the proxies for financial frauds.
This implies that companies which disclose more on administration matters are more
potential to perform better than those that disclose less. The result further revealed
from the correlation result that sample companies with directors’ holdings will
disclose more governance items.
Finally the last hypothesis i.e. no significant difference between the profitability of the healthy and the rescued sample corporations has been rejected. As the result of hypothesis is corroborated effectively with our disclosure result which indicates that the majority of the healthy corporations disclose more governance items and thus performs better than the rescued corporations. The result is in line with Rasid (2008) who also confirmed that firms without governance problems perform better than firms with specific governance problems.

The present study therefore, contributes to the literature of accounting frauds by providing valuable insights on the subject matter and recommends that more accounting and reporting reforms should be introduced to the corporate financial reporting and more severe punishment mounted on any corporate entity that are found to be engaged in accounting fraud practices.