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Investigating Financial Reporting Fraud Intentions in Malaysian Small and Medium Enterprises (SMEs): A Proposed Framework

*Yunita Awang[1], Azuraidah Taib[1], Shazalina Mohamed Shuhidan [2], Norfadzilah Rashid[3]
[1]Faculty of Accountancy, Universiti Teknologi MARA, Cawangan Terengganu, Kampus Dungun, Malaysia
[2]Faculty of Accountancy, Universiti Teknologi MARA, Cawangan Selangor, Kampus Puncak Alam, Malaysia
[3]Faculty of Business & Management, Universiti Sultan Zainal Abidin, Gong Badak Campus, Terengganu, Malaysia
*yunita@uitm.edu.my, azura015@uitm.edu.my, shazalin@uitm.edu.my, nikmfadzilah@unisza.edu.my
Corresponding Author: Yunita Awang

Abstract: Fraud is widely regarded as the most important corporate problem in today's economic environment, and it is only becoming worse, especially in a tight-budget situation. Fraud in financial reporting refers to the intentional falsification of financial facts to mislead financial statement users. It undermines investors' trust in published financial statements. This study aims to identify the factors influencing intention for fraud in financial reporting in Malaysian Small and Medium Enterprises (SMEs). Hence, this study proposes a conceptual framework for financial reporting fraud intentions in Malaysian SMEs using the Theory of Planned Behaviour (TPB) as an underlying theory and supplemented by Rest's four-component model. The proposed framework comprises four main variables – attitude, subjective norm, perceived behavioral control and ethical judgment, while gender is treated as a control variable. This study enhances the current body of knowledge on unethical intention literature. It expands the applications of the TPB model in predicting intention for financial reporting fraud in the setting of small businesses. Additionally, the findings will contribute as a preventive safeguard against fraud in financial reporting.

Keywords: *Conceptual model, Intention for fraud, Fraud in financial reporting, Financial statement fraud, Small and Medium Enterprises*

1. Introduction

Fraud is a worldwide business issue that harms capital market players and poses serious ethical challenges for companies. Fraud is not tolerated by society as it represents a decline in people's moral beliefs and has led to significant financial losses. According to PricewaterhouseCoopers' 2020 Global Economic Crime and Fraud Survey, losses totalling USD 42 billion were reported in the last 24 months due to fraud. Major frauds committed by insiders are potentially far more damaging than offenses committed by outsiders; with 43% of reported incidents resulting in losses of USD 100 million or more being committed by insiders (PwC, 2020).

A report by PricewaterhouseCoopers (PwC, 2020) shows that misappropriation of assets ranks third in the overall frequency of fraud experiences (31%), after customer fraud (35%) and cybercrime (34%). Meanwhile, bribery and corruption (30%) and accounting/financial statement fraud (28%) rank fourth and fifth respectively. In a recent fraud survey report by the Association of Certified Fraud Examiners (ACFE, 2024), accounting fraud was the least prevalent category at 5% but caused the most damage with an average of USD 766,000 per case. This is a much higher figure than misappropriation of assets (89% of cases, with an average loss of USD 120,000 per case) and corruption (48% of cases, with an average loss of USD 200,000 per case).

Small and medium enterprises (SMEs) are currently growing rapidly and have a strong position in Malaysia's economic growth. In Malaysia, SMEs account for more than 98 percent of all business establishments and contribute to almost 40% of the country's Gross Domestic Product (GDP) (Abu Hassan et al., 2023; Han et al., 2018). It is therefore important to ensure that the contribution of SMEs remains on a sustainable growth path. However, this growth path may be destroyed by the increasing fraud rate in Malaysia. The Malaysian section of PwC's Global Economic Crime and Fraud Survey 2020 shows that although Southeast Asia as a whole reported a decrease in fraud levels (39% experienced fraud, down from 47% in 2018), Malaysian businesses still suffer from high levels of fraud (43% of respondents, up from 41% in 2018).

Asset misappropriation, corruption and financial statement fraud are the three main categories of occupational fraud (ACFE, 2024). Financial statement fraud is the intentional falsification of financial data to deceive users of financial statements, thereby jeopardizing investor confidence in publicly available financial statements. Rezaee (2005) stated that accounting fraud is a deliberate attempt by companies to deceive users of public financial statements, especially investors and creditors, by preparing and disseminating materially misleading financial statements. Consequently, financial statement fraud is also referred to as financial reporting fraud. Fraud continues to be a growing problem, especially with limited budgetary resources and is considered a major concern for companies in the current business environment.

Elements of fraud in SMEs such as employee theft, corruption, misappropriation of assets and fraudulent financial statements have been discussed in detail in previous studies. For example, Kennedy's (2018) research on misappropriation of assets in small businesses shows that companies that do not employ a Certified Fraud Examiner (CFE) report different rates of theft compared to companies that do employ a CFE. In certain cases of fraud, a CFE can be just as effective as the initiatives of business owners, managers and other personnel. A recent study by Talib et al (2024) shows that opportunity, rationalization and collaboration are significantly correlated with cases of asset misappropriation in Malaysian SMEs. Meanwhile, Aris et al. (2015) assess the possibility of financial statement fraud in a small to medium-sized automotive company in Malaysia and show the presence of high-risk areas that require additional scrutiny by management. Consequently, SMEs are recommended to establish an internal audit function to ensure the integrity of their operations, the accuracy of financial reporting and compliance with legislation.

Research on fraudulent financial statements has made extensive use of the Fraud Triangle Theory (Isahak et al., 2023), which was the first theory to explain the factors that lead to fraud (Herbenita et al., 2022). The Fraud Triangle Theory includes three variables as major factors for fraud: pressure, opportunity and rationalization (Cressey, 1953), of which the presence in the organization increases the risk of fraud (Kanjanapathy et al., 2022). Cressey's (1953) Fraud Triangle Theory was expanded by Wolfe and Hermanson (2004) to include an additional capability element, the so-called Fraud Diamond Theory (Matei & Bulau, 2024). However, Awang et al. (2020) note in their study that the Fraud Triangle Theory may inadequately address the distinct challenges of small businesses, such as limited resources, economic pressures and advancing technology, which can impact fraud motivations and detection methods differently than in larger organizations. In addition, small businesses often do not have the necessary resources to set up comprehensive fraud detection systems, which limits their ability to effectively combat the elements of 'opportunity' and 'rationalization' (Sánchez-Aguayo et al., 2022).

As financial statements are considered a trustworthy tool for investment decisions and one of the most important sources for stakeholders' assessment of a company's financial performance, numerous corporate scandals linked to financial fraud have raised concerns, particularly because of their damaging impact on global capital markets and investor confidence. Since the early 2000s, several financial scandals, bank failures and unexpected business bankruptcies have raised serious concerns about the independence, value and purpose of auditing and the accounting profession (Cheliatsidou et al., 2023). The collapse of one of the five largest auditing firms in the world, Arthur Anderson, was also due to fraud in financial reporting. Financial statement fraud is also the reason for most of the lawsuits filed by bankrupt clients. For example, Deloitte was sued for USD 7.6 billion for failing to detect fraud at one of the largest private mortgage firms that collapsed during the US housing crash (The Star, 2011). The loss of public confidence in the financial report can lead to significant economic and public welfare problems.

This study focussed on small and medium-sized enterprises (SMEs), as fraud has a particularly detrimental effect on these businesses. Similar to several developing nations, Malaysia is also heavily dependent on SMEs and their collapse could have a negative impact on the overall economy (Sow et al., 2018). According to ACFE (2024), the size of the organization matters. Smaller organizations, i.e. those with less than 100 employees, have disproportionately higher average losses from fraud compared to larger organizations, amounting to USD 150,000, highlighting the vulnerability of smaller businesses.

Global economic pressures expose corporate actors and decision-makers to risk that leads to financial statement fraud (Kukreja et al., 2020). Since fraud is initiated by people, it is almost impossible to develop laws and regulations that would eliminate fraud altogether. Those who want to commit fraud will find possible alternatives to manipulate the rules to achieve their goals. However, fraud may be prevented through various mechanisms, namely an effective control system, embedding an ethical culture in an organization and identifying factors that may influence the propensity to commit fraud. Therefore, the main objective of this study is to propose a conceptual model to investigate the correlation between personal factors and the intention to commit fraud in financial reporting.

Fraudulent financial reporting poses a critical threat to the credibility and integrity of corporate financial statements, particularly in the context of SMEs where resources and oversight may be limited. Despite its pervasive impact on investor confidence and economic stability, there is limited understanding of the psychological and behavioral factors that drive the intention to commit fraud in financial reporting, especially in the Malaysian SME sector. A previous literature review shows a lack of studies on fraud in SMEs, suggesting research expansion in this area to promote SME growth (Zainal et al., 2022). Existing frameworks for predicting unethical behavior have not specifically been applied in this area to identify important influencing factors such as attitude, subjective norms, perceived behavioral control, ethical judgment, and demographic factors such as gender. The present study fills this gap by proposing a conceptual model based on the TPB to investigate these factors and provide insights that contribute to fraud prevention and ethical decision-making in SMEs. In particular, this proposed study aims to examine the individual factors of attitude, subjective norms and perceived behavioral control in line with the TPB, which assumes that these three constructs influence behavioral intention (Ajzen, 1991). An additional variable, ethical judgment incorporates Rest's four-component model, which states that ethical judgment is antecedent to ethical intention (Rest, 1994). The examination of these interactions is significant for SMEs in developing a mechanism to ensure the integrity of their operations as it provides valuable insight into the factors that influence the intention to commit fraud in financial reporting in SMEs.

2. Literature Review

This section of the literature review builds on earlier scholarly research to offer theoretical and empirical justification for the current study.

Fraud in Financial Reporting

Fraud is a significant ethical dilemma for businesses and the most serious business problem in today's business environment. Occupational fraud falls into three categories: Asset misappropriation, corruption and financial statement fraud (ACFE, 2024). Although financial statement fraud was the least prevalent category with 5% of fraud cases, it caused the most damage with an average of USD 766,000 per case, which is significantly higher than that of asset misappropriation and corruption (ACFE, 2024).

Financial statement fraud or financial reporting fraud is an intentional offense committed by a company to deceive or mislead users of published financial statements through manipulation of material financial transactions, material intentional misstatements and manipulation of accounting practices (Rezaee, 2005). Capital market participants, including investors, creditors and analysts, rely on published financial statements to make economic decisions. As the prime source of reference, financial statements are expected to be reliable, transparent and comparable. Attempts to falsify financial reports may be detrimental to these stakeholders. They affect the reliability of financial reports and pose a serious threat to stakeholders' confidence in financial information. There are various techniques of financial statement fraud. Examples include improper or unauthorized recognition of revenue, the inappropriate accrual of expenses, the overstatement of assets other than accounts receivable, the understatement of expenses/liabilities and the misappropriation of assets. It also involves inadequate or inappropriate omissions or disclosures, lack of provisions for bad and doubtful debts, inconsistent application or interpretation of accounting policies or standards, fictitious and premature sales, and the reversal or utilization of unjustified reserves (Beasley et al., 1999; KPMG, 2009, 2013; Lundelius, 2011; Rezaee, 2002).

The pressure on management to meet profit targets motivates them to manipulate figures in their financial reports, leading to fraud in financial reporting. Financial reporting fraud is also committed to improve or maintain a company's financial position, which facilitates embezzlement and stock issuance (Green & Calderon, 2011). Other driving factors include personal gain, ego, greed for an excessive lifestyle and personal financial pressures coupled with lax controls within organizations (KPMG, 2009, 2013; Mung-Ling et al., 2008; Rockness & Rockness, 2005). This shows that there is a need to explore further the behavioral aspects of individuals working in finance and finance-related functions. Therefore, this study focuses on fraud in financial reporting as an attempt to prevent or deter its widespread occurrence.

A study conducted by Sow et al. (2018) examined 126 Malaysian SMEs from various industries and found that these companies were exposed to a variety of fraud tactics. Despite this exposure, the study showed that few SMEs have taken sufficient measures to combat fraud. This indicates a significant vulnerability in this sector. Small and medium-sized enterprises are also vulnerable to fraudulent activity, with figures suggesting that organizations with fewer than 100 employees experience more incidents of fraud than those with more employees (ACFE, 2024).

Theory of Planned Behaviour

The current study proposes to adopt the Theory of Planned Behaviour (TPB) as the framework to guide the study mainly because TPB (and its original theory, Theory of Reasoned Action - TRA) are regarded as the most well-known theory for assessing ethical intention (Leonard et al., 2004). The social psychology theories of TRA and TPB have been widely applied in behavioral intention studies.

Perceived behavioral control is an extra measure included in TPB (as compared to TRA), which is held to affect both behavior and intention (Ajzen, 1991). According to Ajzen and Fishbein (1980), the foundation of TPB is:

The assumption is that human beings are usually quite rational and make systematic use of the information available to them…(and) that people consider the implications of their actions before they decide to engage or not engage in a given behavior (5).

TPB suggests attitudes toward the behavior, subjective norms, and perceived control over the behavior all have an impact on intention, which is the primary explanation of behavior. Attitude is “the person’s judgment that performing the behavior is good or bad, that he [sic] is in favor of or against performing the behavior,” (Ajzen & Fishbein, 1980: 6). Perceived behavior control is a person's assessment of the difficulty in carrying out an intention, whereas the subjective norm is a person's opinion of whether other people who are significant to them believe a specific behavior should be carried out (Ugrin, 2008). Behavioral intention is an individual’s subjective probability whether to engage or not to engage in a particular behavior (Ajzen, 1991). It acts as a proxy for behavior (Buchan, 2005). The degree of behavioral intention determines the likelihood that a behavior will be carried out - the more strongly an individual intends to carry out behavior, the more likely they are to do so.

Ethical Judgment

The actual occurrence of financial fraud cases such as Enron, WorldCom and Xerox, which attracted international attention, serves as evidence of ethical deficits. Public confidence in published audited financial statements was affected by these cases, which made international headlines. In Malaysia, cases such as Renong, Perwaja Steel and Malaysia Airlines were documented as accounting scandals during the 1997-1998 financial crisis (Suhaily et al., 2008).

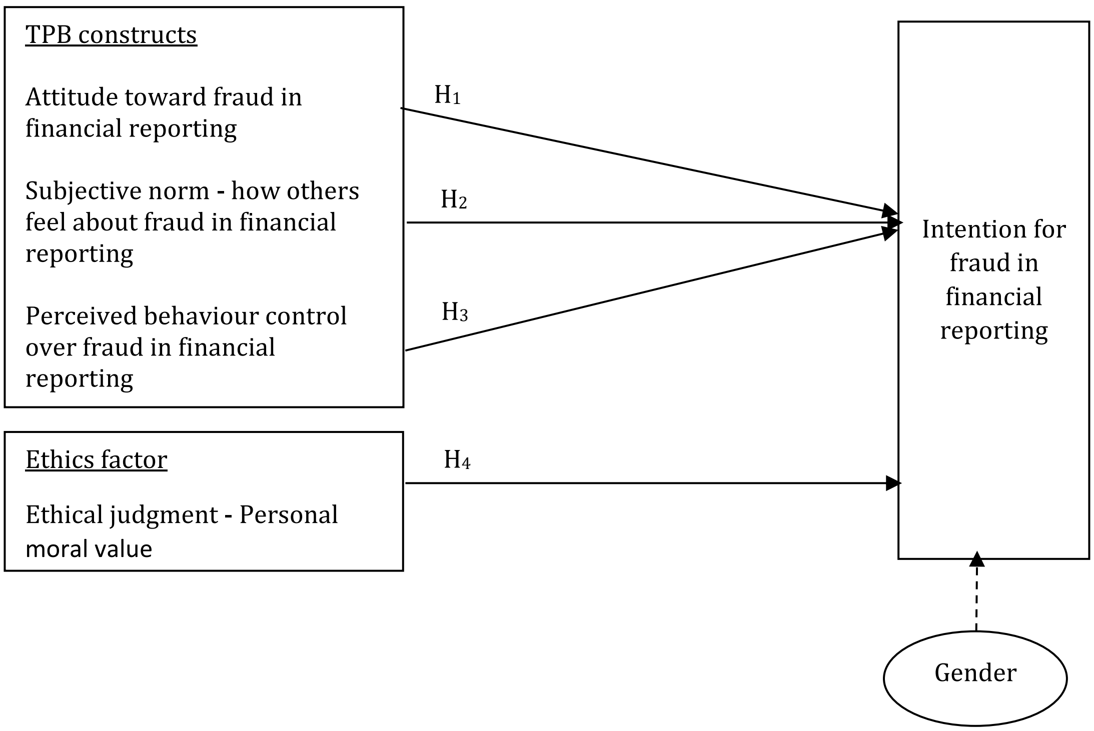
Ethical judgment is associated with ethical failure. According to O'Fallon and Butterfield (2005), ethical judgment is the process by which a person decides which course of action is morally right. People who make poor decisions in ethical dilemmas end up making unethical decisions. Ethical judgment is influenced by various factors such as individual variables, organizational variables and the characteristics of the ethical dilemma (Karassavidou & Glaveli, 2006).

Since behavioral intention and ethical judgment are often presented as key components of the ethical decision-making process, this study examines the impact of ethical judgment on fraud intention in financial reporting. According to Rest's four-component model, ethical judgment comes before ethical intention (Rest, 1994). Similarly, Treviño, Weaver and Reynolds (2006) agree that ethical judgment precedes ethical intention and ethical behavior.

3. Proposed Conceptual Framework

Based on the foregoing discussions, this study aims to present the relevant hypotheses and proposes a conceptual framework as guidance for the current study.

Figure 1: Proposed Conceptual Framework



This study aims to investigate how the intention for financial reporting fraud among preparers of financial reports for SMEs is influenced by attitude, subjective norms, perceived behavioral control, and ethical judgment. Gender is included as a control variable. The following part outlines the development of the hypotheses in accordance with the suggested research framework.

4. Hypotheses Development

In this study, the intention for fraud in financial reporting among preparers of financial reports forms the dependent variable, while the independent variables are TPB constructs (i.e. attitude towards behavior, subjective norm, and perceived control behavior) and ethical judgment. Additionally, gender is included as a control variable. Guided by the analysis of theoretical and empirical literature influencing behavioral intention, specific hypotheses developed on the relationship between the independent variables and dependent variables of this study.

Attitude, Subjective Norm and Perceived Behavioural Control

TPB states that all three fundamental factors of attitude, subjective norm, and perceived behavioral control influence behavioral intention. A shift in behavioral intention should be the outcome of factors that affect each of these determinants (Ajzen, 1991). According to the TPB, each of these factors and behavioral intention are positively correlated (Carpenter & Reimers, 2005).

First, prior research suggests that behavioral intention is significantly predicted by one's attitude toward behavior (e.g. Ajzen & Fishbein, 1980; Buchan, 2005; Syed Shah et al., 2011). According to Fishbein and Ajzen (1977), if a person believes that engaging in a certain behavior is beneficial, they are more likely to plan to engage in that behavior. Attitude is found to be a significant predictor of the behavioral intentions of individuals to commit digital piracy (Liao et al., 2010; Phau & Ng, 2010; Syed Shah et al., 2011; Yoon, 2011). Similar findings in students' intentions to perform academic dishonesty behaviors such as cheating and lying (Alleyne & Phillips, 2011; Hsiao & Yang, 2011) and, in students' intentions to violate confidentiality and charge personal expenses (Alleyne et al., 2014). An individual is more inclined to engage in unethical behavior if they believe that the reward, not the penalty, will follow from their actions (Carpenter & Reimers, 2005).

Recent studies have applied TPB to understand fraudulent financial reporting intentions. For instance, Yuniarwati et al. (2022) found that attitudes significantly influence the intention to commit financial reporting fraud. In their study, they found that the differences in an individual's intention to create false financial statements are mostly determined by their attitude. According to Baridwan and Subroto (2024), a person's attitude might influence them to commit financial reporting fraud, which makes financial reporting unreliable since the company loses a lot of money due to fraudulent activity, which significantly lowers its revenue.

In relation to fraud in financial reporting, if an individual's attitude is positive or in favor of violating generally accepted accounting principles and committing fraudulent financial reporting, it is most likely that his or her decision intentions are biased in that direction. Thus, the proposed hypothesized that:
H_1: There is a significant positive relationship between attitudes and the intention for fraud in financial reporting.

Second, the behavioral intention and subsequent behavior are perceived to be influenced by the subjective norm or referent group, with significant others in organizations—particularly superiors—having a major impact on behavior (Smith et al., 2007). An individual is more likely to engage in the behavior in question if the subjective norm anticipates that they should, and vice versa (Syed Shah et al., 2011). Similarly, it is determined that unethical behavior is influenced by the social network of interactions at work as well as individual traits, problems, and organizational settings (Brass et al., 1998). According to TPB's prediction, an individual is more likely to plan to engage in a behavior if they are certain that referent groups believe that they should (Fishbein & Ajzen, 1977). For example, the subjective norm has a positive and significant impact on Malaysian students' purchasing behavior when it comes to pirated software (Syed Shah et al., 2011). Peer and societal influence also have a significant impact on Taiwanese college students' intention to pirate textbooks (Hung-Jen et al., 2011). According to Alleyne et al. (2014), the subjective norm also plays a substantial role in forecasting accounting students' propensity to act unethically, such as violating confidentiality and charging personal expenses.

According to Carpenter & Reimers (2005), a person is more likely to violate a generally accepted accounting principle and commit financial reporting fraud to meet earnings projections if they believe that their referent group would support or condone the violation (i.e., fraudulent financial reporting). The TPB, which contends that real behavior is the result of psychological drives and is subjective for each individual, is supported by the findings of Zulaikha et al. (2021), which shows that subjective norms in direct testing had a favorable effect on the intention for fraud. The hypothesis of the proposed study is that:
H_2: There is a significant positive relationship between subjective norms and the intention for fraud in financial reporting.

Perceived behavioral control, the third TPB construct, measures the perceived level of ease or difficulty in performing a certain behavior. Two aspects of perceived behavioral control are, firstly, the degree of control an individual has over their behavior and, secondly, their level of confidence in their capacity to carry out or refrain from performing such behavior (Syed Shah et al., 2011). According to TPB, a person's intention to carry out a specific behavior will be stronger if they have more control they perceived over their behavior (Carpenter & Reimers, 2005). This implies that people's behavior is highly impacted by how confident they are in their capacity to perform the behavior. People's behavioral intention increases with how strongly they believe they have control. According to earlier research, for instance, people's intentions to engage in digital piracy (Liao et al., 2010; Yoon, 2011), academic dishonesty and cheating (Alleyne & Phillips, 2011; Hsiao & Yang, 2011), and breaches of confidentiality and personal expense charges (Alleyne et al., 2014) are all significantly influenced by their perceptions of behavioral control.

Regarding financial reporting fraud, the more strongly the individual feels that he or she has control over the decision to violate generally accepted accounting principles; the stronger is his or her intention for violating these principles or making an unethical and fraudulent financial reporting decision. Therefore, the proposed study postulates that:
H_3: There is a significant positive relationship between perceived behavioral control and the intention for fraud in financial reporting.

Ethical Judgment
The two main components of the ethical decision-making process are ethical judgment and behavioral intention (Ferrell & Gresham, 1985; Ferrell et al., 1989; Hunt & Vitell, 1986; Jones, 1991; Rest, 1994; Treviño et al., 2006). According to Rest's four-component model, the factor that determines ethical intention is ethical judgment (Rest, 1994).

According to earlier studies, a person's behavioral intention toward ethical issues and their ethical judgment are strongly correlated. For example, among marketers, the intention to intervene in an ethical issue is primarily determined by ethical judgment (Hunt & Vasquez-Parraga, 1993). While the moral intention to pursue illegal behavior of software copying for personal use is primarily determined by ethical judgment (Thong & Yap, 1998), sales managers' intentions to reward or punish sales force behavior are found to be primarily determined by their ethical judgments (DeConinck & Lewis, 1997). Additionally, public practice accountants exhibit consistent patterns of reasoning in a variety of contexts (Buchan, 2005).

In a similar vein, someone with a better degree of ethical judgment selects the course of action that will have the least negative impact on the people involved. People with strong ethical judgment are less likely to purposefully deceive creditors and shareholders with fraudulent financial reports because they take into account how their actions may affect other people (Uddin & Gillett, 2002). The study by Awang and Ismail (2018) reveals that ethical judgment, albeit important, exerts the least influence on the desire to engage in unethical financial reporting among accounting professionals. In addition, the tendency for accounting fraud is significantly impacted negatively by the ethical value variable, indicating that employees are less likely to engage in financial reporting fraud when moral principles and high ethical standards govern their behavior (Pradipta & Bernawati, 2019). Therefore, the proposed study postulates that there is a negative correlation between unethical intention and ethical judgment. Those who exhibit higher levels of ethical judgment express a lower intention to commit financial reporting fraud than those who do not. Thus, the hypothesis of the proposed study is:
H_4: There is a significant negative relationship between ethical judgment and the intention for fraud in financial reporting.

Gender as a Control Variable
A control variable is introduced to support the interpretation of the relationship between the variables (Cooper & Schindler, 2011). Sekaran and Bougie (2010) define a control variable as "any exogenous or extraneous variable that could contaminate the cause-effect relationship, but whose effects can be controlled through a process of either matching or randomization" (p. 437).

Control variables are included in the study to address issues related to the potential threat of alternative explanations (Troy et al., 2011) and to ensure that the results are not skewed by their exclusion (Cooper & Schindler, 2011). The control variable may be a demographic or personal variable such as age or gender that needs to be “controlled" to determine the actual effect of the independent variable on the dependent variable (Creswell, 2009). Since gender is one of the most studied individual-level variables in the business ethics literature, it was included as a control variable in the research framework of this study. Previous data show that men are statistically more likely to commit fraud offenses than women, who account for approximately 72% of incidents. In addition, fraudulent acts committed by men tend to cause greater financial losses, with median losses being about twice as high as for women (ACFE, 2024). The study uses a dummy variable coded 1 (male) and 0 (female) to measure gender, but gender is not specifically predicted, nor is the expected sign of gender assigned.

5. Conclusion and Recommendations

In this study, a conceptual framework is proposed to determine the factors that influence financial reporting fraud in SMEs. Building on the Theory of Planned Behaviour (TPB) as a theoretical framework and extending to include another variable, ethical judgment, based on Rest's four-component model, this study attempts to investigate the four variables of attitude, subjective norms, perceived behavioral control and ethical judgment that influence financial reporting fraud in SMEs, with the inclusion of gender as a control variable. By examining the aforementioned variables, this study not only adds to the current body of knowledge but also provides insights into the factors that influence financial statement preparers in their intention to commit financial reporting fraud.

Theoretical Implications

Theoretically, this study expects to contribute to the current unethical intention literature, particularly concerning the intention to commit fraud in financial reporting. It also draws attention to the paucity of research on SMEs' ethical perspective. The results of this study expand the applications of the TPB model in predicting intention for financial reporting fraud. In a similar vein, this study supports Rest's four-component model stance regarding the connection between ethical judgment and ethical intention.

Additionally, this study addresses a critical research gap regarding the ethical perspectives model on SMEs, which are often under-regulated in comparison to larger firms. It will also provide empirical evidence that expands the understanding of unethical decision-making within the SME sector. Financial reporting fraud is a growing concern in corporate governance, but most of the literature on unethical intentions has focused on large corporations rather than SMEs.

Practical Implications

This study aims to provide a number of useful insights. Firstly, the results will serve as a preventive safeguard against fraud in financial reporting. In addition, as failing to detect existing fraud in a company's financial statements is costly to the audit firm (Carpenter et al., 2002), determining the elements that contribute to fraud in financial reporting may help reduce some of the potential litigation costs and improve the reputation of the profession (Uddin, 2000). The findings will provide a better understanding of the actual intentions of those involved in engaging in unethical financial reporting in SMEs.

Concisely, through a comprehensive investigation of the proposed variables, the findings of this study will provide a better understanding of the factors influencing the intention to commit fraud in financial reporting. The results will also have important implications for deterring fraud in financial reporting. This study is expected to contribute to and extend previous research by presenting a new framework for financial reporting fraud intentions within the SME environment.

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