

678703

**THE ASSOCIATION BETWEEN FINANCIAL  
PERFORMANCE, ENVIRONMENTAL  
CHARACTERISTICS, CORPORATE GOVERNANCE  
MECHANISM AND FRAUDULENT FINANCIAL  
REPORTING: EVIDENCE FROM MALAYSIAN LISTED  
COMPANIES**

**by**

**MAHANUM SULAIMAN**

**Thesis submitted in fulfillment of the requirements  
For the Degree of Doctor of Philosophy**

**March 2014**

## ACKNOWLEDGEMENT

I would like to express my sincere gratitude and appreciation to my principal supervisors, Professor Datin Dr Hasnah Haji Haron and Associate Professor Datuk Dr Ishak Ismail who has proved to be a great mentor, guidance and inspiration by providing invaluable support throughout the PhD journey. I offer equal thanks to my second supervisor, Dr. Effiezal Abdul Wahab, for his support, suggestions and guidance through this process. I would like also to thank, Associate Professor Dr. SofriYahya and Dr. Chee Hong Kok for their suggestions and comments.

I would like to express my gratitude to the Dean, School of Management, Professor Dr Fauziah Md Taib as well as to Deputy Dean, Professor T. Ramayah for their concern and assistance.

I would like to thank to all my colleagues who have shared their time and knowledge while studying in the PhD room especially Zunirah Mohd Talib, Yana, Marlina, Farzah and many others who were very supportive. I am most grateful to Universiti Teknologi MARA for granting me this precious opportunity to enhance my career and professionalism. I look forward to serve university at all time. Lastly, I am grateful to my family especially to my brother, Sholeh, sister, Mahzom and sister-in law, Kak Ton and all family members for their courage and love to make this dream come true.

## TABLE OF CONTENTS

	<b>Page</b>
<b>ACKNOWLEDGEMENT</b>	ii
<b>TABLE OF CONTENTS</b>	iii
<b>APPENDICES</b>	xi
<b>LIST OF TABLES</b>	xii
<b>LIST OF FIGURES</b>	xv
<b>LIST OF ABBREVIATIONS</b>	xvi
<b>ABSTRAK</b>	xix
<b>ABSTRACT</b>	xx
<b>CHAPTER 1:INTRODUCTION</b>	
1.1 Introduction	1
1.2 Fraud Trend and Fraudulent Financial Reporting	1
1.3 Corporate Governance, Legal and Regulatory Improvements in Malaysia	6
1.4 Factors Contributing to Fraudulent Financial Reporting	9
1.5 The Problem Statement	12
1.6 Research Objectives	15
1.7 Research Questions	15
1.8 Significance of the study	16
1.8.1 Theoretical Significance	16
1.8.2 Practical Significance	17
1.9 Scope of the Study	18
1.10 Organization of the chapters	19
<b>CHAPTER 2: FRAUDULENT FINANCIAL REPORTING, CORPORATE GOVERNANCE AND OFFICIAL PRONOUNCEMENTS</b>	
2.1 Introduction	21
2.2 Fraud, Occupational Fraud and Fraudulent Financial Reporting	21
2.2.1 Occupational Fraud and Fraudulent Financial Reporting	21

2.2.2	Perpetrators of Fraudulent Financial Reporting	27
2.2.3	Why Fraudulent Financial Reporting Occurs	29
2.2.4	Methods of Fraudulent Financial Reporting	30
2.3	Corporate Governance	35
2.3.1	Definition of Corporate Governance	36
2.3.2	Corporate Governance in Malaysia	36
2.3.3	Corporate Governance and Accountability	41
2.3.4	Factors Influencing Good Corporate Governance Function	43
	2.3.4.1 The Oversight Function	44
	2.3.4.2 The Managerial Function	49
	2.3.4.3 The Internal Audit Function	50
	2.3.4.4 The External Audit Function	51
2.3.5	Fraud and ISA 240 on “Fraud and Error”	52
2.3.6	Fraudulent Financial Reporting	53
2.4	Detecting Fraudulent Financial Reporting	55
	2.4.1 The Auditor and Fraud	56
	2.4.2 Red flags	56
2.5	Corporate Illegal Activities	57
2.6	Internal Control	58
	2.6.1 Quality of Internal Control System	63
	2.6.2 Control Factors that Prevent or Detect Fraudulent Behavior	68
	2.6.3 Internal Control Requirements: Summary of key Differences	70
	2.6.4 Whistle Blowing as an Internal Control Mechanisms	72
	2.6.5 Audit Oversight Board	73
2.7	Financial Reporting Requirements	74
2.8	Activity of Legislative and Regulatory Bodies	75
	2.8.1 The Securities Commission	75
	2.8.2 The Bursa Malaysia Berhad	77
2.9	Regulation and Standard in the United States	78
2.10	Official Pronouncements	80
	2.10.1 The Capital Market and Service Act 2007	83
	2.10.2 Securities Commission Enforcement	86
2.11	Analysis of Securities Commission Enforcement Releases	88

2.11.1	Criminal Prosecution	88
2.11.2	Civil Actions	89
2.11.3	Corporate Governance-related enforcement actions	89
2.12	Chapter Summary	90

## **CHAPTER 3: LITERATURE REVIEW AND HYPOTHESIS**

### **DEVELOPMENT**

3.1	Introduction	92
3.2	Theoretical Foundations	92
3.2.1	Agency Theory	92
3.2.2	Agency Theory and Family Ownership, Concentrated Ownership, Institutional Ownership and Entrenchment Theory	95
3.2.3	Corporate Governance, Agency Theory and Fraud	98
3.2.4	Top Management and Agency Theory	100
3.2.5	Fraud Triangle Theory	101
3.2.5.1	Incentive and Pressure	102
3.2.5.2	Opportunity	102
3.2.5.3	Attitude/Rationalization	103
3.2.6	Fraud Risk Factors	103
3.2.6.1	Fraud Risk Factor Proxies for Pressure	106
3.2.6.2	Fraud Risk Factor Proxies for Opportunity	108
3.2.6.3	Fraud Risk Factor Proxies for Rationalization	109
3.3	Fraudulent Financial Statement Prevention and Detection Process	110
3.3.1	Studies on Fraud Detection	111
3.4	Fraudulent Financial Reporting	115
3.5	Corporate Illegal Activity and Fraudulent Financial Reporting	119
3.5.1	Financial Performance Factors and Fraudulent Financial Reporting	122
3.5.1.1	Company Profitability	128
3.5.2	Environmental Factors and Fraudulent Financial Reporting	131
3.5.2.1	Dynamic Environment	134
3.5.2.2	Heterogenous Environment	136

3.6	Empirical Studies on Corporate Governance and Fraudulent Financial Reporting	137
3.6.1	Board of Director Independence	142
3.6.2	CEO also the Board Chairman	146
3.6.3	Tenure of CEO	148
3.6.4	Insider Stock Ownership	149
3.6.5	Audit Committee Independent	159
3.6.6	Audit Committee Meeting Frequency	162
3.6.7	Financial Experts of Audit Committee	165
3.6.8	Quality of External Auditor	167
3.7	Internal Control Quality	169
3.7.1	Internal Control and Fraudulent Financial Reporting	169
3.8	Control Variable: Firm Size	173
3.9	Theoretical Framework	175
	Development of Hypothesis	177
3.10.1	Company's Profitability	177
3.10.2	Environmental Characteristics	180
3.10.2.1	Dynamic Environment	180
3.10.2.2	Heterogeneous Environment	181
3.10.3	Corporate Governance Factors	183
3.10.3.1	Board Independence	183
3.10.3.2	CEO also the Board Chairman	184
3.10.3.3	Tenure of CEO	186
3.10.3.4	Insider Stock Ownership	187
3.10.3.5	Independence of Audit Committee	189
3.10.3.6	Audit Committee Meeting Frequency	190
3.10.3.7	Financial Experts of Audit Committee	191
3.10.3.8	Quality of External Auditor	192
3.10.4	Internal Control Quality	194
3.10.4.1	Internal Control Quality Disclosures	194
3.11	Chapter Summary	195

## **CHAPTER 4: RESEARCH METHODOLOGY**

4.1	Introduction	197
4.2	Research Design	197
	4.2.1 Population and Sample	197
	4.2.2 Data Collection	200
4.3	Operational Definition and measurement of variables	201
	4.3.1 Dependent variable	201
	4.3.1.1 Comparing Fraud Firms to Non-Fraud Firms	201
	4.3.2 Independent variables	202
	4.3.2.1 Measurement of Internal Control Quality	203
4.4	Statistical Analysis	207
	4.4.1 Descriptive Statistics	207
	4.4.2 Correlation Analysis	208
	4.4.3 Internal Control Quality Analysis	208
	4.4.4 Univariable Analysis	208
	4.4.5 Multivariable Logistic Regression Analysis	209
	4.4.6 Variable Selection	210
	4.4.7 Checking Multicollinearity	212
	4.4.8 Checking the Linearity of Numerical Independent Variable	212
	4.4.9 Check the Two-Way interaction term	213
	4.4.10 Assess the Goodness of Fit	213
	4.4.11 Diagnostic and Influential Statistics	215
4.5	Establishing the Final Model	216
4.6	Chapter Summary	218

## **CHAPTER 5 RESULTS**

5.1	Introduction	219
5.2	Sample	219
5.3	Descriptive Statistics	221
	5.3.1 Continuous Variables	221
	5.3.2 Categorical Variables and Chi-Square Test	222
5.4	Correlation Analysis	225
	5.4.1 Correlation Among Independent Variables	225

5.4.2	Correlation Between Independent and Dependent Variable	227
5.5	Internal Control Quality Analysis	228
5.5.1	Number of Mandatory Sentences of Internal Control Disclosures	228
5.5.2	Mandatory Index of Internal Control Disclosure	229
5.5.3	Number of Voluntary Sentences of Internal Control Disclosures	230
5.6	Univariate Analysis	231
5.7	Univariable Analysis	233
5.7.1	Simple Logistic Regression	233
5.8	Multivariable Logistic Regression	234
5.8.1	Hypotheses Testing	235
5.8.1.1	Multiple Logistic Regression for Hypotheses test of Company's Profitability and Fraudulent Financial Reporting	235
5.8.1.2	Multiple Logistic Regression for Hypotheses test of Company's Environment and Fraudulent Financial Reporting	236
5.8.1.3	Multiple Logistic Regression for Hypotheses test of Corporate Governance and Fraudulent Financial Reporting	238
5.8.1.4	Multiple Logistic Regression for Hypotheses test of All Variables and Fraudulent Financial Reporting	239
5.9	Variable Selection	242
5.9.1	Forward LR	242
5.9.2	Backward LR	243
5.9.3	Selection of Model	244
5.10	Test of Multicollinearity	244
5.11	Check of Linearity of Numerical Independent Variables	245
5.12	Interaction Effects	246
5.12.1	Interaction between Tenure of the CEO and Insider Stock Ownership	246
5.13	Preliminary Final Model	247
5.14	Assessing Goodness of Fit of Model	248

5.14.1	Hosmer-Lemeshow Goodness-of-Fit	248
5.14.2	Classification Table	249
5.14.3	Receiver Operating Characteristic Curve Analysis (ROC Curve)	250
5.15	Diagnostic and Influential Statistics	251
5.16	Final Logistic Regression Model	256
5.17	Chapter Summary	258

## CHAPTER 6 DISCUSSION AND CONCLUSION

6.1	Introduction	260
6.2	Recapitulation of Findings	260
6.2.1	Company's Profitability and Fraudulent Financial Reporting	264
6.2.2	Environmental and Fraudulent Financial Reporting	266
6.2.2.1	Dynamic Environment	266
6.2.2.2	Heterogeneous Environment	267
6.2.3	Corporate Governance and Fraudulent Financial Reporting	268
6.2.3.1	Board of Director Independence	268
6.2.3.2	Duality	270
6.2.3.3	Tenure of CEO	272
6.2.3.4	Insider Stock Ownership	273
6.2.3.5	Audit Committee Independence	274
6.2.3.6	Audit Committee Meeting Frequency in a Year	276
6.2.3.7	Audit Committee Financial Expert	277
6.2.3.8	Big-Four audit firms	278
6.2.3.9	Firm Size	280
6.2.3.10	Internal Control Quality	281
6.2.3.11	Differences between the MCCG 2012, the 2007 Code and Bursa Malaysia Listing Requirement on Internal Control Statements	283
6.3	Implications of this Study	285
6.3.1	Theoretical Implication of this Study	285
6.3.2	Practical Implication of this Study	287
6.4	Limitation of this Study	288
6.5	Suggestions for Future Research	289

6.6	Conclusions	290
	<b>REFERENCES</b>	<b>294</b>

## APPENDICES

	<b>Page</b>	
Appendix A	Companies committing financial statement fraud	317
Appendix B	Part 1 -13 Principles of corporate governance	318
Appendix C	Overview of the MCCG	319
Appendix D	Comparison between the Security Industry Act 1983 and the Capital Markets and Service Acts 2007	320
Appendix E	Comparison between the Securities Commission Act 1993 And the Capital Markets and Service Acts 2007	321
Appendix F	List of Companies	322
Appendix G	Measurement of Mandatory Disclosure on Internal Control	325
Appendix H	Analysis of Mandatory and Voluntary Disclosure of 114 Observation in the Study	327
Appendix I	Receiving Operating Curve (ROC Curve)	329
Appendix J	Duality and Big-Four Audit Firms	330

## LIST OF TABLES

		<b>Page</b>
Table 1.1	Malaysia's Corruption Perception Index	5
Table 2.1	Summary of Models/Typologies/Taxonomies	27
Table 2.2	Perpetrators of Financial Statement Fraud	29
Table 2.3	Twenty-First-Century Scandals	33
Table 2.4	Malaysian Companies Scandals	34
Table 2.5	Differences Between MCCG 2007 and MCCG 2012	41
Table 2.6	Summary of regulation and legislation of internal control in the United Kingdom, United States and Malaysia	62
Table 2.7	List of frameworks issued in United States and United Kingdom	67
Table 2.8	List of regulations issued in Malaysia	68
Table 2.9	Organizational Internal Control Framework	69
Table 2.10	Key areas of differences	77
Table 3.1	Examples of Fraud Risk Factors	105
Table 3.2	Summary of empirical studies on the relationship between financial factor and fraudulent financial reporting	123
Table 3.3	Summary of empirical studies of relationship between the environmental Factors and fraudulent financial reporting	132
Table 3.4	Summary of empirical studies of relationship between the corporate Governance and fraudulent financial reporting	138
Table 3.5	Summary of empirical studies of relationship between directors' share ownership and fraudulent financial reporting	155
Table 4.1	Sample of Selection Process	199
Table 4.2	Independent Variables and measurement	202
Table 5.1	The Sample of Companies	220
Table 5.2	Distribution of Years of Observation	220
Table 5.3	Descriptive statistics of continuous variables	222
Table 5.4	Categorical Variables using Crosstabulation, Chi-Square and p-value	224
Table 5.5	Correlation Matrix	226
Table 5.6	Number of Mandatory Sentences of Fraud and No-Fraud	229

	Companies	
Table 5.7	Mandatory Index of Internal Control Disclosure of Fraud And No-Fraud Companies	230
Table 5.8	Number of Voluntary Sentences of Internal Control Disclosure of Fraud and No-Fraud Companies	231
Table 5.9	Independent t-test	232
Table 5.10	Sum of Simple Logistic Regression	234
Table 5.11	Multiple Logistic Regression results of Company's Profitability and Fraudulent Financial Reporting	235
Table 5.12	Multiple Logistic Regression results of company' Environment and Fraudulent Financial Reporting	237
Table 5.13	Multiple Logistic Regression results of Corporate Governance and Fraudulent Financial Reporting	239
Table 5.14	Multiple Logistic Regression results of all variables and Fraudulent Financial Reporting	240
Table 5.15	Summary of Multiple Logistic Regression	241
Table 5.16	Forward Stepwise	243
Table 5.17	Backward Stepwise	243
Table 5.18	Forward Stepwise	244
Table 5.19	Fractional Polynomial Analysis for Checking Linearity of the Numerical Variable	246
Table 5.20	Fractional Polynomial Analysis for Checking Linearity of the Numerical Variable	246
Table 5.21	Interaction between Tenure of CEO and Insider Stock Ownership	247
Table 5.22	Preliminary Fraud Prediction Model	248
Table 5.23	Hosmer and Lemeshow Test	249
Table 5.24	Classification Table	249
Table 5.25	Outlier and Influential Statistics based on Cut Point	254
Table 5.26	Estimated Logistic Regression Coefficients and the Percentage Changes when Covariate Pattern Removed	254
Table 5.27	Final Fraud Prediction Model	256
Table 5.28	Hosmer and Lemeshow Test	256

Table 5.29	Classification Table	257
Table 5.30	The Summary Results of Hypotheses Testing	259

## LIST OF FIGURES

		<b>Page</b>
Figure 2.1	Type of Fraud according to Albrecht <i>et al.</i> (2004)	22
Figure 2.2	Classification of Fraud according to Rittenberg, Schwieger & Johnstone (2008)	25
Figure 3.1	Theoretical Framework	176
Figure 5.1	Area Under the ROC Curve	250
Figure 5.2	Delta Chi Square vs Predicted Probability	252
Figure 5.3	Delta Deviance vs Predicted Probability	253
Figure 5.4	Delta Beta vs Predicted Probability	253
Figure 5.5	ROC – delete covariate pattern no. 99	329
Figure 5.6	ROC – delete covariate pattern no. 96	329
Figure 5.7	ROC – with all covariate patterns deleted	255

## LIST OF ABBREVIATIONS

AAER	-	Accounting and Auditing Enforcement Release
ACCA	-	The Association of Chartered Certified Accountants
ACFE	-	Association of Certified Fraud Examiner
AICPA	-	American Institute of Certified Public Accountants
ALN	-	Adaptive Logic Network
AOB	-	Audit Oversight Board
ASB	-	Auditing Standards Board
ASX	-	Australian Stock Exchange
BAFIA	-	Banking and Financial Institution Act
BMB	-	Bursa Malaysia Berhad (or Malaysia Securities Exchange Bhd)
BMLR	-	Bursa Malaysia Listing Requirement
BNM	-	Bank Negara Malaysia (Malaysia Central Bank)
BOD	-	Board of Directors
BODIND	-	Board Independence
BRC	-	Blue Ribbon Committees
CCM	-	Companies Commission of Malaysia
CEO	-	Chief Executive Officer
CFO	-	Chief Financial Officer
CIC	-	Capital Issue Commission
CMSA	-	Capital Markets and Service Act 2007
COSO	-	Committee of Sponsoring Organization
CPA	-	Certified Public Accountants
EM	-	Earnings Management
ERM	-	Enterprise Risk Management

FFR	-	Fraudulent Financial Reporting
FDICIA	-	Federal Deposit Insurance Corporation Improvement Act of 1992
GAAP	-	Generally Accepted Accounting Principles
GANNA	-	Generalized Adaptive Neural Network Architectures
GAO	-	General Accounting Office (of the United States of America)
ICD	-	Internal Control Deficiencies
IIAM	-	Institute of Internal Auditors Malaysia
IOSCO	-	International Organization of Securities Commission
IPPF	-	International Professional Practices Framework
ISA	-	International Standard on Auditing
KLSE	-	Kuala Lumpur Stock Exchange
LRs	-	Listing Requirements
MCCG	-	Malaysian Code of Corporate Governance
MCDA	-	Multi Criteria Decision Aid
MIA	-	Malaysian Institute of Accountants
MICPA	-	Malaysian Institute of Certified Public Accountants
MIM	-	Malaysian Institute of Management
MITI	-	Ministry of Trade and Industry
MOF	-	Ministry of Finance
MWSG	-	Minority Shareholder Watchdog Group
NED	-	Non Executive Directors
NYSE	-	New York Stock Exchange
OECD	-	Organization for Economic Co-Operation and Development
PLC	-	Public Limited Companies

ROA	-	Return on Assets
RM	-	Ringgit Malaysia
SAS	-	Statement on Auditing Standards
SC	-	Securities Commission (of Malaysia)
SEC	-	Securities and Exchange Commission
SCA	-	Securities Commission Act 1993
SIA	-	Securities Industry Act 1983/1991
SOX	-	Sarbanes-Oxley Act 2002
SRO	-	Self-Regulating Organization
U.K.	-	United Kingdom
U.S.	-	United States of America

**PERHUBUNGAN ANTARA FAKTOR PRESTASI KEWANGAN, FAKTOR ALAM PERSEKITARAN DAN MEKANISMA TADBIR URUS KORPORAT DAN PENIPUAN LAPORAN KEWANGAN: KAJIAN DALAM SYARIKAT TERSENARAI AWAM DI MALAYSIA**

**ABSTRAK**

Kejatuhan syarikat-syarikat di sebabkan oleh penipuan akaun oleh pengurus syarikat telah membangkitkan isu-isu serious tentang keberkesanan mekanisma pengawasan untuk melindungi kepentingan pelabur dan mengawal sikap pengurus yang oportunistik. Kajian ini meneliti prestasi kewangan, faktor alam persekitaran dan mekanisme tadbir urus korporat dalam menyumbang kepada penipuan laporan kewangan di Malaysia. Regresi logik keatas 36 syarikat yang terlibat dengan penipuan dan di bandingkan dengan 46 syarikat yang tidak terlibat dengan penipuan untuk jangkamasa tahun 2001 ke 2009. Ketepatan ramalan regresi logistik menunjukkan adalah 66.1 persen. Kajian ini juga mendapati apabila pengarah syarikat memiliki saham yang lebih tinggi, kebarangkalian penipuan laporan kewangan adalah berkurangan. Pemilihan saham syarikat yang tinggi oleh pengarah syarikat akan meningkatkan nilai syarikat, dan seterusnya mengurangkan masalah konflik teori agensi diantara pihak pengurusan dan pemegang saham dimana pihak pengurusan membuat keputusan yang menguntungkan mereka berbanding kepentingan pemilik syarikat. Kajian ini juga mendapati apabila Ketua Pegawai Eksekutif memegang jawatan dalam jangkamasa yang pendek, kecenderungan syarikat terlibat dengan penipuan laporan kewangan adalah lebih tinggi. Walaupun kualiti kawalan dalaman didapati tidak signifikan menyumbang kepada penipuan laporan kewangan, adalah didapati syarikat yang terlibat dalam penipuan kurang mendedahkan pendedahan sukarela sistem kawalan dalaman. Adalah dicadangkan Suruhanjaya Sekuriti Malaysia dan Institut Akauntan Malaysia harus menggalakkan syarikat tersenarai untuk mendedahkan lebih banyak pendedahan sukarela sistem kawalan dalaman, lembaga pengarah untuk memiliki lebih banyak saham dalam syarikat dan menggalakkan Ketua Pegawai Eksekutif untuk berkhidmat dengan lebih lama. Cadangan jangkamasa perkhidmatan Ketua Pegawai Eksekutif adalah 9 tahun atau lebih kerana dapatan kajian mendapati Ketua Pegawai Eksekutif yang mempunyai jangkamasa perkhidmatan 9 tahun atau lebih adalah kurang terlibat did dalam penipuan laporan kewangan. Saranan ini patut di masukkan juga di dalam keperluan Penyenaraian Bursa Malaysia.

**THE ASSOCIATION BETWEEN FINANCIAL PERFORMANCE,  
ENVIRONMENTAL CHARACTERISTICS, CORPORATE GOVERNANCE  
MECHANISM AND FRAUDULENT FINANCIAL REPORTING: EVIDENCE  
FROM MALAYSIAN LISTED COMPANIES**

**ABSTRACT**

The collapse of a number of companies as a result of accounting manipulation by managers has raised serious questions about the effectiveness of the monitoring mechanism to protect investors' interests and control managerial opportunistic behavior. This study examines financial performance, environmental characteristics and governance mechanisms on fraudulent financial reporting in Malaysia. Logit regression was performed on a sample of 36 fraud firms and 46 no-fraud firms for the period of 2001 to 2009. The predictive accuracy of the logistic regression model is 66.1 percent. This study found that the greater the direct shares of the company owned by the board of director, the lesser would be the likelihood of fraudulent financial reporting. High stock ownership of board of director will increase the firm value, thus eliminating some of the inherent agency conflicts between the management and shareholders which is related to managers making decisions to benefit themselves rather than the shareholders. This study also found that the shorter the tenure of the CEO, the greater the tendency of the company to be involved in fraudulent financial reporting. Even though the internal control quality was found not to contribute significantly to fraudulent financial reporting, it was found that fraud companies, have lesser voluntary disclosure of internal control system compared to no-fraud companies. It is suggested that the Securities Commission and the Malaysian Institute of Accountants should encourage a greater level of voluntary disclosure of internal control system by all public listed companies, board of director to own greater number of shares in companies and CEO is encouraged to have a longer tenureship. Length of CEO tenureship is recommended to be 9 years or more as findings have shown that CEO with 9 years or more tenure is found to commit less in fraudulent financial reporting. This can also be included in Bursa Malaysia Listing Requirement (BMLR).

# CHAPTER 1

## INTRODUCTION

### 1.1 Introduction

This chapter discusses some issues encountered by the Malaysian listed companies regarding fraud in Malaysia. Previous studies have shown that the trend of fraud is increasing worldwide, particularly in Malaysia. The discussions in this chapter will be presented as follows. The first is to discuss fraud trend and fraudulent financial reporting. Then the development of corporate governance, the legal and regulatory improvement in Malaysia. Next, factors contributing to fraudulent financial reporting, the problem statement, research questions and objectives, significance of the study, scope of study and finally, the chapter ends with organizations of the chapter.

### 1.2 Fraud Trend and Fraudulent Financial Reporting

Fraud and white collar crimes have increased considerably over the recent years and professionals believe that this trend is expected to continue. Since not all fraud and abuse are discovered and reported, the cost of fraud to businesses is difficult to estimate. However, studies have shown that the monetary amount associated with fraud is huge. In Malaysia, the KPMG Survey Report 2009 Malaysia, distributed fraud survey questionnaire to all listed companies on the Bursa Malaysia and another 100 private companies. The results of the survey revealed that 66% of respondents felt that fraud is a major problem for Malaysian business and 61% of respondents believe that fraud will be on the increase which is substantially higher than the 44% that was reported in the 2004, while 78% expect a corresponding rise in

financial reporting fraud. Only 40 out of 85 organizations that experienced fraud disclosed fraud amounting to RM63.95 million. Financial losses due to fraud range between of RM10,001 to RM100,000 which accounted for 20% of the fraud incidents reported and this is consistent with 2004 survey results.

Another survey done by Pricewaterhouse Coopers (PwC), the Global Economic Crime Survey 2011 reported the economic crime of the 44% figure represented a 57% increase over the 28% reported in 2009 survey. In Malaysia, theft or asset misappropriation (83%) was the most common type of economic crime reported, followed by bribery and corruption (34%), and accounting fraud (27%). The survey reported that direct costs of economic fraud has been rising as 7% of respondents (2009: 0%) said they lost between USD5 million to USD100 million while 37% (2009: 11%) said that they lost between USD100,000 to USD5 million.

Losses due to fraud is increasing and management of companies are found to be involved in the scandal too. KPMG Fraud Survey 2009 in Malaysia found that the internally or management perpetrated fraud still accounted for a majority of the value of fraud perpetrated, although the number fraud cases involving external sources was higher. This is consistent with previous survey in 2004.

Another research by PricewaterhouseCoopers Global Economic Crime Survey in 2005 reported that in 21% of the reported cases, members of senior management have been incriminated, which is higher than the 17% registered for the Asia and Pacific region, and 18% globally. Results of the Malaysian survey also found that a high percentage of perpetrators were from their own organization. In 70% of cases, the defrauder was employed by the company. This is higher than the figure in Asia Pacific region (56%) and 45% globally. In Malaysia, the perpetrators were more

likely part of the management team (53%) compared with the Asia and Pacific region (46%), and the rest of the world (42%). According to Pricewaterhouse Coopers (PWC), Global Economic Crime 2007 Survey, 20% of the crimes in Malaysian companies were committed by senior management.

In the United States, the Committee of Sponsoring Organizations of the Treadway Commission (COSO) did an analysis of the fraudulent financial reporting on approximately 200 public companies in the United States for the period from 1987 to 1997, conducted by Beasley, Carcello and Hermanson (1999). The results showed that the incidence of fraud usually involved the top senior executives. In 72% of the cases, the chief executive officer (CEO) was associated with financial statement fraud. Further, the study of "Fraudulent Financial Reporting: 1998-2007 (2010) by COSO examined nearly 350 alleged accounting fraud cases investigated by the SEC, and they found that CEOs and CFOs were involved in 89% of the fraud cases. Within two years of the completion of the SEC investigation, about 20% of CEOs and CFOs have been indicted and over 60% of those indicted were convicted. Another survey conducted by Association of Certified Fraud Examiners (ACFE) Report to the Nation on Occupational Fraud and Abuse (2008) reported that the executive and upper management level employees are more likely to be involved in corruption and fraudulent statement. Over 25% of all executive level cases were related to fraudulent financial statements.

Financial reporting fraud is the least prevalent, but it is the most costly form of fraud, with the average dollar loss of more than USD250 million per incidence of fraud (KPMG the Fraud Survey, 2003). The Association of Certified Fraud Examiners (ACFE) Report to the Nation on Occupational Fraud and Abuse (2012)

stated that financial statement fraud constitute 7.6% (4.8% in 2010) of all cases studied, but it is the most costly form of fraud. In 2012, the median loss caused by fraudulent statement mentioned by the study was USD1 million (USD4.1 million in 2010), whereas asset misappropriation and corruptions constitute USD120,000 (USD135,000 in 2010) and USD250,000 (USD250,000 in 2010), respectively. Further, Ernst and Young's 9th Annual Global Survey (2006) commented, "While occurring less often than other type of fraud, financial statement fraud frequently does the most harm to organizations". According to Albrecht, Albrecht, Dolan, and Malangueno (2008), when a company manipulates its financial statements, the market value of the company's stock usually drops considerably, sometimes by as much as 500 times the amount of the fraud.

The increase of fraud cases could also be shown by a lower Corruption Perceptions Index (CPI) issued by Transparency International (2011). It showed that Malaysia had a score of 4.30 out of 10, which placed Malaysia in the 60th position among 183 nations surveyed. There was a fall of 0.10 (from 4.40) point from previous year. The cause of this decline was due to the increase in fraud cases prior to 2009, which was linked to poor or biased external and internal auditing systems (Haron, 2010) as shown in Table 1.1.

Table 1.1  
*Malaysia's Corruption Perception Index*

Year	Ranking	No. of Countries	Score
2000	36	90	4.80
2001	36	91	5.00
2002	33	102	4.90
2003	37	133	5.20
2004	39	146	5.00
2005	39	159	5.10
2006	44	163	5.00
2007	43	179	5.10
2008	47	180	5.10
2009	56	180	4.5
2010	56	178	4.5
2011	60	183	4.5

*Notes.* Adapted from Transparency International, 2001.

The recent accounting scandals occurring in prominent companies such as Enron, HealthSouth, Tyco, Worldcom, seemed to indicate the flaws in accounting profession, corporate governance, and regulatory bodies, which consequently have shaken the confidence of investors. Many of these of companies are forced to file for bankruptcy. Reported earnings are unreliable due to the increase in the frequency of earnings restatements by firms (Agrawal & Chadha, 2005). There are an increasing number of restatements (Plumlee & Yohn, 2010).

In the United States, the restatement of financial statements almost doubled from 2004 (616) to 2005 (1,195), representing almost 8.5% of publicly traded companies. The three areas responsible for restatements were equity, revenue recognition, and misclassification (Apostolou & Crumbley, 2008).

In Malaysia, several companies have been publicly reprimanded by the Securities Commission and they have been directed to rectify and to reissue their

financial statements. These companies include NasionCom Holding Berhad, MEM Technology Berhad, Oilcorp Berhad, and Talam Corporation Berhad. For example, NasionCom Holding Berhad's (NHB) group revenue of RM194,984,186 as reflected in its 2005 financial statements comprised sales totalling RM143,109,727. These sales that were not transacted but were recorded in the financial statements of two NHB subsidiaries, namely, Nasioncom Sdn. Bhd. and Express Top-up Sdn. Bhd. NasionCom Holding Berhad was asked to rectify and to reissue its financial statements for the financial year ended 31 December 2005 (Securities Commission, 15 February, 2007).

In Malaysia, there have been cases of public accounting related irregularities in companies such as Transmile Group Berhad and Megan Media Berhad which have put pressure on the role of auditors in the accounting profession. For example, there were alleged misappropriation of funds amounting to RM36.3 million by a former managing director of Multi-Code Electronics Industries (M) Bhd., claims of fraud and fictitious sales in Transmile Berhad, and alleged missing or destroyed accounting records at OCI Bhd. by its previous management. The accounting scandals have eroded the trust of shareholders and stakeholders in the affected companies as well as the integrity of the capital market, the regulators, and the profession was also questioned.

### **1.3 Corporate Governance, Legal and Regulatory Improvements in Malaysia**

In the intention to restore the investors confidence, several efforts have been taken to reform the corporate governance. Good corporate governance starts with an organization having a good oversight structure. The chair of the Securities

Commission (SC) Malaysia, Tan Sri Zarinah Anwar, said in the SC Annual Report 2009, on 19 March 2010, that the key elements to improve corporate governance practice lies in shaping Boards to be more effective in providing leadership on corporate governance. The SC has reviewed the board structures of the Malaysian public listed companies and found the following weaknesses:

- (a) independent directors who are related to each other;
- (b) independent directors with tenures exceeding 30 years;
- (c) the chairperson and the CEO are related;
- (d) the independence of the board being compromised due to too many executive directors;
- (e) an individual serving in an executive director capacity in more than one company and in large boards.

The findings showed that many of the public listed companies have chosen merely to comply with the form rather than the substance of the Malaysia Code of Corporate Governance.

Malaysia has undertaken various actions to strengthen the legal and regulatory frameworks to restore investor confidence and enhance corporate transparency and accountability. One of the initiatives taken was the introduction of the Capital Market Services Act 2007 (CMSA), which consolidates part of the Securities Commission Act (SCA), the Securities Industry Act, and the Futures Industry Act, to come into force.

Further, the Securities Commission put continuing efforts in improving the quality and governance of the public listed companies by bringing three important

regulatory developments. In 2009, the Parliament passed amendments to the securities laws. First, the Audit Oversight Board (AOB) was established. The AOB provides an independent oversight over auditors who audit public interest entities, which include public listed companies, banks, insurance companies, and capital market intermediaries. Second, two new provisions under the sections (317A and 320A) were introduced. These provisions were added to the Capital Markets and Service Act (CMSA) to pursue corporate governance transgressions which was previously limited to disclosure type offences (Securities Commission, 19 March, 2010). Third, whistleblower provisions and protection Bill was passed by the Malaysian parliament under Whistleblower Act 2010, embodied in the Capital Market and Service Act 2010, which protects informants who provide confidential information to the government. Fourth, the Malaysian Institute of Accountants (MIA) has set up the Practice Review Committee in 2002 to monitor the quality of work performed by external auditors. Further, MIA also set up the Ethics Standards Board on June 2009 for issuing professional and ethical standards.

The Malaysian Code of Corporate Governance (the Code) was introduced in March 2000 with the intent to strengthen the governance framework of publicly listed companies, which made it mandatory for public listed companies to publish a Statement of Corporate Governance in their annual report. In cases where companies do not adhere to the Code, the companies need to explain the noncompliance and furnish the alternative mechanism deployed. The Malaysian Code of Corporate Governance was revised in 2007 to strengthen the board of directors and audit committees in discharging their roles, responsibilities, and the internal audit function. On July 2011, the Securities Commission Malaysia (SC) released the Corporate Governance Blueprint 2011 to strengthen self- and market discipline and to promote

good compliance and corporate governance culture. More recently, the new Malaysian Code on Corporate Governance 2012 (MCCG 2012) was released and supersedes the MCCG 2007.

#### **1.4 Factors Contributing to Fraudulent Financial Reporting**

The recent corporate governance scandals that contributed to the collapse of large organizations such as Enron, WorldCom, Adelphia, Parmalat, and HealthSouth, resulted from proven or alleged financial reporting frauds committed and then concealed by senior executives. Empirical evidence shows that weak corporate governance is associated with financial reporting fraud (e.g., Beasley, 1996; Dechow et al., 1996). Mitton (2002) associated weak corporate governance as one of the causes of the East Asian financial crisis. This was supported by Haron (2010) who found poor corporate governance and unethical practices as the main cause of the Asian financial crisis. Rezaee (2002) claimed that financial statement fraud cost market participants more than USD500 billion in the late 1990s. Senior management fraud is the most costly type of fraud. Senior managers might perpetrate financial statement falsifications to deceive investors and lenders, or to inflate profits and thereby gain higher salaries and bonuses.

Fraud can be categorized into fraud committed against an organization and fraud committed on behalf of an organization (Albrecht & Albrecht, 2004). Fraud committed against an organization is the result of employee misconduct such as embezzlement and management deception. Fraud committed through actions of top management to deceive financial statement users is known as fraudulent financial reporting. Fraudulent financial reporting as elaborated in ISA 240 (MIA, 2006)

involves intentional misstatements including omissions of amounts or disclosures in financial statements to deceive users of the financial statement.

Research on fraud has focused on the detection of fraud or explanation of the factors leading to fraud. Previous studies have examined the detection of fraudulent financial reporting using either financial ratios or nonfinancial factors relating to corporate governance (Grove & Basilico, 2008).

Corporate governance is one of the factors leading to fraud. Prior studies have examined the relationship between governance and fraudulent financial statements (Beasley, 1996; Abbott & Parker, 2000; Sharma, 2004; Farber, 2005; Persons, 2005; Wan Ismail, Dustan & Zijl, 2009). Persons (2005) investigated the likelihood of financial statement fraud and five corporate governance characteristics which are part of the new corporate governance rules of the Sarbanes-Oxley Act. The likelihood of financial statement fraud was found lower when audit committee solely comprised independent directors and audit committee members holding fewer directorships in companies. On the other hand, Farber (2005) examined the association between the detection of financial reporting fraud and subsequent improvements in the quality of governance mechanisms. The study found that fraud firms take actions to improve their governance, and in three years after fraud detection the firms would have good governance characteristics, in terms of the number and percentages of outside members on the board. Furthermore, they tend to hold more audit committee meetings than the nonfraud firms. Wan Ismail et al., (2009) found that after the implementation of the Malaysian Code of Corporate Governance in 2001, the size of the board of directors and the size of audit committees are positively associated with the earnings quality.

Further, several studies have used financial statements to identify factors associated with fraudulent financial reporting (Courtis, 1978; Persons, 1995; Dechow, Sloan, & Sweeney, 1996; Beneish, 1997; Summer & Sweeney, 1998; Spathis, 2002; Kaminski, Wetzel, & Guan, 2004; Skousen, 2004). Persons (1995) found that financial leverage, capital turnover, asset composition, and firm size are significant factors. He found support that fraud firms are less profitable than nonfraud firm. Kaminski et al. (2004) found that profitability ratios measured by gross profit over sales are not significant, whereas the two ratios of net income over total assets and retained earnings over total assets are significant for year two and year three fraud year. This is apparently an empirical evidence of the limited ability of financial ratios to detect and predict the occurrence of fraud.

Some studies have used financial ratios and nonfinancial factors relating to corporate governance such as studies by Crutchley, Jensen, and Marshall, 2007; Grove and Basilico, 2008; Gaganis, 2009. Grove and Basilico (2008) used five financial indices and corporate governance factors. They found that for the fraud firms, the gross margin index indicated the most red flags, that is, 72% of the time. They also found that three corporate governance factors were significant, that is, percentage of board members common stock holdings held by insiders, insiders having greater than 50% control of the board, and the CEO being the chairman of the board.

The present study intends to find the association of financial performance factor, that is, profitability, environmental factors, and corporate governance factors to fraudulent financial reporting.

Another factor which could influence the occurrence of fraudulent financial reporting is internal control quality of an organization. In most major fraud cases, the companies had poor internal controls over financial reporting. Internal control systems are corporate governance mechanisms set to protect the attainment of the firm's objectives (Beretta, Bozzolan & Michelon, 2008). Internal control reporting requirement is important because of the belief that internal controls ensure the credibility of financial reporting and it could restore investor's confidence in financial reporting. Anecdotal evidence shows that internal control deficiencies lead to fraudulent financial reporting. For example, an overview of COSO Research Study, "Fraudulent Financial Reporting: 1998 – 2007," an analysis of U.S. Public companies, reasserted that a poor internal control environment contributes to the occurrence of fraud documented for the 10-year period. Further, ACFE (2008) found that lack of internal controls is the most commonly cited control weakness in all three major occupational fraud categories, that is, asset misappropriation, corruption, and fraudulent financial statements. In Malaysia, the new MCCG 2012 on principle one suggests that the board has to ensure that there is a sound framework of reporting through internal controls and regulatory compliance.

### **1.5 The Problem Statement**

The recent corporate governance scandals that contributed to the collapse of large organizations such as Enron, WorldCom, Adelphia, Parmalat, and HealthSouth, resulted from proven or alleged financial reporting frauds committed and then concealed by senior executives. Empirical evidence shows that weak corporate governance is associated with financial reporting fraud (e.g., Beasley, 1996; Dechow et al., 1996). Mitton (2002) associated weak corporate governance as one of the

causes of the East Asian financial crisis. This was supported by Haron (2010) who found poor corporate governance and unethical practices as the main cause of the Asian financial crisis. Rezaee (2002) claimed that financial statement fraud cost market participants more than USD500 billion in the late 1990s. Senior management fraud is the most costly type of fraud. Senior managers might perpetrate financial statement falsifications to deceive investors and lenders, or to inflate profits and thereby gain higher salaries and bonuses.

The collapse of a number of companies as a result of accounting manipulation by managers has raised serious questions about the effectiveness of the monitoring mechanism to protect investors' interests and to control managerial opportunistic behaviour. The monitoring devices include different corporate governance factors such as independent directors on corporate boards, independent audit committees, and other factors that may affect the share of power within the board. In addition to the previous factors that had been examined by previous researchers, quality of internal control system also contribute to the occurrence of fraudulent financial reporting (COSO, 1998-2007; ACFE, 2008).

This research is different from prior studies in that it studies occurrences of fraudulent financial statement in a number of ways. First, prior studies focused on corporate governance factors alone, or financial ratios in relation to fraudulent financial statement. This study uses financial ratio, nonfinancial ratios relating to corporate governance mechanisms, and external environmental factors in determining which factors are significant in contributing to fraudulent financial reporting.

Second, this study includes internal control quality as a part of corporate governance variables being examined, which has never been considered by previous researchers. Studies by Saksena (1997, 2001, 2003) have examined the relationships between financial performance factors, environmental factors and corporate governance factors that may lead to the incidence of management fraud. However, he did not include internal control as one of the variables. Therefore, this study introduces a new variable, namely, internal control quality as one of the corporate governance factor, which may impact instances of fraudulent financial reporting.

Third, previous studies had examined the fraudulent financial reporting using agency theory. This study uses both agency theory and fraud triangle theory that is incentive or pressure, opportunity and rationalization in developing the independent variables to fraudulent financial reporting.

Fourth, previous studies on fraudulent financial reporting have selected the fraud companies using public releases such as Accounting and Auditing Enforcement Releases (AAERs) in the US (Beasley, 1996; Dechow et al., 1996; Green & Choi, 1997; Fanning & Cogger, 1998; Beasley, Carcello and Hermanson, 1999; Beneish, 1999; Abbott & Parker, 2000; ; Feroz, Kwon, Pastena & Park, 2000; Cullivan & Sutton, 2002; Dunn, 2004; Persons, 2005). However, in this study a comprehensive sample of companies that experienced fraud during 2001 to 2009 is identified from Malaysian Securities Commission (SC) website and from newspaper releases. The process of selecting and identifying fraud companies involved manually reading and reviewing the print version of SC cases, newspaper, electronic media releases, annual report, and articles from 2001 to 2009.

Therefore, this study intends to investigate the association between corporate governance mechanisms, financial factors, environmental factors, internal control quality factor and fraudulent financial statements. This study does not intend to develop a model for predicting fraudulent financial reporting. However, the study tries to identify the determinant factors, or the factors which contribute most to motivate management to commit fraudulent financial reporting.

### **1.6 Research Objectives**

The following are the specific research objectives of this study:

1. To examine the relationship between internal company's profitability and occurrence of fraudulent financial reporting.
2. To examine the relationship between external environmental factors and occurrence of fraudulent financial reporting.
3. To examine the relationship between corporate governance mechanisms and occurrence of fraudulent financial reporting.
4. To examine the relationship between internal control quality and occurrence of fraudulent financial reporting.

### **1.7 Research Questions**

This study seeks to find the answers to the following research questions.

1. What is the relationship between company's profitability and occurrence of fraudulent financial reporting?

2. What is the relationship between external environmental factors and occurrence of fraudulent financial reporting?
3. What is the relationship between corporate governance mechanisms and occurrence of fraudulent financial reporting?
4. What is the relationship between internal control quality and occurrence of fraudulent financial reporting?

## **1.8 Significance of the Study**

The significance of this study could be viewed in terms of its theoretical and practical contributions towards fraudulent financial reporting in Malaysia.

### **1.8.1 Theoretical Significance**

Fraudulent financial reporting which is the focus of the study is a problem that concerns regulators, the investing public, and the accountancy profession. This study uses the agency theory in explaining the relationship of the independent variables, namely, profitability, environment factors, and corporate governance factors, while and dependent variable, that is, fraudulent financial reporting. It also uses fraud triangle theory, that is, incentives, opportunities, and rationalization of a fraudster in committing fraud in identifying the independent variables. Previous studies have shown the importance of internal control system in deterring fraud, however, none of the current studies have tested internal control as a variable that could contribute to fraudulent financial reporting. Therefore, using the agency theory, the study introduces a new variable, that is, internal control quality, as one of the causes of fraudulent financial reporting.

### 1.8.2 Practical Significance

Fraudulent financial reporting could have an impact on any organizations and individuals who have financial interest in the company. They rely on the financial statements of the company to make investment decisions. Therefore, the failure or success of the company may influence their returns on investment in the company. The public loses trust in the company and its top management, while the survival or going concern of the company becomes doubtful.

This study explores the relationship between corporate governance factors, financial factor, environmental factors, corporate governance factors, and the likelihood of fraudulent financial reporting by companies in Malaysia. This study foresees the significant influence of all these factors on likelihood of fraud, which will be beneficial to regulators such as the Securities Commission, the investing public, practitioners such as Malaysian Institute of Accountants, and academicians. They could use this evidence and the results of this research as a reference to improve rules and regulations, and corporate governance awareness.

This study also explores the internal and external corporate governance mechanisms such as the effectiveness of board of directors, the audit committees, and external auditors in companies that experience fraud. Further, this study introduces internal control quality as a part of corporate governance variable, which has been neglected by previous researchers. This could give some insight in improving specific corporate governance factors which could be used in mitigating fraud.

## 1.9 Scope of the Study

This study is limited to public listed of companies in Malaysia. The focus of the study is to examine the association of company's profitability, corporate governance mechanisms that include board of directors, audit committees, internal control quality, and fraudulent financial reporting.

Insider stock ownership by the directors is measured using direct shares ownership only. Other studies such as Gardner, Hussin, McGowan, Mohd Sanusi, and Sulong (2012); Johari, Salleh, Jaffar, and Hassan (2008); Sulong and Mat Nor (2008), also used direct shares ownership only.

In examining the relationship between corporate governance mechanisms and fraudulent financial reporting, agency theory was used to hypothesize and explain the relationships and fraud triangle theory was used to identify the independent variables. For example, when there is a weakness in the internal control system such as no segregation of duties, there is always an opportunity to the fraudster to commit fraud.

This research is using logistic regression since the dependent variable is measured using dichotomous that is firms involve in fraudulent financial reporting and firms free from fraudulent financial reporting. Using simple logistic regression, variables are selected. Then, check for multicollinearity, linearity of numerical independent variables and two-way interactions. Next, assess the goodness of fit of the model using Hosmer-Lemeshow test, the classification table and the area under ROC curve. Perform diagnostic and influential analysis to identify the subsets of data

that appear to have a disproportionate influence on the estimated model. Outliers value shall be deleted from the model and establishing the final model.

#### **1.10 Organization of the Chapters**

This study consists of six chapters. The beginning chapter, Chapter 1, presents a brief introduction on the background of the study that explains the fraud trends in Malaysia and worldwide and the factors which contribute to the fraudulent financial reporting. This chapter also reviews the corporate governance, legal and regulatory improvements in Malaysia, fraud detection, and fraudulent financial reporting. It also highlights the problem statement, objectives, and significance of the study.

Chapter 2 defines fraud, fraudulent financial reporting, corporate governance mechanisms, and official pronouncements in Malaysia. Chapter 3, reviews on literature and previous researches of fraud detection, agency theory, fraud triangle theory, organization profitability, environmental influences, corporate governance mechanisms including internal control quality, and official pronouncements. It also includes research conceptual framework, research hypothesis and previous evidence on the relationship of all the factors mentioned, and fraudulent financial reporting.

Chapter 4 illustrates the research methodology employed in attempting to answer the research questions. It includes the research design, population and sample selection, variables definition and measurements, data sources, and statistical analysis. Chapter 5 presents the results of data analysis through statistical tests and their interpretation. It also presents the result of hypothesis tests.

Finally, Chapter 6 discusses the results of the hypotheses tested, implication of the study on theory and practical, limitations of the study, suggestions for future research, and lastly, the conclusion.

## CHAPTER 2

### FRAUDULENT FINANCIAL REPORTING, CORPORATE GOVERNANCE AND OFFICIAL PRONOUNCEMENTS

#### 2.1 Introduction

This chapter discusses the different types of fraud, definition of fraudulent financial reporting, the perpetrators, why fraudulent financial reporting is committed, the form or methods of fraudulent financial reporting, and the consequences after committing fraud. It also defines corporate governance issues and discusses the factors that influence good corporate governance including oversight function of board of directors, audit committees, the managerial duties, the internal and external audit functions. Next, definition of fraud, fraudulent financial reporting, the quality of internal audit systems and requirements. Lastly, this chapter ends with explanation of the activity of legislative and regulatory bodies and pronouncement in Malaysia.

#### 2.2 Fraud, Occupational Fraud, and Fraudulent Financial Reporting

##### 2.2.1 Occupational Fraud and Fraudulent Financial Reporting

There are many different types of fraud, and there are many ways to characterise fraud. However, frauds can be commonly classified into (a) fraud committed against an organisation and (b) fraud committed on behalf of an organisation. Employee fraud is where the employees directly or indirectly steal from their employers and the victim of the fraud is the employer. On the other hand, fraud committed on behalf of an organisation and usually through actions of the top management is known as fraudulent financial reporting or financial statement fraud. Figure 2.1 shows the two types of fraud that summarize the various frauds that occur.

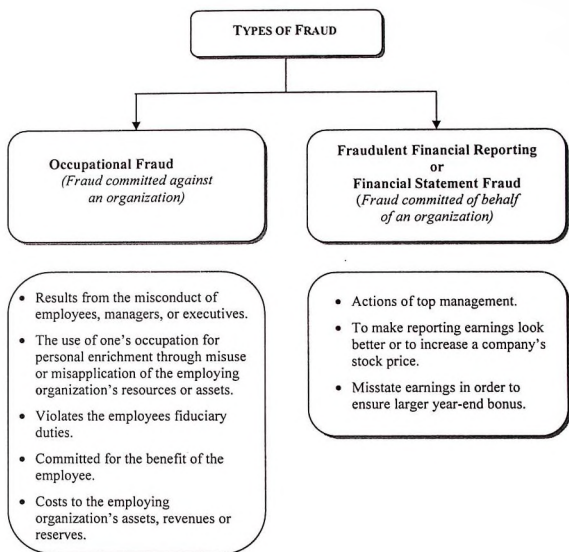


Figure 2.1. Types of fraud. Adapted from *Fraud Examination and Prevention* (p. 7), by A. A Albrecht and B. B. Albrecht, 2004, Thomson South-Western.

The Association of Certified Fraud Examiners (ACFE) classifies fraud as occupational fraud. The Association of Certified Fraud Examiners (1996) in the Report to the Nation on Occupation Fraud and Abuse (ACFE) defines occupational fraud as “The use of one’s occupation for personal enrichment through the deliberate misuse or misapplication of the employing organisation’s resources or assets” (p. 6). Further, it states “The key to occupational fraud is that the activity (1) is clandestine,

(2) violates the employee's fiduciary duties to the organisation, (3) is committed for the purpose of direct or indirect financial benefit to the employee, and (4) costs the employing organisation assets, revenues, or reserves" (p. 6). The ACFE includes three main categories of occupational fraud. First, asset misappropriations that involve stealing or misusing of an organisation's resources; second, fraudulent statements that involve the intentional misstatement or omission of material information from the organization's financial reports, and third, corruption, which fraudsters use their influence in business transaction in a way that violates their duty to their employers to obtain a benefit for themselves or someone else.

Rittenberg, Schwieger, and Johnstone (2008) defined corruption as fraud in which fraudsters wrongfully use their influence in a business transaction to procure some benefits for themselves or another person, contrary to their duty to their employer or the rights of another. There are four categories of corruption, namely (1) conflicts of interest, (2) bribery, (3) illegal gratuities, and (4) economic extortion. A conflict of interest occurs when an employee, a manager, or an executive has an undisclosed economic or personal interest in a transaction that adversely affects the company. Illegal gratuities are similar to bribes, but they are not necessarily with an intention to influence a business decision. For example, a person of influence could be given an expensive gift, or free vacation for her influence in a negotiation or business deal, but the gift is made after the deal is over. Corruption and bribery are often linked with fraud schemes in the purchasing area and with government officials. Economic extortion is when the employee demands payment from a vendor to favour the vendor.

Fraudulent financial reporting is characterised by intentional misstatements or omissions of amounts or disclosures in financial reporting to deceive financial statement users. More particularly, when financial statements are prepared, they involve manipulation, falsification, or alteration of accounting records or supporting documents. The Treadway Commission (1987, p. 2) defined fraudulent financial reporting as the "... intentional or reckless misconduct, whether act or omission that results in materially misleading financial statements. It may entail gross and deliberate distortion of corporate records and the misapplication of accounting principles."

Rittenberg et al. (2008) defined fraud into broad categories, that is, defalcations and financial reporting fraud. Defalcation is defined as when an employee takes assets from an organization for personal gain. Rittenberg et al. (2008) further defines fraudulent financial reporting or financial reporting fraud as "intentional manipulation of reported financial results to portray a misstated economic picture of the firm. Figure 2.2 shows the fraud classification by Rittenberg et al. (2008). Further, according to Soltani (2007, p. 534) fraudulent financial reporting involves intentional misstatement including omissions of amounts or disclosures in financial statements, designed to deceive financial statement users, where the effect causes the financial statements not to be presented, in all material respect, in conformity with generally accepted accounting principles.

According to the study conducted by the Association of Certified Fraud Examiners (2006), cases involving fraudulent financial reporting were the least commonly reported. Only 120 cases were reported representing 10.6% of all cases; however, the median loss was the largest at 2 million USD. These frauds were