

PRE FRAUD: AN EMPIRICAL IN MALAYSIA

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Abstract

The paper specifically examines the pre fraud firms' characteristics for over 3 years before fraud occurred. Selections of companies were made from Securities Commissions' enforcement actions released between the years 2000 until 2008. A matched pair sampling was made with the control group, and 192 firms' observations were made. Findings revealed that there were decreased in cash flow as well as lesser number of board sizes during the three years before the fraud for fraud firms. In addition, roles of independent directors may lessen the impact of fraud.

Key words: *Fraud, board size, long term debt, firm size.*

JEL Classification: M40, M42, M48, J24.

1. INTRODUCTION

The aim of this study is to empirically investigate fraud firms' characteristics before the fraud occurred. The purpose is to examine signals or red flags that exist among fraud firms such as their audit committee size, audit committee independence, board's size, independent directors, block holders, cash flows, long term debts, sales and firm size. Companies of fraud firms were identified from the Securities Commission enforcement actions from year 2000-2008, specifically for companies that were related in producing fraudulent financial reporting. Finding reveals that roles of independence directors may lessen the impact of fraud.

This paper is organised as follows: the following section discusses the literature review on fraudulent financial reporting, followed by framework and hypothesis. In the next section, the research method is explained briefly, followed by analysis of results and discussion. The final section will briefly explain the implication and provide the conclusion.

2. FRAUDULENT FINANCIAL REPORTING

Issues on corporate governance have grown a long way since the 1970s starting from financial reporting, until it evolves to fraudulent financial reporting and Malaysia is no exceptional. As an emerging economy, fraudulent reporting is undeniably difficult to restrain from even though the implication was not as massive as Enron debacle. But still, many stakeholders will be affected.

In Malaysia, various studies performed had included many aspects of fraud's background such as Nelson (2011) had proxied fraud as a measure for financial reporting quality when examining the audit committee expertise effectiveness and documented certain aspects of audit committee that are significant to fraud. On the other hand, Nor *et al.* (2010), examined the relationship between fraudulent financial reporting and firms' characteristics such as size, type of ownership and audit quality in companies audited by the Inland Revenue Board of Malaysia (IRBM) after the implementation of a self assessment system in Malaysia. A qualitative study conducted by Kassim and Khalid (2010), examined the influence of the concept of 'taklif' to accountants in preventing fraudulent financial reporting and auditing. Whilst, an empirical study by Arshad and Othman (2011) examined the propensity of financial reporting fraud as a proxy of regulatory efforts in enhancing the quality of financial reporting which include the influence of ownership structure and capital structure on the likelihood of financial reporting fraud.

The current study extends current fraud literature by investigating corporate governance in association to financial reporting quality proxy by fraudulent financial reporting. At the same time, contributes to the current literature by examining the boards' and firms' characteristics during pre of fraud year, when most literature mainly focused on the year fraud occurred.

3. SAMPLE SELECTION AND DATA COLLECTION

The sample is limited to publicly traded firms because listed companies represent wider stakeholders such as public at large, other institutional holders, and regulators. The study had identified 32 fraud firms similar to prior studies (see Nelson, 2011), consistent with prior literature (see Erickson *et al.*, 2006; Owens-Jackson *et al.*, 2009). The small sample companies are consistent with Peyrefitte *et al.* (2002) with a final sample of 66 and Mustafa and Youssef (2010) at 28 cases of misappropriation of assets. Data was hand collected via annual reports.

For each firms, information regarding board's and firm's characteristics were identified for three consecutive years before the fraud's year. Hence, the study arrives to 192 firms' observations, including their control group. Subsequently, based on a match pair sampling (1:1) and a dichotomous dependent variable, a logistic regression is most appropriate for further investigation.

4. ANALYSIS OF RESULT

4.1 Descriptive

Table 1 shows the relevant sectors involved in the fraud sample for the period of 2000 to 2008. Trading and Services sector and Industrial products, show highest percentage at 18.8 percent consecutively. Both sectors involve with high volume and basically companies with trading items and products, therefore the possibility of the high volume and exposure to risks, causes these two sectors have higher number of fraud occurrences.

Table 2 shows the descriptive analysis and basic parametric test of F and T tests. Only one variable shows significant p values in the both tests, i.e. LTDEBT. In addition, CASHFLOW is marginally significant in the F-test. It may be conclude that, long term debt and cash flow may be useful variables to distinguish between fraud and non fraud firms.

Table 1 Sectors

Sectors	Frequency	Percentage
Construction	5	15.6
Consumer products	5	15.6
Finance	4	12.5
Industrial products	6	18.8
Plantation	2	6.3
Properties	2	6.3
Technology	2	6.3
Trading & Services	6	18.8
Total	32	100.0

Table 2 Descriptive analysis

*, **, significant at 5%, 1% level.

<i>Variable</i> <i>N=192</i>	<i>Mean</i>	<i>S.D.</i>	<i>F-test</i> <i>(p-value)</i>	<i>T-test</i>
ACSIZE				
Fraud	2.58	1.519	2.070	0.724
Non fraud	2.67	1.733	(0.152)	
ACINDP				
Fraud	0.519	0.326	0.235	0.493
Non Fraud	0.487	0.326	(0.628)	
BOARDSIZE				
Fraud	5.35	3.337	1.736	0.714
Non fraud	5.54	3.719	(0.189)	
INED				
Fraud	0.264	0.212	0.282	0.813
Non fraud	0.271	0.217	(0.596)	
BLOCK				
Fraud	27.42	26.56	2.620	0.309
Non fraud	31.50	28.84	(0.107)	
CFO(RM)				
Fraud	15.1m	59.7m	2.375	0.211
Non fraud	33.9m	134m	(0.125)*	
LTDEBT (RM)				
Fraud	126m	3.31m	13.618	0.043*
Non fraud	49m	1.56m	(0.000)**	
SALES(RM)				
Fraud	194m	2.8m	0.364	0.980
Non fraud	192m	5.4m	(0.547)	
FIRMSIZE(RM)				
Fraud	530m	8.9m	2.187	0.453
Non fraud	130m	1.0m	(0.596)	

Table 3 Correlation (N=192)

	FRAUD	AC SIZE	AC INDP	BOD SIZE	INED	BLOC K	CFO	LT DEBT	SALES	FIRM SIZE
FRAUD	1	-0.025	0.050	-0.027	-0.017	-0.074	-0.091	0.146*	0.002	-0.054
AC SIZE		1	0.699**	0.736**	0.650**	0.439**	0.078	0.196**	0.258**	0.047
ACINDP			1	0.767**	0.668**	0.605**	0.161*	0.234**	0.248**	0.141
BODSIZE				1	0.550**	0.568**	0.152*	0.197**	0.319**	0.088
INED					1	0.268**	0.035	0.200**	0.161*	0.098
BLOCK						1	0.282**	0.157**	0.325**	0.132
CFO							1	0.116	0.109	0.109
LTDEBT								1	0.447**	0.061
SALES									1	0.018
FIRMSIZE										1

*** , * , significant at 1% , 5%*

4.2 Correlation Analysis

Table 3 shows the correlation analysis. Only one variable is significantly correlated with fraud, i.e., LTDEBT. Long term debt is significant positively related with fraud, suggesting that higher amount of debt would increase the number of fraudulent financial reporting. In contrary, audit committee size, board size, independent director, block holder, cash flow and firm size are negatively related with fraud. Even though the results are negatively related, however all results show non significant relationship with fraudulent financial reporting.

4.3 Analysis of results and discussion

Table 4 shows the multivariate analysis from a logistic regression. The model is a good and reliable model based on the goodness of fit shown by the pseudo R, at 13.3%, and the non significant of Hosmer and Lemeshow test, with 59.4% correct prediction.

Three of the variables, are firms' financial variables that are significant at 1% and 5% significant level. They are BOARD SIZE, CASHFLOW and FIRM SIZE. Both BOARD SIZE and CASHFLOW are negatively significant with fraud. Board's size negative association with fraud may suggest that for fraud companies, prior to fraud, they have lesser board members. Perhaps the firms thought as non importance to have larger board size, similar as what was suggested by Haniffa and Hudaib (2006) that a large board is seen as less effective in monitoring performance.

In addition, the negative relationship of operating cash flow with fraud, may suggest that prior to fraud, fraud firms tend to spend less on operating activities. According to Lee and Yeh (2004), the recurring negative cash flow from operations or an inability to generate cash flow from operations while reporting earnings and earnings growth may induce management to commit financial statement fraud.

Table 4 Logistic Regression

$$\text{FRAUD} = \alpha + \beta_1 \text{ACSIZE} + \beta_2 \text{ACINDP} + \beta_3 \text{BOARDSIZE} + \beta_4 \text{INED} + \beta_5 \text{BLOCK} + \beta_6 \text{CASHFLOW} + \beta_7 \text{LTDEBT} + \beta_8 \text{SALES} + \beta_9 \text{FIRMSIZE} + \beta_{10} \text{DUMMY YEAR Pre 1} + \beta_{11} \text{DUMMY YEAR Pre 2} + \varepsilon_i$$

Independent Variable	Coef.	Wald χ^2
Intercept	-0.215	0.602
ACSIZE	-0.071	0.654
ACINDP	1.202	0.226
BOARDSIZE	-0.221	0.036*
INED	-1.849	0.102
BLOCK	-0.298	0.351
CASHFLOW	-0.143	0.009**
LTDEBT	-0.090	0.433
SALES	0.121	0.216
FIRMSIZE	0.322	0.014
DUMMY YEAR PRE 1	0.082	0.836
DUMMY YEAR PRE 2	0.236	0.539
N	192	
Cox & Snell R square	0.100	
Nagelkerke R square	0.133	
Hosmer and Lemeshow test	0.380	
Correct predictions	59.4	

** , * significant at 1%,5% level.

Note :**ACSIZE**=Number of AC member; **ACINDP**=Proportion of independent AC members to size of AC; **BODSIZE**=Number of directors on board; **INED**=Proportion of independent directors on board; **BLOCK**=Number of block holders (5% and more); **CFO**=Operating cash flow; **LTDEBT**=Long term liabilities; **SALES**= Sales or turnover; **FIRMSIZE**=Natural log of firm' total assets. AC=audit committee.

On the other hand, FIRM SIZE is positively significant with fraud. This may suggest that before the fraud occurred, the companies initially increased their assets in order to increase firm's value.

Another important determinant pre fraud is independent director. It was marginally supported in the regression. This result may suggest the roles of independent directors in recuperating tendency of fraud activities. The independent non-executive directors' existence would limit managerial opportunism in fraud

tendency and result in more effective board monitoring (Fama and Jensen, 1983). Hence, provide weak evidence to suggest the role of independent directors to promote lesser fraud.

5. CONCLUSION AND RECOMMENDATIONS

It may be suggested for future research, roles of independence directors in an organisation be expanded, and how their influence may lessen the impact of fraudulent financial reporting. Furthermore, other than utilising the dominant agency theory, other theories that may be useful to explain why fraud firms spend lesser and shy away from larger board's size.

The study provides recent empirical evidence on the prevalent roles of independence directors before of fraudulent reporting. It may be conclude that in the three years' pre fraud; fraud firms increased their assets but lacked the appropriate control and advantages of larger board, as well as independent directors to manage the companies' operating activities.

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