UNIVERSITI TEKNOLOGI MARA

MANAGEMENT PREDISPOSITION, MOTIVES, OPPORTUNITY AND EARNINGS MANAGEMENT FOR FRAUDULENT FINANCIAL REPORTING

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Thesis submitted in fulfillment of the requirements
for the degree of
Doctor of Philosophy

Faculty of Accountancy

December 2010

Abstract

This study investigates the factors that lead to the occurrences of fraudulent financial reporting. Specifically, this study examines the effect of predisposition (i.e. history of prior violations, related party transactions, and founders on the Board), motives (i.e. economic factor, ownership factors and political factor) and opportunity (i.e. poor corporate governance) on the occurrences of fraudulent financial reporting in Malaysia. In order to see the impact of predisposition, motives, opportunity and the occurrences of fraudulent financial reporting, 94 non-financial companies listed on Bursa Malaysia over the period 1996-2006, with complete data for predisposition, motives, and opportunity variables were selected. From the analysis conducted, the study finds that the corporate environment most likely to lead to an accounting fraud is characterized by factors that include fewer related party transactions, higher number of prior violations, higher proportion of founders on the board, higher level of financial distress, higher level of cross directorship and lower audit quality. The study also finds that firms with family and foreign investors are less likely to have enforcement actions against them. Despite the general belief that greater independence of the board is associated with a lower incidence of fraudulent financial reporting, this study finds no evidence that level of board independence plays a role in the potential for fraudulent financial reporting. In addition, the study finds that political connection is not a determinant of fraudulent financial reporting in Malaysia. To the best of the researcher's knowledge, this study is the first to test whether the practice of earnings management may escalate to the level of accounting fraud. Interestingly, the study provides evidence that earnings management has a positive and significant relationship with fraudulent financial reporting. This confirms that the practice of earnings management, in addition to other governance variables, affects the probability of fraudulent financial reporting. Furthermore, the findings reveal that fraud firms were consistently aggressive in their reporting practices for several years before the accounting fraud. Perhaps, the most interesting finding is the fact that this study is the first to report that the existence of founders on the board and the level of financial distress has both a direct effect as well as mediating effect through earnings management on the occurrences of fraudulent financial reporting. Overall, this study makes a contribution to the extant literature by evidencing that the occurrences of fraudulent financial reporting depend on the culture of an organization that tends to "push the envelope" in reporting earnings; as well as the efficiency of a bundle of governance mechanisms that an organization has that need to be explored from the agency theory perspective, while taking into account the unique institutional context of an Asian country. Finally, it is hoped that the study will benefit and help the regulatory bodies in formulating and improving the rules and laws, the companies in formulating the best corporate strategies and improving their system controls and the users of the financial information, especially the investors in making their financial decisions.

Acknowledgements

Praise to Almighty Allah who gave me the strength, patience and the ability to complete this thesis. Doing academic research is like mountaineering. At times, progress may feel difficult but the goal to reach the summit motivates one to press on. I look back on my climb towards a doctorate feeling great satisfaction. This climb would not have been possible without a safety harness and sound guy ropes. Thus, I am full of gratitude to those individuals who safeguarded my journey during my doctoral studies.

First, I am deeply indebted to Professor Dr. Rashidah Abdul Rahman and Professor Dr. Sakthi Mahenthiran for being such inspiring supervisors. Special thanks to Professor Dr. Rashidah Abdul Rahman for the enormous support she provided to me throughout my entire doctoral programme. I am greatly indebted for the number of hours she spent helping me to improve the quality of this thesis. She has been an incredible mentor as an academic advisor and an endless source of inspiration. It is difficult to overstate my gratitude to Professor Dr. Sakthi Mahenthiran. With his enthusiasm, his inspiration and his great efforts to explain things clearly and simply, he helped to make accounting numbers more interesting than I could have ever imagined. I really appreciate his guidance and readiness to help. His comments and suggestions have gone a long way in improving this research. I would have been lost without him.

Different versions of this study have been presented at several seminars and conferences. I would like to thank the participants at the AFAANZ Doctoral Colloquium in Gold Coast, Australia (2007) and at the 19th Asian Pacific Conference on International Accounting Issues (APCIA) Doctoral Colloquium in Kuala Lumpur (2007) for their valuable comments, suggestions and advice on the study. I also wish to thank the anonymous conference participants for their constructive comments at the JCAE/CAR Conference in Hong Kong (2009). I am especially grateful to Professor Dr. Ferdinand Gul, Prof. Suresh Radhakrishnan, and Prof T. J. Wong for their excellent comments and suggestions, which contributed significantly to my study.

I am also grateful to the University Teknologi MARA Young Lecturer Scheme Program for their financial support, which enabled me to work as a full-time doctoral student.

Finally, I owe my deepest gratitude to my family for providing me with an excellent base camp where I always felt safe and loved. I would like to thank my parents, Encik Hasnan Taib and Puan for their unwavering support and encouragement throughout my life. My deepest gratitude goes to my husband, Muhammad Shaifuddin Abdul Latiff, my daughter, Sofea Arisya and my twin boys, Amir Rayyan and Anas Rayyan for their love, constant encouragement, enduring patience and understanding throughout these years. With all of them on my side, I feel ready to reach for new heights in the future.

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CHAPTER ONE
INTRODUCTION

This chapter provides the background and motivation for the study. It also presents the objectives of the study in section 1.3, followed by the significance or contribution of this study in section 1.4. The chapter ends with section 1.5, which outlines the contents of this thesis.

1.1 INTRODUCTION

Fraudulent financial reporting has recently received considerable attention from the public, press, investors, financial community and regulators following the high profile reported fraud at large companies in the United States (U.S.) such as Enron Corporation, Global Crossing, WorldCom and Tyco as well as in other developed countries (e.g. Parmalat, Adecco, and Ahold in Europe). The United States General Accounting Office (GAO) Report in 2002 estimates that fraudulent financial reporting in the U.S. alone has cost investors more than US$500 billion in recent years. In addition, GAO estimates that loss of market capitalization resulting from the reported financial statement fraud committed by Enron, WorldCom, Qwest, Tyco and Global Crossing is about US$460 billion. More recently, the result of the fraud survey conducted by KPMG United States in 2009 revealed that the aftermath of the 2008/2009 global economic downturn further uncovered various forms of fraud and misconduct that caused investors to watch billions more vanish. Numerous surveys repeatedly report mind-blogging statistics on fraudulent financial reporting. However, these statistics by necessity are purely estimates, since not all cases of fraud are detected and not all detected cases are reported. In reality, the fraud problem may be even worse than the statistics suggest (Peterson, 2004).

Fraudulent financial reporting is defined as "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" (Treadway Commission, 1987). Basically, fraudulent financial reporting may