EFFECTS OF ABILITY TO ASSESS FRAUD RISK, FRAUD RISK LEVEL AND PERSONALITY FACTORS ON THE ABILITY TO DETECT THE LIKELIHOOD OF FRAUD

NAHARIAH JAFFAR.

GSM 2008 5
EFFECTS OF ABILITY TO ASSESS FRAUD RISK, FRAUD RISK LEVEL AND PERSONALITY FACTORS ON THE ABILITY TO DETECT THE LIKELIHOOD OF FRAUD

By

NAHARIAH JAFFAR

Thesis Submitted to the Graduate School of Management, Universiti Putra Malaysia, in Fulfillment of the Requirement for the Degree of Doctor of Philosophy

April 2008
The Malaysian Approved Standards on Auditing, AI 700 on “The Auditor’s Report on Financial Statements” (MIA, 1997) states that the responsibility of the auditor is to provide assurance that the financial statements are free from material misstatements. Misstatement may be due to error or fraud. Error is unintentional misstatement while fraud is intentional misstatement. Fraud, which can be divided into two types i.e. fraudulent financial reporting and misappropriation of assets, may both cause materially misleading financial statements (Elliot & Willingham, 1980).

In Malaysia, although standards and guidelines have been issued, yet fraudulent financial reporting still occurs in this country as reported by the KPMG Malaysia’s (2003) survey. Although the issue of fraud may not be well documented in Malaysia, this issue cannot be taken for granted since what happens in other countries, for instance in the US, may also happen elsewhere. Even though guidance has already been provided by the Malaysian standards, KPMG Malaysia’s (2003) survey reports that
external auditors discover only 4% of fraud incidences in Malaysian companies. Due to this, the public may question why external auditors are not able to detect fraud during the conduct of the annual audit. Therefore, it is important to know the ability of the external auditor to detect fraud because fraudulent financial reporting is false representation to society.

The AI 240 on “Fraud and Error” (MIA, 1997) requires the external auditor to appropriately assess fraud risk during the planning of the audit work so that he/she can provide reasonable assurance that any material misstatement in the financial statements has been detected. The ability of the external auditor to detect the likelihood of fraud may be influenced by his/her ability to appropriately assess the fraud risk. Meanwhile, the concept of fraud risk underlying the audit risk model would be fundamental in influencing the external auditors’ ability to detect the likelihood of fraud. In addition, literature has shown that personality moderates the relationship between a construct and job performance.

Therefore, the objective of the present study is to examine the effect of the external auditors’ ability to assess fraud risk on their ability to detect the likelihood of fraud. In addition, the present study examines the moderating effects of fraud risk level and personality factors on the relationship between the external auditors’ ability to assess fraud risk and their ability to detect the likelihood of fraud.
A within-subjects experimental approach was adopted. Research materials concerning a hypothetical audit client were developed in two versions, i.e. high fraud risk case scenario and low fraud risk case scenario. Two levels of fraud risk were developed in order to examine the effect of the contextual of fraud risk level on the relationship between the external auditors' ability to assess fraud risk and their ability to detect the likelihood of fraud. The research materials were mailed to practicing independent auditor, designated as audit partners or audit managers of auditing firms operating in Malaysia, and were sent to all auditing firms in Malaysia. Altogether there were 80 useable research materials received. Each subject was required to answer both sets of research materials. The subjects were asked to assess fraud risk and provide their opinion regarding the likelihood that fraudulent financial reporting occurred in the hypothetical audit client's company.

The data was analyzed using general linear model repeated measures ANOVA. The results suggest that the ability to assess fraud risk is not related to the ability to detect the likelihood of fraud. High fraud risk level, on the other hand, has a positive effect on the relationship between the ability to assess fraud risk and the ability to detect the likelihood of fraud. Out of five personality factors tested only one, i.e. neuroticism, has an effect on the relationship between the ability to assess fraud risk and the ability to detect the likelihood of fraud. However, the effects are only present in a high fraud risk situation. In other words, in a high fraud risk situation, high on neuroticism will have a greater negative effect on the relationship between the ability to assess fraud risk and the ability to detect the likelihood of fraud, as compared to a low fraud risk situation.
Abstrak tesis yang dikemukakan kepada Senat Universiti Putra Malaysia sebagai memenuhi keperluan untuk ijazah Doktor Falsafah

KESAN KEUPAYAAN MENILAI RISIKO PENIPUAN, TAHAP RISIKO PENIPUAN DAN FAKTOR-FAKTOR PERSONALITI KE ATAS KEUPAYAAN MENGESESAN KEMUNGKINAN PENIPUAN

Oleh

NAHARIAH JAFFAR

Pengerusi: Profesor Madya Arfah Salleh, Ph.D.

Fakulti: Sekolah Pengajian Siswazah Pengurusan


AI 240 “Penipuan dan Kesilapan” (MIA, 1997) memerlukan juru audit luar menilai risiko penipuan yang bersesuaian sewaktu merancang kerja audit. Dengan itu beliau boleh memberikan kepastian yang munasabah bahawa sebarang kenyataan salah di dalam penyata-penyata kewangan telah dikesan. Keupayaan juru audit luar mengesan kemungkinan penipuan mungkin dipengaruhi oleh keupayaan beliau menilai risiko penipuan. Di samping itu, konsep risiko penipuan bersandarkan model risiko audit mungkin menjadi asas dalam mempengaruhi keupayaan juru audit luar mengesan kemungkinan penipuan. Tambahan pula, sorotan karya telah menunjukkan bahawa personaliti memberi kesan peyederhanaan ke atas perhubungan di antara suatu konstruk dengan prestasi kerja.
Dari itu, objektif kajian ini adalah untuk mengkaji kesan keupayaan juru audit luar menilai risiko penipuan ke atas keupayaan mereka mengesan kemungkinan penipuan. Di samping itu, kajian ini mengkaji kesan penyederhanaan oleh tahap risiko penipuan dan faktor-faktor personaliti ke atas perhubungan di antara keupayaan juru audit luar menilai risiko penipuan dan keupayaan mereka mengesan kemungkinan penipuan.


Data-data dianalisa menggunakan model linear umum ukuran berulang ANOVA. Hasil kajian mencadangkan bahawa keupayaan menilai risiko penipuan tidak berkaitan dengan keupayaan mengesan kemungkinan penipuan. Tahap risiko penipuan yang
ACKNOWLEDGEMENTS

First and foremost, all praised be to Allah (S.W.T) for giving me the strength to pursue and complete this PhD program, His blessing has made this journey a success.

My heartfelt gratitude goes to my supervisors, Associate Professor Dr Arfah Salleh, chairman of my supervisory committee, Professor Dr Takiah Mohd Iskandar and Professor Dr Hasnah Haji Haron, committee members, for their guidance and supervision. My deep appreciation and sincere thanks go to all my supervisory committee members for the invaluable ideas and consistent guidance in the preparation of this thesis.

My deep and sincere thanks also go to my family for their understanding, continual encouragement and constant prayers: my husband; Norazlan Alias; my mother and my brothers and sisters. My children: Afiah Nasuha, Ahmad Anwar Nazif and Afiah Nadiah, whose love and inquisitive minds help enliven this arduous journey.

Last but not least, I would like to extend my appreciation to the GSM staffs and the library staffs of UPM for their assistance.
I certify that an Examination Committee met on 18 April 2008 to conduct the final examination of Graduate Student on his or her Doctor of Philosophy thesis entitled “Effects of Ability to Assess Fraud Risk, Fraud Risk Level and Personality Factors on the Ability to Detect the Likelihood of Fraud” in accordance with Universiti Pertanian Malaysia (Higher Degree) Act 1980 and Universiti Pertanian Malaysia (Higher Degree) Regulations 1981. The Committee recommends that the candidate be awarded the relevant degree. Members of the Examination Committee are as follows:

**Foong Soon Yau, PhD**  
Professor  
Graduate School of Management  
Universiti Putra Malaysia  
(Chairman)

**Ayoib Che Ahmad, PhD**  
Associate Professor  
Faculty of Accountancy  
Universiti Utara Malaysia  
(External Examiner)

**Faudziah Hanim Fadzil, PhD**  
Associate Professor  
College of Business  
Universiti Utara Malaysia  
(Internal Examiner)

**Mohd Hassan Che Haat, PhD**  
Pusat Pengajian Siswaazah  
Universiti Sains Malaysia  
(Internal Examiner)

**Hasnah Haron, PhD**  
Professor/Deputy Dean (Academic)  
Advanced Management Centre  
School of Management  
Universiti Sains Malaysia  
(Representative of Supervisory Committee/Observer)

---

**SHAMSHER MOHAMAD RAMADIL MOHD, PhD**  
Professor/Deputy Dean  
Graduate School of Management  
Universiti Putra Malaysia

Date: 22/7/08
The thesis submitted to the Senate of Universiti Putra Malaysia has been accepted as fulfillment of the requirement for the degree of Doctor of Philosophy. The members of the Supervisory Committee are as follows:

**Arfah Salleh, PhD**  
Associate Professor  
Graduate School of Management  
Universiti Putra Malaysia  
(Chairman)

**Takiah Mohd Iskandar, PhD**  
Professor  
Faculty of Economics and Business  
Universiti Kebangsaan Malaysia  
(Member)

**Hasnah Haji Haron, PhD**  
Professor/Deputy Dean (Academic)  
Advanced Management Centre  
School of Management  
Universiti Sains Malaysia  
(Member)

---

SAMSINAR MD. SIDIN, PhD  
Professor/Dean  
Graduate School of Management  
Universiti Putra Malaysia

Date: 14/8/08
DECLARATION

I hereby declare that the thesis is based on my original work except for quotations and citations which have been duly acknowledged. I also declare that it has not been previously or concurrently submitted for any other degree at UPM or any other institutions.

NAHARIAH JAFFAR

Date: 19/09/2008
## TABLE OF CONTENTS

<table>
<thead>
<tr>
<th>Chapter</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>ABSTRACT</td>
<td>ii</td>
</tr>
<tr>
<td>ABSTRAK</td>
<td>v</td>
</tr>
<tr>
<td>ACKNOWLEDGEMENTS</td>
<td>ix</td>
</tr>
<tr>
<td>APPROVAL</td>
<td>x</td>
</tr>
<tr>
<td>DECLARATION</td>
<td>xii</td>
</tr>
<tr>
<td>LIST OF TABLES</td>
<td>xvi</td>
</tr>
<tr>
<td>LIST OF FIGURES</td>
<td>xviii</td>
</tr>
<tr>
<td>LIST OF ABBREVIATIONS</td>
<td>xix</td>
</tr>
</tbody>
</table>

### CHAPTER

1 **INTRODUCTION**
- 1.1 Overview of chapter
- 1.2 Background of the study
- 1.3 Definition of terms
- 1.4 Problem statement
- 1.5 Objectives of the study
- 1.6 Justifications of the study
- 1.7 Limitations
- 1.8 Contributions
- 1.9 Organization of thesis
- 1.10 Conclusion

2 **LITERATURE REVIEW**
- 2.1 Overview of chapter
- 2.2 Pronouncements
- 2.3 Empirical evidences
- 2.4 Overall summary
- 2.5 Conclusion

3 **CONCEPTUAL FRAMEWORK AND HYPOTHESES DEVELOPMENT**
- 3.1 Overview of chapter
- 3.2 Ability to assess fraud risk versus ability to detect the likelihood of fraud
- 3.3 Attribution Theory
- 3.4 Context Theory of Classification
- 3.5 Five-factor theory
- 3.6 Conclusion
4 RESEARCH METHOD
4.1 Overview of chapter 159
4.2 Research design 159
4.3 Research instrument 160
4.4 Administration of the research instrument 167
4.5 Variables of the study 169
4.6 Conclusion 176

5 RESULTS
5.1 Overview of chapter 178
5.2 Sample 178
5.3 Response rate 180
5.4 Allocation of subjects for the research design 183
5.5 Descriptive statistics 186
5.6 Data check 209
5.7 Hypotheses testing 210
5.8 Additional tests 238
5.9 Conclusion 239

6 DISCUSSION, CONCLUSION AND IMPLICATIONS OF STUDY
6.1 Overview of chapter 240
6.2 Discussion 240
6.3 Conclusion 252
6.4 Implications 255
6.5 Future research 258

BIBLIOGRAPHY 260

LIST OF APPENDICES

Appendix A: Fraud cases in Malaysia. 282

Appendix B: Securities Commission enforcement action. 284

Appendix C: Fraud risk factors. 297

Appendix D: AI 300 Planning (MIA, 1997) (extracts). 299

Appendix E: Case materials. 301

Appendix F: Goldberg’s 50 Big-five factor marker instrument. 315
Appendix G: Allocation of the self-rating scales for the five trait dimensions in Goldberg’s 50 Big-five factor marker instrument.

Appendix H: Reliability statistics.

Appendix I: Early-versus-late test results.

Appendix J: Additional tests.

BIODATA OF THE CANDIDATE
## LIST OF TABLES

<table>
<thead>
<tr>
<th>Table</th>
<th>Description</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>2.1</td>
<td>Previous studies related to the ability to detect fraud.</td>
<td>64</td>
</tr>
<tr>
<td>2.2</td>
<td>Previous studies related to the validity of fraud indicators.</td>
<td>78</td>
</tr>
<tr>
<td>2.3</td>
<td>Previous studies related to the unaided fraud risk assessment.</td>
<td>90</td>
</tr>
<tr>
<td>2.4</td>
<td>Previous studies related to the mechanically aided fraud risk assessment.</td>
<td>98</td>
</tr>
<tr>
<td>2.5</td>
<td>Previous studies related to the personality factors in accounting literature.</td>
<td>105</td>
</tr>
<tr>
<td>2.6</td>
<td>Previous studies related to the effect of experience on auditor’s work.</td>
<td>112</td>
</tr>
<tr>
<td>4.1</td>
<td>Fraud risk indicators of the case materials.</td>
<td>162</td>
</tr>
<tr>
<td>5.1</td>
<td>Distribution of research instruments.</td>
<td>181</td>
</tr>
<tr>
<td>5.2</td>
<td>Response rate.</td>
<td>183</td>
</tr>
<tr>
<td>5.3</td>
<td>Division of subjects based on two levels of each personality trait.</td>
<td>184</td>
</tr>
<tr>
<td>5.4</td>
<td>Research design and subjects per cell.</td>
<td>186</td>
</tr>
<tr>
<td>5.5</td>
<td>Paired samples test Ability to assess fraud risk versus ability to detect the likelihood of fraud (High fraud risk case and low fraud risk case scenarios).</td>
<td>188</td>
</tr>
<tr>
<td>5.6</td>
<td>Subjects’ answers for Question 1 of Part B versus subjects’ answers for Question 2 of Part B (High fraud risk case scenario).</td>
<td>190</td>
</tr>
<tr>
<td>5.7</td>
<td>Subjects’ answers for Question 1 of Part B versus subjects’ answers for Question 2 of Part B (Low fraud risk case scenario).</td>
<td>191</td>
</tr>
<tr>
<td>5.8</td>
<td>Factor analysis results for neuroticism.</td>
<td>192</td>
</tr>
<tr>
<td>5.9</td>
<td>Factor analysis results for extraversion.</td>
<td>193</td>
</tr>
<tr>
<td>5.10</td>
<td>Factor analysis results for conscientiousness.</td>
<td>194</td>
</tr>
<tr>
<td>Section</td>
<td>Title</td>
<td></td>
</tr>
<tr>
<td>---------</td>
<td>----------------------------------------------------------------------</td>
<td></td>
</tr>
<tr>
<td>5.11</td>
<td>Factor analysis results for openness to experience.</td>
<td></td>
</tr>
<tr>
<td>5.12</td>
<td>Factor analysis results for agreeableness.</td>
<td></td>
</tr>
<tr>
<td>5.13</td>
<td>Reliability analysis (Alpha).</td>
<td></td>
</tr>
<tr>
<td>5.14</td>
<td>Demographic profile.</td>
<td></td>
</tr>
<tr>
<td>5.15</td>
<td>Experience in fraud detection versus fraud training.</td>
<td></td>
</tr>
<tr>
<td>5.16</td>
<td>Demographic profile for high fraud risk and low fraud risk scenarios.</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Paired samples statistics.</td>
<td></td>
</tr>
<tr>
<td>5.17</td>
<td>Number of subjects who are able to detect the likelihood of fraud.</td>
<td></td>
</tr>
<tr>
<td>5.18</td>
<td>Ability to assess fraud risk, fraud risk level, neuroticism and ability to detect the likelihood of fraud.</td>
<td></td>
</tr>
<tr>
<td>5.19</td>
<td>Ability to assess fraud risk, fraud risk level, extraversion and ability to detect the likelihood of fraud.</td>
<td></td>
</tr>
<tr>
<td>5.20</td>
<td>Ability to assess fraud risk, fraud risk level, conscientiousness and ability to detect the likelihood of fraud.</td>
<td></td>
</tr>
<tr>
<td>5.21</td>
<td>Ability to assess fraud risk, fraud risk level, openness to experience and ability to detect the likelihood of fraud.</td>
<td></td>
</tr>
<tr>
<td>5.22</td>
<td>Ability to assess fraud risk, fraud risk level, agreeableness and ability to detect the likelihood of fraud.</td>
<td></td>
</tr>
<tr>
<td>5.23</td>
<td>Summary of results.</td>
<td></td>
</tr>
</tbody>
</table>
# LIST OF FIGURES

<table>
<thead>
<tr>
<th>Figure</th>
<th>Description</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>2.1</td>
<td>Areas of losses due to fraud.</td>
<td>45</td>
</tr>
<tr>
<td>2.2</td>
<td>Methods of fraud detection</td>
<td>46</td>
</tr>
<tr>
<td>2.3</td>
<td>The components of the Eclectic Fraud Detection model.</td>
<td>56</td>
</tr>
<tr>
<td>3.1</td>
<td>External auditor's responsibility to detect fraud.</td>
<td>119</td>
</tr>
<tr>
<td>3.2</td>
<td>Model linking risk assessment policy to knowledge, cues, and audit planning decisions.</td>
<td>124</td>
</tr>
<tr>
<td>3.3</td>
<td>Conceptual framework for the external auditors' ability to detect the likelihood of fraud.</td>
<td>125</td>
</tr>
<tr>
<td>5.1</td>
<td>Plot for the interaction effect of ability to assess fraud risk and fraud risk level (Neuroticism as a personality trait).</td>
<td>217</td>
</tr>
<tr>
<td>5.2</td>
<td>Plot for the interaction effect of ability to assess fraud risk and fraud risk level (Extraversion as a personality trait).</td>
<td>218</td>
</tr>
<tr>
<td>5.3</td>
<td>Plot for the interaction effect of ability to assess fraud risk and fraud risk level (Conscientiousness as a personality trait).</td>
<td>218</td>
</tr>
<tr>
<td>5.4</td>
<td>Plot for the interaction effect of ability to assess fraud risk and fraud risk level (Openness to experience as a personality trait).</td>
<td>219</td>
</tr>
<tr>
<td>5.5</td>
<td>Plot for the interaction effect of ability to assess fraud risk and fraud risk level (Agreeableness as a personality trait).</td>
<td>219</td>
</tr>
</tbody>
</table>
## LIST OF ABBREVIATIONS

<table>
<thead>
<tr>
<th>Abbreviation</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>MIA</td>
<td>Malaysian Institute of Accountants</td>
</tr>
<tr>
<td>SEC</td>
<td>Securities and Exchange Commission</td>
</tr>
<tr>
<td>SC</td>
<td>Securities Commission</td>
</tr>
<tr>
<td>KLSE</td>
<td>Kuala Lumpur Stock Exchange</td>
</tr>
<tr>
<td>ROC</td>
<td>Registrar of Companies</td>
</tr>
<tr>
<td>ROB</td>
<td>Registrar of Business</td>
</tr>
<tr>
<td>SSM</td>
<td>Suruhanjaya Syarikat Malaysia</td>
</tr>
<tr>
<td>SIA</td>
<td>Securities Industry Act</td>
</tr>
<tr>
<td>SCA</td>
<td>Securities Commission Act</td>
</tr>
<tr>
<td>EFD</td>
<td>Eclectic fraud detection</td>
</tr>
<tr>
<td>ROP</td>
<td>Rationalizations, opportunity and crime-prone personality</td>
</tr>
<tr>
<td>SAS</td>
<td>Statement of Auditing Standards</td>
</tr>
</tbody>
</table>
CHAPTER 1
INTRODUCTION

1.1 Overview of chapter
This chapter presents the background of study by highlighting the responsibility of external auditors to assess fraud risk and detect fraud. It then continues by discussing the problem statement that necessitates the present study to be carried out and this is followed by definitions of terms, research objectives, justifications, limitations, contributions of the study, organization of remaining chapters and the conclusion.

1.2 Background of study
Published audited financial statements are the source of corporate information available to stakeholders and information derived from these statements can be used for making economic decisions. The Companies Act 1965, Section 167 (1) requires corporate management to keep accounting and other records to ensure that true and fair accounts are prepared and to ensure that the accounts are fairly presented. The Act, under Section 169 (4) further requires that the profit and loss account and the balance sheet be duly audited by the company’s auditor. The Malaysian Approved Standards on Auditing, AI 700 on “The Auditor’s Report on Financial Statements” (MIA, 1997) states that the responsibility of the auditor is to provide assurance that the financial statements are free from material misstatements. Misstatements may be due to error or fraud. The Malaysian Approved Standards on Auditing, AI 240 on “Fraud and Error” (MIA, 1997) defines error as unintentional mistake in financial statements, such as, mathematical or
clerical mistakes in the underlying record and accounting data. On the other hand, fraud is an intentional act by one or more individuals among management, employees, or third parties, which results in a misrepresentation of financial statements. Examples of fraud are purposely manipulated, falsified or altered accounting records or documents. The difference between error and fraud is in the intention. Fraud can be divided into two types i.e. fraudulent financial reporting or so-called management fraud, and misappropriation of assets or also referred to as employee fraud. Statement of Auditing Standard (SAS) No. 82 (AICPA, 1997) indicates that misappropriation of assets may be accompanied by false or misleading records or documents. Arens, Loebbecke, Iskandar, Susela and Isa (1999), note that both types of fraud are potentially harmful to users. In addition, Elliot and Willingham (1980) state that these frauds may both cause materially misleading financial statements. Thus, the present study focus on fraud, as it may pose a potential peril to users of financial statements.

The topic on fraud is very important for public accountants (e.g. Mitchell, 1997; Vanasco, 1998; Uddin, 2000). Inability to detect fraud may lead to litigation actions being taken against the external auditor (Feroz, Park & Pastena, 1991). Palmrose (1987) describes that business failures and management fraud cause legal actions to be brought against auditors and the settlement of such actions. For instance, when Xerox was sanctioned for overstating earnings by US$3 billion, its auditor KPMG was liable for US$22 million in penalties (Ettredge, Sun, Lee & Anandarajan, 2005).
Spathis (2002), states that “No one knows how many business failures are actually caused by fraud, but undeniably lots of businesses, especially small firms, go bankrupt each year due to fraud losses.” Researchers in some countries like the United Kingdom (UK) and United States (US) have reported the seriousness of fraud activities (e.g. Tyler, 1997; Wells, 1997; Mitchell, 1997; Vanasco, 1998; and Grant, 1999). UK’s Audit Commission reported that the number of frauds increased by 38% since 1990 (Tyler, 1997). Estimates of the annual cost of fraud for the UK ranged from a few billion pounds to over £10 billion (Grant, 1999). Mitchell (1997) indicates that the Association of Certified Fraud Examiner (ACFE) reported costs of US$15 billion involving 2,608 reported cases over the last ten years. Meanwhile, Wells (1997) reported that costs due to fraud of US businesses are estimated to be more than US$400 billion annually. The following two fraud cases are extracted from Vanasco (1998, pp. 9):

“In the United States v. Weiner, 578 F.2d 757 (9th Cir. 1978), three auditors of Equity Corporation of America were convicted after a jury trial of multiple counts of securities fraud and filing false statements with the Securities and Exchange Commission (SEC). The case involved the auditors’ failure to detect that US$2 billion of the company’s US$3.5 billion of assets were fraudulently obtained through computer-produced, bogus insurance policies. In addition to criminal convictions against the three auditors, five accounting firms paid US$44 million in damages. At Equity Funding, many employees knew about the fraudulent activities and even participated in the fraud.

In Cenco Inc.v. Seidman & Seidman, 686 F.2d 449 (7th Cir. 1982), the defendants were charged with violating SEC Rule 10b-5 and several federal securities laws. The case dealt with the auditors’ failure to detect US$25 million inventory fraud perpetrated by top management.”
In the US, Wells (1997) reported that fraud cut across all industries with the greatest losses apparent (fraud losses by industry) in real estate financing, manufacturing, banking, oil and gas, construction and health care. In the case of Enron, its financial statements reported misleading information that made Enron appear to be in better financial condition than it actually was. A report prepared by the US Senate Permanent Subcommittee on Investigations (2003) disclosed evidence of Enron’s participation in accounting deceptions, price manipulation, insider abuse, and unfair dealing with employees, investors and creditors. For instance, one of its transactions involved US$8 billion in deceptive transactions, referred to as “prepays”, which two major US financial institutions, Citigroup and Chase, issued huge loans to Enron disguised as energy trades. The report revealed that the law enforcement agencies indicted Enron’s former chief financial officer for fraud, money laundering and other misconduct. It was also reported that an Italian company, Parmalat, is facing possible bankruptcy charges after admitting to an enormous black hole in its accounts (http://news.bbc.co.uk/1/hi/business/3333431.stm). Parmalat’s bank had discovered that the company documents certifying 4bn euros (£2.8bn; $5bn) in assets were false. The company was suspected of using a related company to hide its financial losses (http://news.bbc.co.uk/2/hi/business/3333431.stm).

For the last ten to fifteen years, Malaysia has not been spared of the occurrence of cases of fraudulent activities in its public companies. Examples of these include the Bank Rakyat, Bumiputra Malaysia Finance (BMF), Pan Electric Group of Companies, Perwira Habib Bank, Deposit Taking Cooperatives (DTCs) and Cooperative Central
Bank (CCB) cases (Ali, 1994). KPMG Malaysia (2003) in their Fraud Survey 2002 Report stated that from 168 responses from chief executives of public listed and top private companies in Malaysia, 50% of them had experienced fraud in their organization. Forty percent of the companies claimed that they had suffered losses between RM10,001 and RM100,000 over the past years (i.e. a period from January 2001 to December 2002) due to fraud, 33% above RM1 million, while 12% reported incurring losses of RM10,000 and below.

In another instance, the Managing Director of Tat Sang Holding was charged with submitting false information to the Securities Commission (SC) in respect of Tat Sang’s listing proposal and for knowingly authorising the furnishing of false information to Kuala Lumpur Stock Exchange (KLSE) (http://www.sc.com.my/html/resources/press/pr_20021212.html). Meanwhile, the SC enforcement official, Deputy Chief Executive, Datin Zarinah Anwar, in a 2002 press release, noted that among offences uncovered from investigations made on the PN4 companies’ directors include submission of false/misleading information and submission of schemes to defraud. The SC directed companies like CSM Corporation Berhad to restate their financial statements, which were found to be misleading, and legal action had been instituted by the present

---

1 On April 14, 2004, the Kuala Lumpur Stock Exchange (KLSE) has changed its name to Bursa Malaysia Berhad, following its demutualization exercise, the purpose of which was to enhance its competitive position and to respond to global trends in the exchange sector by making it more customer-driven and market-oriented.

2 Refer to Criteria and Obligations pursuant to Paragraph 8.14 of the Listing Requirements of KLSE. “PN4 companies” are affected listed companies that fail to meet the financial conditions for continued trading and listing on KLSE. In this context, the provisions of KLSE’s Practice Note 4/2001 (PN4) which became effective on 15 February 2001 are intended to ensure that affected listed companies take expeditious steps to regularise their financial conditions within the stipulate time frame. PN4 also aims to protect the interests of investors by ensuring that sufficient information disclosures are made on the