UNIVERSITI PUTRA MALAYSIA

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

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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 MENGESAN KEMUNGKINAN PENIPUAN

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Piawaian Pengauditan Malaysia Diluluskan, AI 700 "Laporan Juru Audit ke atas Penyata-penyata Kewangan" (MIA, 1997) menyatakan bahawa tanggungjawab juru audit adalah memberikan jaminan bahawa penyata-penyata kewangan adalah bebas daripada kenyataan-kenyataan yang salah. Kenyataan yang salah ini mungkin disebabkan samada oleh kesilapan atau penipuan. Kesilapan merupakan kenyataan salah yang dilakukan tanpa disengajakan manakala penipuan adalah kenyataan salah yang disengajakan. Penipuan, boleh dibahagikan kepada dua jenis, iaitu pelaporan kewangan palsu dan penyalahgunaan asset, di mana kedua-dua jenis kenyataan-kenyataan salah ini boleh menyebabkan penyata kewangan melaporkan maklumat yang mengelirukan (Elliot & Willingham, 1980).

Di Malaysia, walaupun piawaian-piawaian dan garispanduan-garispanduan telah di sediakan, namun begitu pelaporan kewangan palsu masih lagi berlaku di negara ini, sebagaimana yang dilaporkan oleh KPMG Malaysia (2003) di dalam tinjauan mereka.

Walaupun isu penipuan mungkin tidak didokumenkan dengan baik di Malaysia, isu ini tidak boleh dianggap ringan kerana apa yang berlaku di negara-negara lain, seperti di US, mungkin boleh berlaku di mana-mana. Meskipun, garispanduan-garispanduan telah disediakan oleh piawaian Malaysia, tinjauan yang dilakukan oleh KPMG Malaysia (2003) melaporkan bahawa juru audit luar menemui hanya 4% daripada insiden-insiden penipuan yang berlaku di dalam syarikat-syarikat di Malaysia. Oleh kerana itu, pihak awam mungkin tertanya-tanya kenapa juru audit luar tidak dapat mengesan penipuan tersebut sewaktu melaksanakan audit tahunan. Dari itu, adalah amat penting untuk mengetahui keupayaan juru audit luar untuk mengesan penipuan kerana pelaporan kewangan palsu adalah pernyataan palsu kepada masyarakat.

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.

Pendekatan eksperimen antara-subjek digunakan di dalam kajian ini. Bahan-bahan kajian berkaitan pelanggan audit yang diandaikan telah disediakan di dalam dua versi, i.e. senario kes risiko penipuan tinggi dan senario kes risiko penipuan rendah. Dua tahap risiko penipuan dibentuk bagi memeriksa kesan kontekstual tahap risiko penipuan ke atas perhubungan di antara keupayaan juru audit luar menilai risiko penipuan dan keupayaan mereka mengesan kemungkinan penipuan. Bahan-bahan kajian diposkan kepada juru audit luar yang sedang berkhidmat, iaitu mereka mestilah berjawatan sebagai rakan kongsi atau pengurus audit di firma-firma audit yang beroperasi di Malaysia dan dihantar kepada semua firma audit di Malaysia. Keseluruhannya sebanyak 80 bahan kajian yang boleh digunakan telah diterima. Setiap subjek dikehendaki melengkapkan kedua-dua set bahan kajian tersebut. Subjek-subjek diminta menilai risiko penipuan dan memberikan pendapat mereka berkenaan kemungkinan pelaporan kewangan palsu berlaku di dalam syarikat pelanggan audit yang diandaikan.

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 tinggi pula mempunyai kesan ke atas perhubungan di antara keupayaan menilai risiko penipuan dan keupayaan mengesan kemungkinan penipuan. Daripada lima faktor personaliti yang diuji, hanya satu, iaitu "neuroticism", mempunyai kesan ke atas perhubungan di antara keupayaan menilai risiko penipuan dan keupayaan mengesan kemungkinan penipuan. Namun begitu, kesan ini hanya wujud di dalam situasi di mana risiko penipuan adalah tinggi. Dengan kata lain, di dalam situasi risiko penipuan yang tinggi, "neuroticism" yang tinggi mempunyai kesan negatif yang lebih ke atas perhubungan di antara keupayaan menilai risiko penipuan dan keupayaan mengesan kemungkinan penipuan, berbanding situasi risiko penipuan yang rendah.

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TABLE OF CONTENTS

LIST OF TABLES

LIST OF FIGURES

LIST OF ABBREVIATIONS

MIA	Malaysian Institute of Accountants
SEC	Securities and Exchange Commission
SC	Securities Commission
KLSE	Kuala Lumpur Stock Exchange
ROC	Registrar of Companies
ROB	Registrar of Business
SSM	Suruhanjaya Syarikat Malaysia
SIA	Securities Industry Act
SCA	Securities Commission Act
EFD	Eclectic fraud detection
ROP	Rationalizations, opportunity and crime-prone personality
SAS	Statement of Auditing Standards

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)[1] (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[2] 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

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[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