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Full Length Research Paper

Post fraud: An empirical study of firms in Malaysia

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The paper specifically examines the post fraud firms' characteristics for over 3 years after fraud had 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 256 firms' observations were made. Findings revealed declining sales as well as increased in debts during the three years after the fraud for fraud firms. However, roles of block holders and board's size may lessen the impact of fraud.

Key words: Fraud, board size, block holders, long term debt, corporate governance.

INTRODUCTION

Malaysia is an interesting case to study because it is claimed that corporate governance practices used by Malaysian listed companies are different from those practised in developed markets (Yatim et al., 2006). The focus with emerging economies, or transition economies such as Malaysia, provide a different economic environment giving rise to pressures to managers to expropriate assets for benefit of controlling stockholders or their personal business interests (Chen et al., 2006) and thus, impacting the financial reporting credibility and quality. Hence motivates the current study to examine fraudulent reporting, among firms in Malaysia amidst the existing corporate governance landscape.

The aim of this study is to empirically investigate fraud firms' characteristics after the fraud had 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, after the fraud had occurred. Unlike many prior studies, fraud were examined through perceptions of auditors (Hegazy and Kassem, 2010; Owusu-Ansah et al., 2002), or the periods fraudulent reporting occurred (Beasley et al., 1999; Beasley, 1996). Hence, current study examines fraud after it occurred to determined factors that are likely to assist in alleviating fraud. The current study reveals that the role of block holders is prevalent to reduce the likelihood of fraud, and fraud firms experienced downward sales after fraud aftermath.

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

REVIEW OF RELATED LITERATURE

Fraud may be identified as intentional misstatements that arise from two scenarios: fraudulent financial reporting and misstatements from misappropriation of assets (Hussain et al., 2010). Fraudulent financial reporting is becoming a serious threat for gaining investor's confidence in the financial information. Prior literatures have examined fraudulent financial reporting with many factors such as fraud detection (Owusu-Ansah et al., 2002; Jaafar et al., 2008; Hegazy and Kassim, 2010; and Grove and Basilico, 2011), restatement (Abbott et al., 2004), fraud risk (Prawitt et al., 2011) and fraud's nature (Zhu and Gao, 2011). Fraud is a worldwide problem which has become increasingly prominent in the eyes of the public and world's regulators and Malaysia's corporate sector is no exceptional. Indeed, it represents a corporate threat for Malaysian businesses as number of fraud cases documented has increased considerably over the recent years. There have been few recent studies on fraudulent financial reporting in Malaysia, Omar and Bakar (2012), Nelson (2010, 2011), Arshad and Othman (2011) and Yap et al. (2011), to name a few.

The growth in fraud cases may indicate a strong need for research that aims to find alternatives to mitigate fraud. Thus, in Malaysia various studies performed had included many aspects of fraud's background such as Yap et al. (2011) examined the association between corporate governance mechanisms, ownership structures, Internet visibility and fraud activities via Internet financial reporting. The result shows high transparency level by corporations is required to use the Internet to communicate information in order to reduce fraud occurrences. An empirical study by Nelson (2010) 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. While 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.

On the other hand, Ahmad et al. (2008) examined fraudulent financial reporting quality from tax evidences. They examined the relationship between companies' characteristics with the types and amount of fraudulent reporting that were submitted to Inland Revenue Board (IRB) for tax purposes, and utilised real tax cases. These tax cases where the non-compliance with the Malaysian statutes and tax laws are used as a measure for fraudulent financial reporting. In addition, studies have also expanded into utilising qualitative method.

Studies in relation to behavioural factors had also gained interest in the Asian region, such as China. Zhu and Gao (2011) from China also adopt qualitative study by investigating the nature, types, and methods of fraudulent financial reporting committed by Chinese listed companies with a view to understanding corporate behaviour relating to management fraud in China.

The corporate governance of an organisation, indirectly reflects the process of how the organisation is being managed, no doubt that the failure in governance itself will result in reporting failure as well. Thus, corporate governance mechanisms play significant function in the financial reporting quality (Beasley, 1996; Carcello and Nagy, 2004; Sharma et al., 2009). Given the association between fraudulent financial reporting and corporate governance, an important contribution of this study is to understand the factors that could improve fraud firms after the said fraud had occurred. Furthermore, a well defined governance responsibilities and structure in the firms are likely to reduce the probability of financial fraud when sufficient red flags or warnings exist (Vlad et al., 2011; Grove and Basilico, 2011).

The current study expands existing 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 post fraud years. More importantly provide an avenue to understand how fraud firms cope after fraud.

Theory

Agency theory provides a powerful theoretical framework for analysing the behaviour of managers in different organisations. In this study, board's characteristics that represent the board of directors are designed to mitigate problems and acts as monitoring mechanism on the preparers of financial statement and shareholder (Shapiro, 2005). Given the problems in mitigating agency problems through the use of contracts, scholars have suggested various governance mechanisms to address the agency problems. Agency theory thus provides a basis for firm governance through the use of internal and external mechanisms (Weir et al., 2002; Roberts et al., 2005). The governance mechanisms are designed to "protect shareholder interests, minimize agency costs and ensure agent-principal interest alignment" (Davis et al., 1997: 23).

Hence, the study expects that with good governance such as, larger board's size, larger audit committee size, higher number of independent audit committees, and higher number of independent directors will result to lesser fraud occurrence.

RESEARCH METHOD

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 (Nelson, 2010, 2011), consistent with prior literature (Erickson et al., 2006; Owens-Jackson et al., 2009). The small fraud 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 from publicly available data. Data was hand collected via annual reports.

For each firms, information regarding board's and firm's characteristics were identified for three consecutive years following the fraud's year. Hence, the study arrives to 256 firms' observations, including their control group. Subsequently, based on a match pair sampling and a dichotomous dependent variable, a logistic regression is most appropriate for further investigation.

Table 1. Summary of offences as fraudulent financial reporting.

List of offences	Sections	Acts
Making a statement that is misleading in material particulars. Issued prospectus contained misleading information. Submission of false information to Securities Commission. Making false statement in documents, which is use in the preparation of financial statement.	Section 176	Capital Market Securities Act 2007
False or misleading documents or information. Disclosure of information to SC that is false or misleading, material omission, or misleading or deceptive.	32B (Deleted) 33E 152 (2)	Securities Commission Act 1993
False reports to Commission, stock exchange or recognized house.	122 B	Securities Industry Acts 1983
Criminal Breach of Trust		Penal Code

Sources: (Nelson, 2010).

Table 2. Sectors.

Sector	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 and services	6	18.8
Total	32	100.0

Fraud firms' selection

To identify firms accused of fraud, the study searched the Securities Commission (SC) enforcement actions based on the offences as shown in Table 1, consistent with Erickson et al. (2006), Zhao and Chen (2008) and Owens-Jackson et al. (2009), the study compiles a matched sample of firms not accused of fraud. The number of firms in the sampling is consistent with Peyrefitte et al. (2002) with a final sample of 66 and Mustafa and Youssef (2010) that examine 28 cases of misappropriation of assets.

ANALYSIS OF RESULTS

Descriptive

Table 2 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% consecutively. Both sectors involve with high volume and involved basically 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 3 shows the descriptive analysis and basic parametric test of F and T tests. Two variables show significant p values in both the tests that is, BLOCK and FIRMSIZE. Whilst LTDEBT is marginally significant in the t-tests, but significant in the F-test and is consistent with Nelson (2010), where it shows leverage has a significant p value. It may be concluded that, block holders, firms' size and long term debt may be useful variables to distinguish between fraud and non fraud firms.

Correlation analysis

Table 4 shows the correlation analysis. Only one variable is significantly correlated with fraud, that is, BLOCK. Block holders is significant negatively related with fraud, suggesting that larger number of block holders would reduce the number of fraudulent financial reporting. It is consistent with Dechow et al. (1996) that investigated on the block holders with higher motivation and ability to monitor managers' actions might reduce manipulation through their closer monitoring. Block holder is significantly negative with fraud because the higher size of block holders in monitoring managers' actions potentially reduces manipulation by restricting managers' discretion with financial reporting and mitigating their incentive to manage earnings.

However, an area of concern needs to be highlighted when the correlation value is more than 0.8; even though correlation among variables is considered high, if values exceeding 0.9 (Tabacknick and Fidell, 2007). For instance, between board's size and audit committee size, and independent directors and audit committee independence.

Even though both relationships show significant positive relationships, but they are also highly correlated to one another. Such as, audit committee's size is highly correlated with board's size. This is because, the same

Table 3. Descriptive analysis.

Variable N=256	Mean	S.D.	F-test (p-value)	T-test
ACSIZE				
Fraud	2.11	1.798	0.386	0.202
Non fraud	2.40	1.816	(0.535)	
ACINDP				
Fraud	0.446	0.387	0.470	0.397
Non Fraud	0.487	0.384	(0.493)	
BOARDSIZE				
Fraud	4.14	3.701	0.240	0.094
Non fraud	4.91	3.597	(0.625)	
INED				
Fraud	0.264	0.242	0.883	0.217
Non fraud	0.301	0.235	(0.348)	
BLOCK				
Fraud	21.69	24.03	5.345	0.004**
Non fraud	31.01	27.38	(0.022)*	
CFO(RM)				
Fraud	10m	77.15m	0.183	0.660
Non fraud	13.8m	60.8m	(0.669)	
LTDEBT (RM)				
Fraud	128m	4.79m	9.689	0.069
Non fraud	48m	1.21m	(0.002)**	
SALES(RM)				
Fraud	219m	5.8m	1.121	0.726
Non fraud	199m	3.4m	(0.291)	
FIRMSIZE(RM)				
Fraud	469m	9.8m	5.051	0.025*
Non fraud	343m	5.2m	(0.025)*	

*,**Significant at 5 and 1% level. Note: **ACSIZE**=Number of AC member; **ACINDP**=Proportion of independent AC members to size of AC; **BOARDSIZE**=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**=Firms' total assets. AC=audit committee.

person who sits in the audit committee, is also among the board of directors. And audit committees who are independent, are also included as independent directors from the total number of independent directors.

ANALYSIS OF RESULTS AND DISCUSSION

Table 5 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 13.9%, and the non significant of Hosmer and Lemeshow test, with 63.7% correct prediction.

Two of the variables, are firms' financial variables that are significant at 1% significant level. They are LTDEBT and SALES. LTDEBT or long term debt, is positively significant with the likelihood of fraud, while SALES is negatively significant with fraud. According to Bell et al. (1991), LTDEBT is positively significant with fraud because the poor condition may motivate unethical insiders to take actions intended to improve the appearance of the company's financial position.These may suggest that after the fraud occurred, companies would engage in higher debt to improve relevant control or take necessary action to reduce the fraud's impact. It is consistent with Lee and Yeh (2004), that investigated the level of debt, as well, induces the firms to commit a fraud in order to show positive results or a better financial situation which can reflect an overall more positive situation to reassure the market and the investors. Long term debt, is an important determinant post fraud as it was supported in the earlier t-test, where it was significant, but it was otherwise in the correlation analysis. At the same time also, faces declining sales or turnover due to the fraud exposure that indirectly gave negative impact to the firm's sales. It is consistent with

Table 4. Correlation (N=256).

	FRAUD	AC SIZE	AC INDP	BOD SIZE	INED	BLOCK	CFO	LT DEBT	SALES	FIRM SIZE
FRAUD	1	-0.080	-0.053	-0.105	-0.077	-0.179**	-0.028	0.114	0.022	0.079
AC SIZE		1	0.796**	0.889**	0.841**	0.603**	0.487**	0.051	0.212**	0.248**
ACINDP			1	0.785**	0.828**	0.628**	-0.002	0.076	0.177**	0.310**
BODSIZE				1	0.735**	0.658**	0.168**	0.183**	0.351**	0.348**
INED					1	0.569**	-0.035	0.049	0.151*	0.248**
BLOCK						1	0.039	0.021	0.131*	0.139*
CFO							1	0.606**	0.603**	0.570**
LTDEBT								1	0.775**	0.722**
SALES									1	0.660**
FIRMSIZE										1

,*Significant at 1 and 5%. 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.

Table 5. Logistic regression.

Independent variable	Coefficient	Wald χ^2
Intercept	0.225	0.796
ACSIZE	0.227	0.303
ACINDP	0.601	0.445
BOARDSIZE	-0.199	0.058
INED	-1.644	0.267
BLOCK	-0.519	0.103
CFO	-0.075	0.143
LTDEBT	0.565	0.001**
SALES	-0.646	0.002**
FIRMSIZE	0.339	0.063

Table 5 Contd.

DUMMY YEAR POST 1	-0.106	0.745
DUMMY YEAR POST 2	0.018	0.957
N	256	
Cox & Snell R square	0.104	
Nagelkerke R square	0.139	
Hosmer and Lemeshow test	0.966	
Correct predictions	63.7	

FRAUD = $\alpha + \beta_1$ACSIZE + β_2ACINDP + β_3BOARDSIZE + β_4INED + β_5BLOCK + β_6CASHFLOW + β_7LTDEBT + β_8SALES + β_9FIRMSIZE + β_{10}DUMMY YEAR Post 1 + β_{11}DUMMY YEAR Post 2 + ε_i **, significant at 1% level; Dependent variable = 1, if fraudulent financial reporting, 0 otherwise. Note :**ACSIZE**=Number of AC member; **ACINDP**=Proportion of independent AC members to size of AC; **BOARDSIZE**=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.

Baucus (1994) who shows that SALES is negatively significant because decreasing sales has been linked to various form of illegal behavior such as collusion, price-fixing, and anti-trust violations.

Another important determinant post fraud is block holders. It was initially supported in the t-test but marginally supported in the regression. Similarly, board's size is also marginally significant in the regression. This is consistent with the analytical findings by Uzun et al. (2004) that document a negative relationship between board structure and the likelihood of corporate fraud as the number of independent outside directors increased on a board; when the number increased on an auditing board and compensation committees, the likelihood of corporate fraud declined. These results may suggest the roles of larger board's size and block holders in recuperating after the fraud.

CONCLUSION AND RECOMMENDATIONS

The study provides recent empirical evidence on the prevalent roles of block holders in the aftermath of fraudulent reporting. It may be concluded that in the three years' post fraud, fraud firms tend to engaged in higher debt due to the fraud consequences that may suggest the need to restore and improve the organisation. But, at the same time fraud firms faces declining sales due to negative impact and reputation after the fraud had occurred. Hence provide initial findings to assist how fraud firms or other financial distress firms to improve in the aftermath, and manage their business operation more effectively.

It may be suggested for future research that roles of block holders 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 theory may be useful to explain the presence, functions and influence of stakeholders or ownerships within the organisation.

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