

A case study on fraudulent financial reporting: evidence from Malaysia

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Abstract

Purpose – This paper aims to examine cases of fraudulent financial reporting (FFR) which were subject to published enforcement actions by the Securities Commission Malaysia (SC) from 1998 to 2012 for reasons of alleged financial misreporting. It investigates the main attempts used (how) and sensible motives (why) for these fraudulent reporting.

Design/methodology/approach – This study undertakes a close examination of the financial reports manipulated – annual accounts, interim reports and financial reports in listing proposals, initial public offering prospectuses and corporate restructuring proposals. Due to the limited number of FFR published, a close examination of these cases is the best way to reach a more comprehensive and detailed understanding of “how” FFR takes place, rather than performing large sample statistical analyses. This study also collects data which provide evidence for the possible motivations in resorting to the FFR.

Findings – The most common attempt used by the sample companies was to overstate their reported revenue by recognising fictitious sales from bogus customers. Sample companies who attempted this initial manipulation often followed with consequential manipulations and in some cases also embarked on masking manipulations. Sensible motives for the sample companies to manipulate their financial statements include capital raising exercises, closeness to defaulting on debt repayments and sustaining equity overvaluations.

Research limitations/implications – The primary limitation of this study is its lack of breadth due to the limited number of reported cases available. Moreover, taking the sample companies used from enforcement action releases published by the SC presupposes that the SC has diligently and correctly identified all the FFR cases – whereas there is a possibility that some companies involved in FFR may not yet have been detected or publicly revealed. Notwithstanding these limitations, our findings provide a comprehensive insight, which is sufficient in depth, into the operational aspects of FFR in Malaysia.

Practical implications – One practical lesson from the findings on “how” within the chain of manipulations is that auditors ought to review the effectiveness of their analytical and substantive procedures, as a number of the FFR cases remained undetected by the audit process. A second is that accounting standards setters may wish to reconsider the amount of discretion given to managers in financial reporting. On the one hand, some managers have used this discretion to provide useful information to the market; however, others have opportunistically used it for personal gain.

Social implications – From the societal perspective, it is time for managers, as agents of capital providers, to self-review their responsibilities and stewardship in financial reporting. There needs to be a paradigm shift in their attitudes towards the perceived incentives of, and opportunities for, FFR. Managers’ wrongdoings in these accounting scandals have had significant adverse consequences for society – including minority shareholders, investor confidence, future accountants and managers in the making.



Originality/value – This study provides direct and practical evidence on the “how” and “why” of FFR in the context of a developing country – Malaysia. Such evidence is limited in the existing literature and relevant to practitioners.

Keywords Motives, Methods, Fraudulent financial reporting

Paper type Research paper

1. Introduction

From 2005 to 2007, Malaysia witnessed an unprecedented outbreak of cases of fraudulent financial reporting (FFR) among publicly listed companies on the Bursa Malaysia. In one such prominent case, the company inflated its reported revenue by MYR527 million, about US\$150 million, in three consecutive financial years up to 2006 – a massive 52 per cent higher than the subsequently restated number. The revelations surrounding these cases caused an Enron-like implosion to the Malaysian capital market. In the existing literature, a great majority of studies have focused on FFR in developed countries such as the USA (Beasley *et al.*, 2000; Dechow *et al.*, 2011; Perols and Lougee, 2011). In a developing economy like Malaysia, published academic literature relevant to FFR is in contrast rare[1]. Furthermore, evidence on the detailed operations of FFR is limited, even in developed countries. Our present study aims to fill these gaps and provide insightful evidence on the operational aspects of FFR cases in a developing country. We ask a basic but highly operational research question:

RQ1. How and why do FFR cases take place in Malaysia?

As a developing country, Malaysia has a unique institutional environment for financial reporting, with a number of comparable characteristics to those of developed countries, but also some distinctive features of a developing country. In line with developed countries, Malaysia has a well-developed capital market with established capital market and securities laws, company regulations and statutory audit and disclosure requirements. We conjectured that Malaysian companies should have the same market incentives (motives) to embark on FFR as companies in developed countries. Moreover, Malaysia has since the 1970s gradually adopted the International Accounting Standards (IAS) for corporate reporting (Ball *et al.*, 2003) and achieved full convergence with the IFRS in 2012. As both are based on the same accrual accounting system, we also conjectured that the FFR methods used in Malaysia should be similar to those in developed countries.

On the other hand, like some other developing countries, Malaysia is relatively weak in law enforcement (Sulaiman, 2008) and investor protection (Leuz *et al.*, 2003); while its companies tend to have more concentrated ownership structures (Nurwati *et al.*, 2011) as well as stronger political connections (Gul, 2006) than those in developed countries. Hence, it is reasonable to assume that the opportunities to carry out FFR should be greater in developing countries than developed countries. However, our study focuses only on FFR methods and motives, rather than the opportunities[2]. In other words, we aim to provide empirical evidence of FFR in a developing country rather than a comparative study between developed and developing countries.

For our study, we identified a total of 23 sample companies that had been involved in FFR, drawing on the enforcement action releases (EARs) published by the Securities Commission of Malaysia (SC) from 1998 to 2012[3]. Due to the limited number of FFR cases reported, we believe that a close examination of these cases is the best way to reach

a more comprehensive and detailed understanding of “how” FFR cases take place, rather than performing large sample statistical analyses. This is consistent with the approach of [Dechow and Skinner \(2000\)](#), who concluded that accounting researchers derive their findings mainly from statistical analyses of large samples, whereas practitioners study cases by examining closely specific instances of financial reporting. We also collected data about these companies which provide evidence for their possible motivation in resorting to FFR in the first place – in other words, “why” the FFR took place.

Our study contributes to the relevant body of knowledge in a number of ways. First, it discusses the nature of the common methods to, and possible motives for, FFR in the context of a developing country like Malaysia. Such evidence is limited in the extant literature on FFR. Second, it provides specific instances on cases involved in FFR[4]. It clearly demonstrates how sample companies were involved in a chain of manipulations, i.e. from an initial manipulation to a consequential manipulation, as well as masking manipulations. Next, it provides evidence that interim reporting is also subject to manipulation – a gap for which empirical evidence was lacking ([Hogan et al., 2008](#)). More importantly, it links the relevant theoretical aspects of FFR and earnings management with practice.

The remainder of this paper is organised as follows. The next two sections discuss the literature relevant to FFR and the research design. The fourth section presents the findings and discussion on the methods and motives for FFR. The final section contains the conclusions.

2. Literature review

The term FFR has been widely researched under different constructs, such as earnings management, earnings manipulation and accounting fraud. In fact, many studies show that several of these constructs are closely related, with the occurrence of one construct often leading to another more egregious one, such as earnings management segueing into financial statement fraud ([Badertscher, 2011](#); [Perols and Lougee, 2011](#)). Following [Ball \(2009\)](#), we posited that FFR is a practice in earnings management in which managers knowingly fail to comply with the generally accepted accounting principles (GAAP) and breach the relevant securities laws.

2.1 *Fraudulent financial reporting methods*

Analogously with [Nelson et al. \(2003\)](#), we reviewed and grouped FFR methods into revenue recognition, expense recognition, issues unique to business combinations and other issues.

Revenue is the most pervasive reporting item in FFR – a typical manipulation is to overstate revenue ([Beasley et al., 2000](#); [Nelson et al., 2003](#); [Rezaee, 2005](#); [Dechow et al., 2011](#)), which leads to a direct inflation of reported earnings ([Perols and Lougee, 2011](#)). Revenue manipulation methods may vary from the early or late recognition of real transactions and events (earnings management), to the falsification of non-existent transactions and events (frauds) ([Rezaee, 2005](#); [Perols and Lougee, 2011](#)). [Beasley et al. \(2000\)](#) recorded improper revenue recognition, i.e. recording revenues prematurely and fictitious revenues, as the most common FFR method used among the sample fraud companies.

Nelson *et al.* (2003) concluded that the most common methods used to manipulate expense accounts are the over- or under-recognition of reserves/provisions. Dechow *et al.* (2011) also found that the manipulation of inventory valuation can indirectly reduce the cost of goods sold, as closing inventories are artificially made higher. Provision for the diminution of asset values such as PPE and financial assets, including trade receivables (impairment losses and bad debts), is another commonly used method in expense manipulation. It reduces current income and therefore tends to be avoided by companies with already low income levels prior to such provision.

Transactions in business combinations are usually complex and therefore vulnerable to FFR. Palmrose and Scholz (2004) showed that non-GAAP merger-related items are the most frequent restated areas for non-core accounting restatements in the USA. These restatements involve corrections of accounting methods, from pooling of interest to purchase method, rectifications of goodwill estimates, in-process research and development expenses and acquisition reserves. Nelson *et al.* (2003) also found that managers tended to create a “cookie jar” out of inflated liabilities and goodwill from an acquisition, which they could later use to cover any losses in the post-acquisition period.

Other methods involve, essentially, classification and disclosure issues: managers seek to avoid major expenses or liability items being too “exposed” in their income statements, by manipulating the classification of these items. For instance, Nelson *et al.* (2003) found that managers labelled expenses as *non-recurring*, classified some expenses under the *others* category so as to offset the impact of gains and losses for disclosure purposes, made inadequate disclosures of related party transactions, used off-balance-sheet items and so on.

2.2 Fraudulent financial reporting motives

Unlike FFR methods, there is a much larger body of studies examining various conditions – motives, causes, firm characteristics, etc. – for firms committing FFR (see Dechow *et al.*, 2011 for a comprehensive study on FFR causes). Many of these studies have been structured around the fraud triangle: incentive (motive), opportunity and rationalisation factors (Hogan *et al.*, 2008 for a review of these studies). In our study, we focused on FFR motives consistent with our aims, rather than the various other conditions which may provide opportunities to commit FFR such as corporate governance (Beasley *et al.*, 2000) and audit quality (Carcello and Nagy, 2004) or rationales for acting in this way, such as the attitude of the CFO (Gillett and Uddin, 2005). We reviewed three specific FFR motives relevant to our study.

First, Dechow *et al.* (1996) and Richardson *et al.* (2002) found evidence pointing to the motivation to raise external capital as an important driving force for earnings manipulation. In more recent studies, Dechow *et al.* (2011) found that AAER firms which restated their reported earnings had been actively raising capital in and before the misstating years in relation to other non-AAER firms. Similarly, Firth *et al.* (2011) found that Chinese firms planning to make equity issues were more likely to manipulate their reported earnings. Researchers have also documented evidence of managers embarking on earnings manipulation in initial public offerings (IPOs) (Wan, 2013).

Second, Dechow *et al.* (1996) and Richardson *et al.* (2002) also provided evidence that the motivation to avoid breaching debt covenants is an important driving force in earnings manipulations[5]. Carcello and Palmrose (1994) showed that companies in financial distress are more likely to engage in FFR than healthier companies. Flanagan

et al. (2008) posited that there is a higher tendency in managers to manipulate earnings to obtain more favourable terms on new financing or to remain in compliance with the covenants of existing financing. The closer a company is to breaching its debt covenants and defaulting on repayments, the more likely it is to tip over the edge into FFR to retain its financing sources. Companies with especially high levels of outstanding debts are generally more likely to be more aggressive in their financial reporting than other companies (Richardson *et al.*, 2002).

Third, Jensen (2005) conjectured that equity overvaluation puts a company into a situation that is highly difficult to manage and is eventually likely to destroy part, if not all, of the core value of the company. In this situation, managers are likely to make long-run value destroying decisions to sustain market growth expectations. Eventually, when the condition gets worse, managers may turn to earnings manipulation or fraudulent reporting to create the appearance of growth and value creation to sustain the equity overvaluation. Moreover, FFR methods are likely to segue from within-GAAP earnings management to non-GAAP violations, the longer the equity overvaluation persists (Badertscher, 2011).

3. Research design

The key identifiers for FFR cases in the EARs were descriptions relating to the submission of false statements, or more specifically allegations brought against companies pursuant to Sections 368 or 369 of the Capital Market and Services Act of 2007 (CMSA), which superseded the Securities Industry Act, 1983. Section 368 of the CMSA covers the falsification of records by directors, employees and agents, while Section 369 covers false reports to the Commission, Stock Exchange or recognised clearing house, and requires the perpetrators to have the intent to deceive, or make or furnish false or misleading statements or reports. We examined and collected the required data from the EARs, company announcements to the Bursa Malaysia, financial statements, auditors' reports and disclosures on significant events, all of which provide direct evidence or indicators helpful to analysing the methods and motives for these FFR cases.

We examined the FFR cases listed in Table I and classified the financial reports manipulated into four types: annual audited accounts, quarterly financial reports, financial reports contained in listing proposals or IPO prospectuses and corporate restructuring proposals. It is important to note that most frauds were discovered several years after their actual occurrence (Kaminski *et al.*, 2004). Therefore, the financial statements involved might have been distorted for not only one financial year but also overlapping at least two prior financial years (i.e. Transmile). Furthermore, frauds were not usually detected only in annual financial statements; they might also occur in interim reports, i.e. MEMS. Seven sample companies manipulated the financial reports contained in their proposals or prospectuses to the SC for the approval of IPOs and listing exercises. Two sample companies manipulated financial reports contained in their proposals to the SC for corporate restructuring exercises: Ocean Capital involved a target acquired company, while Omega involved a new transferee company which was the target recipient of its transfer of listing status.

We examined the FFR methods used and classified them into revenue recognition, expense recognition, business combination related and other issues. Analogously with Kaminski *et al.* (2004), we collected the originally reported (misstated) and subsequently

No.	Companies	Year of revelation	Annual audited accounts	Quarterly report	Financial report manipulated Listing proposal/IPO prospectus	Corporate restructuring proposal
1	Zaitun	1998/2000	1997/1999			
2	Ganad	2001			1998	
3	Tat Sang	2002	2000			
4	Aktif Lifestyle	2005	2004			
5	Goh Ban Huat	2005		4th Q 2004		2003
6	Ocean Capital	2005				
7	Oilcorp	2005	2003			2003
8	Omega	2005				
9	GP Ocean Food	2006			2006	
10	Granasia	2006			2006	
11	Hospitech	2006			2006	
12	Polymate	2006	2005			
13	Megan Media	2007		3rd Q 2007	2004	
14	NasionCom	2007	2005			
15	Southern Bank	2007	2005			
16	Transmile	2007	2004-2006			
17	United U-Li	2007	2004			
18	Welli Multi	2007	2005			
19	Wimems	2007	2005		2005	
20	LFE	2008		1st - 3rd Q 2006		
21	Satang	2008		1st - 4th Q 2007		
22	MEMS Technology	2009	2007/2008	1st - 4th Q 2007		
23	Inix Technologies	2010		1st/2nd Q 2009		
	Total attempts		12	7	7	2

Notes: The variable-year, in the columns "financial reports manipulated" refers to the year of the financial reports; for instance, Zaitun manipulated its audited annual accounts for the financial years ended 1997 and 1999; Q denotes quarter

Table I.
Fraudulent financial reporting cases in Malaysia from 1998 to 2012

restated amounts in these FFR cases, where data were available, to ascertain the magnitude of the manipulation. Based on the notion that earnings manipulation has consequential effects on accrual items (Dechow *et al.*, 2011), we identified associated consequential manipulations, such as bogus receivables following initial bogus revenues. In some cases, FFR companies may also have manipulated another related item to mask the initial manipulation – such as inflating the cost of sales to keep a normal gross profit margin, as greater than expected margin may alert the auditors (Church *et al.*, 2001). Hence, we analysed each FFR case, where data were available, along this chain of manipulations.

We read company announcements to identify sample companies that had raised or proposed to raise equity/debt capital (including IPOs) or looked for a better position to raise capital (transfers to another listing board) around the FFR years. We used debt-to-equity ratios (DER) as a proxy to examine whether FFR cases tend to occur because of impending debt covenants and consequent default on repayment (Church *et al.*, 2001; Dechow *et al.*, 2011; Elayan *et al.*, 2008). We used market-to-book ratios (MBR) as an indicator of stock overvaluation and its relationship with FFR occurrence. We reviewed the trends of ratios between 5 years before (–5) and 2 years after (+2) the first FFR year (0) – the first year when the financial statements of a company started to include intentional misreporting (Kaminski *et al.*, 2004). Analogously with Beasley *et al.* (2000) and Carcello and Nagy (2004), we identified a control company which had not been associated with FFR, matched by industry and firm size (measured by total assets), for each of our sample companies. Consistent with Elayan *et al.* (2008) and Firth *et al.* (2011), we ran the *t*-test to examine for differences in ratio means between the sample and control companies.

4. Findings and discussions

We observed that 17 of the 23 FFR cases were revealed during 2005-2007, i.e. the outbreak (Table I). Consistent with Ball (2009), we conjectured that this outbreak was the consequence of a prolonged economic growth cycle coming to an end. After posting negative growth of 7.56 per cent in gross national income (GNI) in 1998 as a consequence of the 1997 Asian financial crisis, the Malaysian economy recorded average GNI growth of above 6 per cent for the period 1999-2007. However, this slowed to 3.7 per cent in 2008, and dipped into negative growth again in 2009, as a consequence of the global financial crisis. During this period, performance expectations built up for some companies which were no longer sustainable, prompting some managers to embark on FFR. At the same time, the prolonged growth period had made corporate monitors such as board members, auditors and regulators (Ball, 2009) come to accept higher performance as a normal pattern rather than a risk indicator. We further conjectured that this outbreak of FFR in Malaysia – and the fact that it came to light – was a contagious effect from the US accounting scandals of 2001-2002. Ball (2009) recognised the fact that scandal waves spread widely and quickly. The revelations of all these US cases within such a short period as well as the post-scandal measures introduced in the USA (e.g. the Sarbanes-Oxley Act 2002 and the formation of the Public Company Accounting Oversight Board) prompted the Malaysian authorities to tighten the governance mechanisms in the capital market and corporate reporting. Post-outbreak, the opportunities to embark on FFR were much reduced, and the expected economic

consequences outweighed the incentives to do so – which explains the drastic drop in FFR cases after 2007.

4.1 Fraudulent financial reporting methods

4.1.1 Revenue recognition. Our findings showed that 19 sample companies inflated their reported revenue in their financial reports (Table II). Collectively, the overstated revenue amounted to MYR1,554 million (about US\$450 million), which was approximately 60 per cent – i.e. more than half – of their subsequently restated amount (Table III). Omega overstated its reported revenue by 382 per cent, the highest percentage recorded among the sample companies. In absolute terms, Transmile reported the highest overstated amount, MYR527 million, while Welli Multi inflated its reported revenue to above MYR1 billion for a period of one financial year plus three subsequent interim quarters.

All the 19 sample companies inflated their revenues by recognising fictitious sales with bogus customers, while one of them also recognised future revenues too early. The IASB *Conceptual Framework of Financial Reporting* (International Accounting Standards Board, 2010) defines income as *increases in economic benefits during the accounting period in the form of inflows or enhancements of assets or decreases of liabilities that result in increases in equity*. Hence, when a company recognises fictitious sales from a bogus customer, it also has to recognise a fictitious increase in an associated non-cash asset. We collected direct evidence from nine of the sample companies which

No.	Companies	Categories of methods/techniques			
		Revenue recognition	Expense recognition	Business combinations	Others
1	Zaitun	X	X		X
2	Ganad	X	X		
3	Tat Sang	X	X	X	
4	Aktif Lifestyle			X	
5	Goh Ban Huat			X	
6	Ocean Capital	X			
7	Oilcorp			X	X
8	Omega	X			
9	GP Ocean Food	X			
10	Granasia	X			
11	Hospitech	X	X		
12	Polymate	X	X		X
13	Megan Media	X	X		X
14	NasionCom	X			
15	Southern Bank		X		
16	Transmile	X	X		
17	United U-Li	X	X		
18	Welli Multi	X	X		
19	Wimems	X	X		
20	LFE	X	X		
21	Satang	X			
22	MEMS Technology	X	X		
23	Inix Technologies	X			
	Total attempts	19	13	4	4

Table II.
Methods of
fraudulent financial
reporting

Table III.
Initial, consequential
and masking
manipulations

No.	Companies	Initial manipulation		Overstated revenue	Consequential manipulation (N5)		Masking manipulation (N5)	
		Reported revenue	Restated revenue		Trade receivable	PPE*/Cash**	Cost of sales	Trade payable
1	Zaitun (N1)		DNA		31			
2	Ganad (N1)		DNA		8	4**		
3	Tat Sang (N1)		DNA		5			
4	Ocean Capital	199	191	8 (4)				
5	Omega (N2)	82	17	65 (382)				
6	GP Ocean Food	180	154	26 (17)				
7	Granasia (N1)		DNA	27 (NA)				
8	Hospitech (N1)		DNA	XX			XX	
9	Polymate	135	112	23 (20)				
10	M. Media (N3)	306	133	173 (130)	324	222*	157	
11	Nasioncom	195	52	143 (275)				
12	Transmile (N4)	1,539	1,012	527 (52)	234	291*/189**		
13	United U-Li	73	69	4 (6)				
14	W. Multi (N4)	1,046	720	326 (45)	73		307	4
15	Wimems (N4)	59	30	29 (97)	32			
16	LFE	257	131	126 (96)				119
17	Satang	68	32	36 (113)	32			
18	MEMS (N3)	163	114	49 (43)	39			
19	Imix (N1)		DNA					
	Total	4,103	2,576	1,554 (60)				

Notes: These are fraudulent financial reporting cases charged by the SC for falsified revenue reporting; however specific data are either not available or incomplete. In the case of four of these six sample companies, the manipulation occurred during their IPO exercises, and there were therefore no or insufficient subsequent data sources for verification; manipulation of revenue recognition in a new company under a proposed corporate restructuring exercise; quarterly figures. The MYR222 million PPE is the fictitious prepayment of a deposit for PPE purchases; combined manipulated figures for two or more financial periods; these figures are either reported or suspected. Reported manipulations are restated figures as directed by the SC; suspected manipulations are reported by auditors when the necessary audit evidence for verification is either insufficient or unavailable; DNA denotes *data not available*; NA denotes *not available*; XX denotes an equal amount; * denotes PPE; and ** denotes cash; all figures in the “manipulations” columns are denominated in MYR million, except those in parentheses, which are in percentages (%)

recognised fictitious trade receivables. In time, such a company has to make a provision for doubtful debts and eventually write these fictitious receivables off as bad debts, which reduces the profit for the period when the provision is made. In some cases, the companies may eventually “receive” another asset such as cash or PPE as a repayment of the fictitious trade receivable, in an attempt to keep deferring the need to write the fictitious asset off. For instance, Transmile, Megan Media and Wimems attempted to reduce their fictitious trade receivables by “receiving” PPE, inventories and/or cash. In fact, Transmile received various cash payments purportedly for the settlement of the trade receivables which, based on audit evidence, originated from bank accounts within its own group. These observations show that companies seek to cover up their inflated revenues through further FFR attempts.

We also found that some of the sample companies which had inflated their revenue also inflated their trade purchases and cost of sales (for instance, Hospitech, Megan Media, Welli Multi and LFE). The level of purchases determines the cost of sales to be charged to the income statement for a financial year, and is a major component of costs in an income statement. The aim of these actions may have been to overstate revenue in such a way that it did not significantly increase the gross profit margin over the previous financial years, but did increase the net income in absolute terms. These are further types of manipulations which aim to mask fictitious sales.

In sum, companies that attempted to manipulate revenue by the recognition of fictitious sales, as initial manipulations would follow these with consequential manipulations, and possibly also masking manipulations. All these manipulations are possible because of the discretion given to managers under the accrual accounting system. However, these same manipulations also increase the sources of evidence which may lead to their eventual discovery. This phenomenon indicates that accrual accounting provides opportunities for FFR, on the one hand, but can also, in time, help to uncover such FFR cases (with audit process as the enabler), on the other.

4.1.2 Expense recognition. We found that two sample companies had manipulated their provision for inventory obsolescence. For instance, Megan Media was found to have overstated its inventory balance by MYR101 million, i.e. it failed to transfer this inventory cost to the cost of sales. We also found that sample companies which had been asked to restate their manipulated figures of PPE were also subject to adjustments in their impairment losses on PPE (for instance, Transmile, Megan Media and Polymate). However, from the limited information available, it was not possible to establish whether and to what extent these impairment losses were a reversal of initial overstatements in PPE or were rather due to intentional omissions aimed at avoiding expense-increasing adjustments. We also found that two companies, namely, Zaitun and Southern Bank, failed to write down the value of, or make sufficient provision for, some financial assets such as derivatives, loans and other investments. Southern Bank, for example, underprovided MYR160 million as an impairment loss of its financial assets, and hence overstated its net assets when it was an acquisition target in a bid by another major bank.

4.1.3 Business combinations and consolidation. As indicated in [Table II](#), we found four FFR attempts in the area of business combinations (and the consolidation of financial statements). Aktif Lifestyle prematurely de-recognised the operations of subsidiaries it had disposed of, and manipulated its consolidated profit upward to MYR47 million from a loss of MYR18 million. Three sample companies attempted to

inflate their bottom lines by not eliminating gains arising from intra-group transactions (Goh Ban Huat and Oilcorp) or pre-acquisition profits (Tat Sang).

4.1.4 Other methods. As presented in Table II, we found four sample companies using other FFR methods. Oilcorp classified an exceptional item as an *extraordinary item*, even although the IASB prohibited the classification of extraordinary items in the income statement. Three other sample companies failed to make the disclosures required by the relevant IFRS. Megan Media and Zaitun failed to disclose certain related party transactions as required by IAS 24 *Related Party Disclosures*, while Polymate failed to disclose contingent liabilities as required by IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*.

4.2 Motives for fraudulent financial reporting

4.2.1 Capital raising exercises. First, we found that five sample companies had structured significant capital raising exercises around the FFR years (Table IV). Five months prior to its FFR, Megan Media received SC approval to issue MYR320 million worth of serial bonds. Nineteen days after the publication of manipulated financial reports, Oilcorp issued a medium term note to raise MYR70 million cash. During the FFR year, LFE issued 55 million new equity shares. One year after the FFR year and prior to this being uncovered, Transmile issued five-year guaranteed redeemable convertible bonds with a nominal value of US\$150 million, and a private placement of shares to raise gross proceeds of approximately MYR228.62 million. Twenty-one days after the release of the first of four quarterly manipulated reports, Satang announced that it had received a total of MYR95 million in bank facilities.

Next, we found seven sample companies manipulated financial reports contained in IPO-related documents. GP Ocean, Granasia and Ganad were seeking to be listed on the then main board of Bursa Malaysia, and therefore had to meet more stringent listing requirements and rules than was the case with listing on the other two boards. For instance, Granasia included fictitious sales and purchases in its financial statements when submitting its listing proposal, to meet the minimum threshold of MYR8 million profit after tax for main

Capital raising exercises	Companies (No.)	Descriptions
Subsequent capital raising	Oilcorp, M. Media, Transmile, LFE, Satang (5)	Subsequent debt and equity capital raising via various financial instruments
Initial public offerings	Gand, GP Ocean, Granasia, Hospitech, Nasioncom, Wimems, Inix (7)	First equity capital raising from the public and listing (main and MESDAQ markets). Three unsuccessful and four listed. Three companies also raised capital subsequent to IPO
Transfer of listing board	United U-Li, MEMS (2)	Transfer from a lower listing board to main board/market
Acquisition bid	Southern Bank (1)	A target company in an acquisition bid

Table IV. Fraudulent financial reporting cases and capital raising exercises

board listing. Four of these sample companies succeeded in their listings despite their financial manipulations. In fact, Inix's initial offerings were over-subscribed by 17.19 times and overpriced, as emerged when the company's first-day trading price closed way below the initial offer price. As no market-determined price is available prior to public listing, issuers and underwriters have to use non-price information to establish a reasonable offer price which reflects the financial strength of the issuer (Friedlan, 1994). Because of the information asymmetry between potential issuing companies and outsiders (Francis, 2004), the sample companies had an incentive to overstate their earnings in the run-up to taking the companies public. Furthermore, we found that three of these sample companies continued to manipulate subsequent financial information, such as annual and/or quarterly interim accounts, after the listing. This is consistent with the finding by Sadka (2006) that companies have to keep up their FFR once they have started. Otherwise, the market will fairly quickly be able to spot the existence of FFR.

Analogously with IPOs, two sample companies were found to have committed FFR for the presumed purposes of transferring listing boards. Generally, the purpose of a transfer to a more prestigious board is to better reflect the stature of a company, as it grows larger and to enhance the company's reputation and boost confidence and recognition among investors. United U-LI was found manipulating its financial statements a year before the company was about to transfer its listing from the Second Board to the Main Board. Similarly, MEMS inflated its revenue by 61 per cent prior to its transfer from MESDAQ to the Main Board in 2007, at the time when its proposal for transfer listing was being submitted to the SC.

4.2.2 Closeness to the default of debt covenant and repayment. The mean values of DER for the sample and control companies are presented in Table V. In Year 1, the sample companies recorded the highest mean value of 1.73, whereas the control companies had a much lower mean value of 0.46 (significant at 10 per cent). In fact, the mean value gap between the sample and control companies first emerged in Year 5 and lasted until Year 0, with the largest gap of 273 per cent recorded in Year 1. This confirms

	Year relative to occurrence of fraudulent financial reporting							
	-5	-4	-3	-2	-1	0	+1	+2
<i>Mean debt-to-equity ratios</i>								
Sample companies	0.84	0.72***	1.04**	0.94*	1.73*	0.80**	0.69	0.55
Control companies	0.65	0.26***	0.42**	0.49*	0.46*	0.39**	0.44	0.43
Variance (%)	+30	+181	+145	+94	+273	+104	+57	+28
<i>Default in repayment</i>								
PN1/GN5 sample companies (N3)					1	2	4	4

Notes: Data with debt-to-equity ratios of negative value have been excluded as outliers. Technically, a negative value ratio is a consequence of negative shareholders' equity and no longer reflects the magnitude of debt in relation to its equity. Conceptually, the value of the ratios should have been higher if equity values had stayed positive. The figures in the "default in repayment" row indicate the number of companies involved; *** indicates $p < 0.01$; ** indicates $p < 0.05$; * indicates $p < 0.10$, one-tailed two-sample t -test; these practice notes, PN1 for the main market and GN5 for the MESDAQ market, pursuant to Bursa Malaysia's Listing Requirements, set out some circumstances upon which a listed issuer must announce an event of default of interest or principal payments for debts

Table V.
Debt-to-equity ratios
and default of debt
repayments

that the sample companies were more highly leveraged than the control companies, and that their debt levels as well as repayment burdens had been building up towards the FFR year (Year 0). We also collected direct evidence from company releases showing that 11 sample companies reported a default of debt repayments around the FFR year (Table V). These observations indicate that the sample companies were motivated to become involved in FFR in an attempt to loosen or avoid breaching their debt covenants, if any, and to window-dress their capacity to raise new capital for debt repayments or debt restructuring.

4.2.3 Sustaining equity overvaluations. Table VI presents the mean values of MBR for the sample and control companies. In Year 1, the sample companies recorded the highest mean value of 1.92, compared to a relatively lower mean value of 0.88 in the control companies (significant at 5 per cent). In fact, the mean value gap between the sample and control companies first emerged in Year 5 and lasted to Year 0, reaching its maximum – a variance of 119 per cent – in Year 1. The consistently larger than 1 mean market-to-book values of the sample companies (Badertscher, 2011) over those of the control companies from Year 5 until Year 0 indicate a sustained build-up of stock overvaluation. In contrast, the market-to-book mean value of the sample companies declined to below 1 after the FFR year and stayed below the comparable value of the control companies. Although the build-up of overvaluation took a number of years, the decline in value was rather immediate after the revelation of the FFR cases (Dechow *et al.*, 2011). Presumably, this decline in company value was due to market corrections, i.e. an efficient market reaction, after the news of the FFR reached the market. Although by Years +1 and +2, not all of the FFR cases had yet become public, insider information about the companies' manipulations may already have leaked out to the market and been incorporated into the stock prices and hence value of the companies.

5. Conclusions

We investigated the common methods of (how), and motives for (why), FFR cases based on a sample of Malaysian companies as reported in SC EARs published from 1998 to 2012. The primary limitation of this study is its lack of breadth due to the limited number of reported cases available. Moreover, taking the sample companies used from EARs published by the SC presupposes that the SC has diligently and correctly identified all the FFR cases – whereas there is a possibility that some companies involved in FFR may not yet have been detected or publicly revealed.

	Year relative to occurrence of fraudulent financial reporting							
	-5	-4	-3	-2	-1	0	+1	+2
Sample companies	1.06*	1.65**	1.39*	1.38*	1.92**	1.27	0.77	0.91
Control companies	0.72*	0.77**	0.72*	0.81*	0.88**	0.92	0.96	0.97
Variance (%)	+48	+115	+93	+71	+119	+38	-17	-6

Table VI. Mean of market-to-book ratios for sample and control companies

Notes: Data with market-to-book ratios of negative value have been excluded as outliers. Technically, a negative value ratio is a consequence of negative shareholders' equity (the book value of net liabilities) and no longer reflects the magnitude of book value in relation to its market value. Conceptually, the value of the ratios should have been higher if equity values had stayed positive; ** indicates $p < 0.05$; * indicates $p < 0.10$, one-tailed two-sample *t*-test

Notwithstanding these limitations, our findings provide a comprehensive insight, which is sufficient in depth, into the operational aspects of FFR in Malaysia. These findings therefore reduce the gap in empirical evidence on FFR cases in Malaysia, a developing market, and provide some implications for future research. First, the growing number of FFR studies in developing countries will enable future research to focus on comparative studies between developing and developed countries. This is especially so with regard to the motives for, and firm characteristics of FFR cases, albeit such studies could still be difficult in the absence of large panel data. An ideal platform for such comparative studies would be the institutional environment of financial reporting in the relevant countries. Second, future research could focus on the how and why of FFR at the outbreak rather than company-specific level; in other words, the characteristics of each outbreak in the past as well as across different countries. Finally, future studies might focus on the chain of manipulations, i.e. the operational details of each FFR.

Our study also sheds some valuable light on the various high-profile FFR cases that have taken place in Malaysia. One practical lesson from the findings on “how” within the chain of manipulations is that auditors ought to review the effectiveness of their analytical and substantive procedures, as a number of the FFR cases remained undetected by the audit process. A second is that accounting standards setters may wish to reconsider the amount of discretion given to managers in financial reporting. On the one hand, some managers have used this discretion to provide useful information to the market; however, others have opportunistically used it for personal gain. From the societal perspective, it is time for managers, as agents of capital providers, to self-review their responsibilities and stewardship in financial reporting. There needs to be a paradigm shift in their attitudes towards the perceived incentives of, and opportunities for, FFR. Managers’ wrongdoings in these accounting scandals have had significant adverse consequences for society – including minority shareholders, investor confidence, future accountants and managers in the making.

Notes

1. A recent published study on determining factors of FFR in Malaysia by [Hasnan *et al.* \(2013\)](#) cited no prior studies in the area.
2. See [Hasnan *et al.* \(2013\)](#) for a study on the opportunities for FFR in Malaysia. Unlike this study, our present study focused on FFR methods and two different key motives.
3. These EARs resemble the Accounting and Auditing Enforcement Releases (AAERs) published by the US Securities and Exchange Commission.
4. The existing body of knowledge in FFR is very much focused on the conditions of occurrence, i.e. motives and causes, and is mainly based on statistical inferences from firm characteristics, both financial and non-financial.
5. Very often, these debt covenants are based on accounting measures such as interest coverage, gearing and dividend payouts.

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