Financial Statements Fraud Control: Exploring Internal Control Strategies in Two Malaysian Public Interest Entities.

Norazida Mohamed

A thesis is submitted in fulfilment of the requirements for the award of the degree of Doctor of Philosophy

Teesside University Business School
Teesside University, Middlesbrough, United Kingdom

October 2013
Financial Statements Fraud Control: Exploring Internal Control Strategies in Two Malaysian Public Interest Entities'

Submitted by
Norazida Mohamed

To Teesside University as a thesis for the degree of Doctor of philosophy in Fraud Management/Forensic Accounting at the Teesside University Business School, October 2013.

The study was undertaken under full scholarship of Ministry of Higher Education Malaysia and University Technology MARA Malaysia

This thesis is available for library use on the understanding that it is copyright material and that no quotation from the thesis maybe published without proper acknowledgement.

I certify that all material in this thesis which is not my own work has been identified and that no material is included for which a degree has previously been conferred upon me

Signed:

Norazida Mohamed
25th October 2013
Pre-Publication of work

Progress of this thesis has been used to inform regular conferences and published. Copies of published materials as follows are bound in appendices:

<table>
<thead>
<tr>
<th>No</th>
<th>Conference details</th>
<th>Publications</th>
</tr>
</thead>
</table>
Abstract

Financial statement fraud control has attracted considerable attention and associated response in recent years due to the incalculable collateral damage that could drain the long term success of companies. This research aims to present recommendations to improve financial statement fraud control in commercial companies. The research also evaluates the current strategies for the prevention and detection of financial statement fraud and the reaction thereto. Accordingly, the research attempts to highlight the best practices and weaknesses from the present practices. Based on the experience of two Malaysian commercial companies, the research provides ameliorations to improve the current weaknesses, in particular, to financial statement fraud control. The research takes a normative point of view in making recommendations for financial statement fraud control. A qualitative research methodology is adopted in conducting the investigation to understand the actual conduct of practices. Hence, the primary data are acquired from the case study companies and interviews with the relevant group of respondents, and secondary data from the law, regulations, legislation and professional guidelines. The research investigates the financial statement fraud regulations to understand the legal framework as well as the legal practice. Furthermore, the professional guidelines are examined to understand what the professional bodies have suggested to manage the risk of fraud, thereby enabling the researcher to understand the consequences of the actual practices and provide improvements for financial statement fraud control. In addition, interviews with regulators, forensic accountants, external auditors and independent bodies are conducted to develop an understanding of the protocols of financial statement fraud in Malaysia. Therefore, the findings of the research are a mix of the present practices, respective roles, and perceptions concerning the issues of financial statement fraud control.

The case study findings demonstrate that neither case study company is highly concerned about the issue of financial statement fraud control. This provides an indication that no
evidence was gained concerning specific controls embedded in the present internal control system and typifies the actual practice, in particular, the prevention, detection and response strategies to mitigate financial statement fraud. The lack of evidence presents a research limitation to identify any best practices for the mitigation of financial statement fraud in the context of commercial companies in Malaysia. The research results indicate that the case study companies are highly reliant on their respective internal controls for the prevention of financial statement fraud and detection strategies. In addition, they demonstrate that the present internal audit functions focus on operational audit and concern pertaining to corporate risk. This provides an indication that the scope of the internal auditing work is not primarily concerned with the accuracy of the financial statement information, but rather with the risk of losses to the respective companies. This certainly leaves scope for an expectation gap to arise in the present internal audit functions and the association of internal audit and risk towards financial statement fraud. The particular aspects concerning the detection of fraud in financial statements and financial statement fraud control have been perceived differently between the company’s internal and external auditors. The combined results of the perceived control by company management, the present audit functions, and the detection and control responsibilities of the internal and external auditors provide and support the existence of an internal audit expectation gap. The overall case study findings indicate evidence of an internal audit expectation gap, which constitutes a serious flaw in the internal control systems adopted by the companies. Therefore, the contribution of this research might improve the present internal control system and provide a more holistic solution for financial statement fraud control. A review of the findings also indicates that Malaysia implements the lowest penalties and exercises the most lenient enforcement in relation to financial statement fraud cases compared to the UK and the US. The research has made contributions to research methodology; contributions to knowledge about the present practices in the form of practical recommendations to improve practice; contributions to academic theory in relation to the theoretical concept of financial statement fraud control and internal auditing of financial statement and, finally, contributions to the regulators and
standard setters. The research also offers anti-fraud programmes, particularly in respect of the prevention, detection and response strategies as part of a company's efforts to mitigate financial statement fraud. Overall, the research contributes to the study of financial statement fraud control and provides practical recommendations for financial statement auditing theory. The focus on financial statement fraud in commercial companies would enhance the reliability of the issued financial statement.

Keywords: Financial statement, fraud, control
Dedication

Alhamdulillah…

I would like to dedicate this thesis to the memory of my late father. He encouraged, supported and inspired me to pursue my education to the highest level possible. Also, to my mother; enduring and praying for every success of mine; you are always in my heart.

A special dedication to my husband. Thank you for your great support and patience throughout my studies. To my daughter Amanda and my son Nazrin, both of you inspired me throughout my studies. My grateful thanks to all my family and friends in Malaysia, I really appreciate your ‘Doa’.

This thesis has meant so much to me and I thank you all very much indeed.
Acknowledgements

I have been blessed to have such an auspicious and great supervisory team. Sincere gratitude to my director of studies, Mr Rob McCusker and Dr Morrison Handley-Schachler (second supervisor) and Associate Professor Dr Norhayati Mohamad (third supervisor).

To Rob, I greatly appreciate your encouragement and thoughtfulness. You have boosted my confidence and aided me to perceive certain things in a new light. Deprived of your great guidance and advice, I would not be where I am today. You have been very patient and supportive in my understanding of this new world. The assistance you have given me was so detailed and thoughtful.

To Dr Handley Schachler your guidance and encouragement has inspired me to complete this thesis. I learned how to look at details and to make them into a whole. Thank you very much indeed for all your advice and patience throughout my studies. To Dr Norhayati, even though you are far away; your constructive comments and guidance encouraged me to finish this thesis.

To Teesside University Business School and all my colleagues: What a wonderful experience we have shared together. Thank you for all the cooperation throughout the years.

To the Ministry of Higher Education Malaysia and University Technology Mara, I am deeply indebted to you for this opportunity to become a PhD scholar. Hopefully, my PhD contribution will benefit all.

Thank you very much indeed.
CHAPTER ONE
Introduction

1.0 Introduction .......................... 2
1.1 Research overview .................. 3
1.2 Research problem statement ....... 4
1.3 Research aim and objectives ...... 6
1.4 Research significance ............... 7
1.5 Research limitations and scope .... 8
1.6 Research ethics ..................... 8

CHAPTER TWO
LITERATURE REVIEW

2.0 Introduction .......................... 9
2.1 Financial statement fraud control and relevant theories 9
2.2 The Fraud Triangle .................. 16
2.3 Significance of financial statements .......... 17
2.4 Financial statement fraud explanation .......... 19
2.5 Motives of financial statement fraud .......... 22
2.6 Nature of financial statement fraud .......... 23
2.7 Indicators and perpetrators of fraud firms .......... 25
2.8 Measures to control financial statement fraud .......... 25
2.9 Financial statement fraud and case profiles .......... 31
CHAPTER THREE
RESEARCH METHODOLOGY

3.0 Introduction 60
3.1 Research Philosophy 60
3.2 Research Methodology 62
   3.2.1 Case studies research methodology 63
      a. Purpose of conducting case studies 64
      b. Multiple case studies 64
      c. Case study research design 65
         i. Case study procedures 65
         ii. Case study research instruments 66
         iii. Questions designed for case studies 67
         iv. Questions designed for interview 70
         v. Case study data collection process 71
         vi. Case study data organizations 72
         vii. Case study analysis 73

   3.2.2 Review financial statement fraud regulations 75
   3.2.3 Review professional guidelines pertaining to fraud policy 76
   3.2.4 Interview research methodology 76
      a. Group of interviewees 77
      b. Interviews setting 77
      c. Interview questions 77
d. Interview procedures 80

e. Conduct of interviews 80

f. Interview transcription 81

g. Extraction of interview information 82

h. Analysis of interview information 82

i. Thematic analysis of interview information 82

j. Interview constraints 84

3.3 Verification of research data 84

3.4 Ethical consideration 85

3.4.1 Ethical Consideration for case studies 85

3.4.2 Ethical considerations for interviews 87

CHAPTER FOUR

THE REVIEW OF FINANCIAL STATEMENT FRAUD REGULATIONS

4.0 Introduction 88

4.1 The relevant financial statement fraud regulations in the US, the UK and Malaysia 89

4.1.1 The United States financial statement fraud regulations 90

a. The Securities Act 1933 90

b. The Securities Act 1934 91

c. The Sarbanes Oxley Act 92

d. The US Generally Accepted Accounting Principles (GAAP) 96

e. The Committee of Sponsoring Organization of the Treadway Commission (COSO) 97

4.1.2 Malaysia Financial statement fraud regulations 98

a. The Securities Commission and the Securities Act 99

b. The Auditing Oversight Board 100

c. The Companies Act 1965 103

d. The Financial reporting Act 1997 105

e. The Accountants Act 1967 (Act 94) 106

f. Penal Code (Act 574) 107

4.1.3 The United Kingdom: Financial statement fraud regulations 108

a. The Financial Services and Market Act 2000 108

b. The Companies Act 2006 109
### CHAPTER FIVE

**THE REVIEW OF GUIDELINES FROM PROFESSIONAL BODIES: MANAGING BUSINESS RISK OF FRAUD: A PRACTICAL GUIDE**

#### 5.0 Introduction

5.1 The five sections to effectively manage the risk of fraud

5.1.1 Section 1: The fraud risk governance

- a. Commitment
- b. Fraud awareness
- c. Affirmation process
- d. Conflict disclosure
- e. Fraud risk assessment
- f. Reporting procedures and whistle blowing protection
- g. Investigation process
- h. Corrective actions
- i. Process evaluation and improvement (Quality Assurance)
- j. Continuous monitoring

5.1.2 Section 2: Fraud Risk Assessment

5.1.3 Section 3: Fraud Prevention

5.1.4 Section 4: Fraud Detection

5.1.5 Section 5: Fraud Investigation and Corrective actions

#### 5.2 Summary of review guidelines

### CHAPTER SIX

**RESULTS AND FINDINGS OF CASE STUDIES**

6.0 Introduction

6.1 Company A

6.1.1 Company’s Corporate Governance

6.1.2 Financial performance
CHAPTER SEVEN
RESULTS AND FINDINGS OF INTERVIEWS

7.0 Introduction

7.1 Interviews findings

7.1.1 Financial statement fraud explanation

7.1.2 Financial statement fraud method and motives

7.1.3 Perpetrators of financial statement fraud

7.1.4 The influence of FSF in Malaysia

7.1.5 Role of Chief Financial Officer

7.1.6 Role of internal auditor

7.1.7 Role of external auditor

7.1.8 The role of Malaysia’s Regulators

a. The role of the Securities Commission
b. The role of the Malaysian Auditing Oversight Board
c. The role of the Companies Commission Malaysia (CCM)
d. The role of the Royal Malaysian Police (RMP)  
7.1.9 Roles of independent bodies  
a. The Association of Certified Fraud Examiners (ACFE)  
b. The Malaysian Institute of Accountants (MIA)  
c. The Institute of Internal auditors Malaysia  
d. The Malaysian Institute of Corporate Governance  
7.1.10 Respondents view on financial statement fraud cases in Malaysia  
7.1.11 Control systems to prevent financial statement fraud  
7.1.12 Prevention, detection and response strategies  
a. Prevention Strategies  
b. Detection Strategies  
c. Response Strategies  

CHAPTER EIGHT  
DISCUSSION AND ANALYSIS OF CASE STUDY AND INTERVIEW FINDINGS  
8.0 Introduction  
8.1 What, if any, prevention, detection and response strategies are in use in relation to financial statement fraud?  
8.1.1 The prevention strategies  
a. Internal auditing and the role of the internal auditor in relation to financial statement fraud control  
b. External auditing and the role of the external auditor in relation to financial statement fraud control  
c. Financial statement fraud detection and control responsibility  
d. Present system of financial statement fraud control  
i. Control in the financial accounting process  
ii. Financial statement fraud preventive and support controls  
8.1.2 The detection strategies  
8.1.3 The response strategies  
8.2 What are the current best practices of PDR strategies?  
8.3 What are people doing and why are they doing it?  
8.3.1 Internal control system  
8.3.2 Whistle blowing, hot line procedures and business ethics  
8.3.3 Corporate governance  

xv
8.3.4 Financial control Framework and the Risk Management Framework 228

8.4 What are the weaknesses that have not been addressed? 229
8.4.1 Financial accounting process control 230
8.4.2 Internal control system and financial statement fraud control 230
8.4.3 Financial statement fraud control responsibilities 232
8.4.4 Internal auditing expectation gap 234
8.4.5 Role of internal auditor in relation to financial statement fraud control 234
8.4.6 Role of external auditor in relation to financial statement fraud control 237

8.5 What methods can be used to ameliorate the current weaknesses? 238
8.5.1 Improvements to the present practices of financial statement fraud control in commercial companies 238
   a. Audit Committee Control in relation to the Financial Control Framework 239
   b. Management Letter in relation to the design of the Financial Control Framework 241
   c. Reviewing the scope of internal auditing function 240
8.5.2 Financial statement fraud control at top management level 241
8.5.3 Inculcating the values of honesty and integrity 244

CHAPTER NINE
CONCLUSION, CONTRIBUTION AND RECOMMENDATION

9.1 Introduction 248
9.2 Research question one: Conclusion concerning present practices of prevention, detection and response strategies in relation to financial statement fraud 249
9.3 Research question two: Conclusion concerning the current best practices in financial statement fraud mitigation 250
9.4 Research question three: Conclusion concerning the understanding of what people are doing and why they are doing it. 251
9.5 Research question four: Conclusion concerning the weaknesses in the present system of financial statement fraud mitigation. 251
9.6 Research question five: Conclusion concerning what approaches can be used to ameliorate the current weaknesses. 254
9.7 The summary of external controls gained from regulators and professional bodies 256
9.8 Summary of the review of the financial statement and financial statement fraud regulations 257

9.9 Contributions and Recommendations 258

9.9.1 Contributions to methodology 258

9.9.2 Contributions to knowledge in the form of practical recommendations to improve practice 259

9.9.3 Contribution to academic theory in relation to theoretical concept of financial statement fraud control 260

9.9.4 Contribution to academic theory in relation to the theoretical concept of internal auditing of financial statement 261

9.9.5 Contribution to policy. 261

9.10 Recommendations for anti-fraud programme: the strategies of prevention, detection and response in relation to financial statement fraud 263

9.10.1 Financial statement fraud risk mechanism 263

a. Prevention Strategies 264

i. Values of honesty and integrity 264

ii. Specific internal control over financial statement 264

iii. Assessment of internal control over financial statement 265

iv. Participation of internal auditor in financial statement auditing 265

v. Greater role of board audit committee 265

vi. Financial statement fraud risk management 265

vii. Effective corporate governance 266

b. Detection strategies 266

c. Response strategy 267

9.10.2 Financial statement fraud evaluation 268

9.6.3 Financial statement fraud Responsiveness 268

9.11 Summary 268

9.12 Limitations 270

9.13 Further research 270

References 271

Appendix 1
# List of figures

<table>
<thead>
<tr>
<th>Figure</th>
<th>Description</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>Figure 1</td>
<td>Issues of financial statement fraud control</td>
<td>5</td>
</tr>
<tr>
<td>Figure 2</td>
<td>Multiple Discriminant Analysis (Atman, 1968)</td>
<td>53</td>
</tr>
<tr>
<td>Figure 3</td>
<td>Diagram of case study methodology</td>
<td>66</td>
</tr>
<tr>
<td>Figure 4</td>
<td>Financial risk management program (IIA et al, 2007)</td>
<td>121</td>
</tr>
<tr>
<td>Figure 5</td>
<td>Components of Financial risk management programme (IIA et al, 2007)</td>
<td>128</td>
</tr>
<tr>
<td>Figure 6</td>
<td>Control activities (IIA et al, 2007)</td>
<td>129</td>
</tr>
<tr>
<td>Figure 7</td>
<td>Fraud risk assessment team (IIA et al, 2007)</td>
<td>130</td>
</tr>
<tr>
<td>Figure 8</td>
<td>Financial accounting process control in case study companies</td>
<td>216</td>
</tr>
<tr>
<td>Figure 9</td>
<td>The financial statement fraud risk preventive and support controls</td>
<td>219</td>
</tr>
<tr>
<td>Figure 10</td>
<td>Present financial statement fraud controls from both case study companies</td>
<td>223</td>
</tr>
<tr>
<td>Figure 11</td>
<td>Internal auditing expectation gap</td>
<td>234</td>
</tr>
<tr>
<td>Figure 12</td>
<td>The improvement of financial statement fraud control in case study companies</td>
<td>240</td>
</tr>
<tr>
<td>Figure 13</td>
<td>Internal auditing approach to financial statement fraud control</td>
<td>242</td>
</tr>
<tr>
<td>Figure 14</td>
<td>Key contributory factors to internal audit expectation gap</td>
<td>253</td>
</tr>
<tr>
<td></td>
<td>Gap in relation to financial statement fraud detection and control</td>
<td></td>
</tr>
<tr>
<td></td>
<td>responsibility</td>
<td></td>
</tr>
<tr>
<td>Figure 15</td>
<td>Financial statement fraud regulatory authority</td>
<td>257</td>
</tr>
</tbody>
</table>
List of tables

Table 1  Different expectation among management, internal and external auditors of the case companies towards financial statement fraud detection and control. 46
Table 2  Case study questions 67
Table 3  Interview questions 70
Table 4  Interview questions (Board audit committee) 85
Table 5  Financial statement fraud regulations of three countries 89
Table 6  The measurable criteria to improve the fraud detection controls (IIA et al, 2007) 137
Table 7  Significant elements in investigation procedures (IIA et al, 2007) 138
Table 8  Regulators and their responsibility 186
Thesis structure

CHAPTER ONE: Introduction

CHAPTER TWO: Literature Review

CHAPTER THREE: Research Methodology

CHAPTER FOUR: The Review of Financial Statement Fraud Regulations


CHAPTER SIX: Results and Findings of Case studies

CHAPTER SEVEN: Results and Findings of Interviews

CHAPTER EIGHT: Discussion and Analysis of Case Study and Interview findings

CHAPTER NINE: Conclusion, Contributions and Recommendations
CHAPTER ONE

RESEARCH INTRODUCTION

1.0 Introduction

As a countermeasure to high profile accounting scandals and business collapses, among the most notable being Enron in 2001, the Sarbanes Oxley Act was passed by the US congress in 2002. The purpose of the Act is to add strength to a public company’s internal control mechanism and financial reporting, which in turn will lead to greater transparency in financial statements (Agami, 2007). In Malaysia, corporate financial scandals such as those committed by Transmile Group Berhad, Tat Sang Holding and Megan Media Holdings Berhad have diminished the firms’ value and shareholders’ wealth. This has possibly had a negative impact on foreign direct investments. Concomitant with the financial and non-financial damage, the faith and reliance of the public in the accounting and auditing profession will be destroyed by financial statement fraud (KPMG, 2007).

PricewaterhouseCoopers (2011) discloses that one of the most challenging issues for businesses globally is fraud. Notwithstanding the imposed regulation and legislation or the control mechanisms implemented by the companies, the intensity of economic crime and the concomitant financial and non-financial damage remains unchanged. In fact, as reported by PricewaterhouseCoopers (2007), out of every two companies worldwide, one had been a target of economic crime within the preceding two years.

In response to the aforementioned crisis, the improvement of financial statement fraud controls and the integrated strategies of prevention, detection and action to response to financial statement fraud are important for reducing financial statement fraud. These strategies need to be practised at all levels in corporations and supported by a board of directors, audit committee oversight, executives, chief executive officer, chief financial officer, chief operating officer and accountants through internal audit, compliance and monitoring functions (KPMG 2007). To date, most discussions have stressed prevention and
detection strategies that can be used to mitigate financial statement fraud. Although previous academic researchers did not examine the actual practices of financial statement fraud controls in commercial companies, it is suggested that an improvement in such control is required. Johl et al. (2013) studied the actual practice of internal control that is related to financial statement fraud. By using Malaysian evidence, Johl et al. (2013) found little attention had been given to examining internal audit’s contribution towards financial reporting quality. In relation to this, the present research focuses on the practices of financial statement fraud control in the context of Malaysian commercial companies and provides qualitative evidence of qualitative aspects of financial statement fraud control.

This research uses the evidence of Malaysian commercial companies in an effort to contribute to the theoretical concept of financial statement fraud control thus contributing to the nation in relation to the National Economic Model, which was reformed in 2010. Malaysia is using this model to transform itself into a ‘high income nation by 2020’. The development of this model was in response to the Asian Financial Crisis and global export competition in order to attract foreign direct investment, thus benefiting the business and investment community on a long-term basis (Economic Transformation Programme, 2013). Hopefully, the improvised focus area in financial statement fraud control will assist Malaysian commercial companies in providing greater control in relation to financial reporting, thus increasing the confidence of investors in the Malaysian capital market. Furthermore, the methodology used and the contribution derived from this research can be generalized to other types of fraud control. For example, the focus area of strategic control of financial statement fraud can be specifically enhanced to control other types of fraud such as earnings management and revenue recognition. In other words, it is not limited to Malaysian practices and can be generalized to other countries.
1.1 Research overview

According to the Malaysian results of the PricewaterhouseCoopers Global Economic Crime survey (2011), rising economic crime is a threat which also prevails in Malaysia. The survey indicated that fraud constituted a significant challenge to companies globally. Results of the Malaysian survey also found that a high percentage of the perpetrators of fraud emanated from the organizations that were defrauded. In 70% of cases in Malaysia, the fraudster was employed by the company (against 56% in the Asia and Pacific region and 45% globally) and were more likely in Malaysia to be part of the management team (53%) as compared to the Asia and Pacific region (46 %) and the rest of the world (42%).

Deterring financial statement fraud is important because of the fraud cost to all companies. In Malaysia there were over RM 3 billion losses reported between 1998 and 2007 for misrepresentation in connection to financial statement fraud (Royal Malaysia Police, 2007). The two-yearly survey, which included 3,634 companies from 34 countries, found that the losses borne by 1,227 of these companies in the preceding two years totalled more than US $1 billion. There are two possible reasons underlying the reported losses above – greater corporate transparency and increased inclination by public companies to acknowledge cases of fraud.

According to PricewaterhouseCoopers (2007), concerns have been raised by some executives who were involved in preparing the self-report and improvement programme. They contended that such an activity might result in an excessive and disproportionate cost burden compared to companies that undertake different tactics in addressing fraud. However, irrespective of the size of the company, the problem of fraud remains.

Strategies for detecting and preventing fraud cases have been detailed in the literature (KPMG, 2005; PWC, 2007; Rejda, 2008; Vaughan, 1997; Wells, 2002; Smith et al., 2002) and many techniques have been recommended to manage potential losses or risks in business, including financial statement fraud. Unfortunately, these have failed in preventing
major frauds. The question now is what needs to be done to fight fraud cases? In relation to this, it is now timely to address whether the deterrent strategies put in place by industry are adequate in today’s business environment. In accordance with the above scenario, it is anticipated that the results of this research will provide improvements for financial statement fraud control and thus assist in reducing financial statement fraud cases.

1.2 Research problem statement

In capital markets, financial statement provided by the companies should be fair, efficient, transparent and free from any misleading information. Financial statements or financial reports are supposed to be tools upon which users can rely when making investment decisions. Therefore the dissemination of financial statement information from companies should be timely, accurate, complete and free from any material misstatements. This is very important for investors to be able to determine their investment decisions and trading strategies. However in reality, the reliability of financial statement information seems to be questioned by investors and public due to previous financial statement fraud cases. In actual fact, dependence on the information provided in financial statements constitutes one of the greatest global challenges for businesses (PWC, 2007). Thus, the research found financial statement fraud has become a serious problem and tends to be extensive and momentous which requires improvement in financial statement fraud control due to the huge impact of financial statement fraud losses. Figure 1 below depicts the financial statement fraud control framework as explained in this paragraph.
According to ACFE (2012), financial statement fraud cases triggered the greatest median loss at $1 million despite the small number of cases involved in the research investigation. The issue is serious as the actual level of economic crime and the associated financial and non-financial damage has been reported to be on the rise as the number of financial statement fraud cases has increased since 2003 (PWC, 2007).

ACFE (2012) revealed that globally an average organisation is estimated to lose 5% of its revenue each year due to significant frauds which also include financial statement fraud. If this rate of loss is applied to 2011 Gross World Product, this causes an anticipated fraud loss of $3.5 trillion (ACFE, 2012). The impact is that financial statement fraud cases have resulted in financial losses, a loss of shareholder value and bankruptcies (Center for Audit Quality, 2010). As such, it leads to the question what is lacking in the internal control system adopted by the companies?

Strategies in detecting and preventing fraud cases have been presented in the literature (KPMG, 2004; PWC, 2007; Rejda, 2008; Vaughan, 1997; Wells, 2002). However, the
investigation of the actual practices of financial statement fraud control to provide improvement appears from the literature to be very limited. Most of the related literature is from professional bodies such as Institute of Internal Auditors (IIA), American Institute of Certified Public Accountants (AICPA), Association of Certified Fraud Examiners (ACFE), KPMG and PricewaterhouseCoopers (PWC). Hence, in this research, improvements for financial statement fraud control and the awareness of financial statement fraud control will be suggested. This research further evaluates the three strategies of prevention, detection and response towards financial statement fraud.

1.3 Research aim and objectives
The purpose of this research is to explore internal control strategies of financial statement fraud control in two case study companies in Malaysian public interest entities. In order to achieve this, the research evaluates and develops strategies in relation to financial statement fraud namely strategies of prevention and detection of financial statement fraud and actions in response to it. Specifically, the research focuses on the following questions which are related to financial statement fraud control within the selected two case companies:

1. What, if any, prevention, detection and response strategies are used in relation to financial statement fraud by the management in the case companies?
2. What are the current best practices in financial statement fraud mitigation at commercial company level in Malaysia?
3. What are people doing and why are they doing it in regard to financial statement fraud mitigation?
4. What are the weaknesses in the present system of financial statement fraud control of financial statement fraud mitigation?
5. What approaches can be used to ameliorate the current weaknesses?
1.4 Research significance

The research contributes to the study of financial statement fraud control and also provides practical recommendations for commercial companies seeking to reduce financial statement fraud and the impact of financial statement fraud. The research explores internal control strategies of financial statement fraud control and thus makes recommendations to improve financial statement fraud control, while evaluating and developing the strategies of prevention and detection of financial statement fraud and actions in response to it. The previous academic researchers have addressed the trends, determinants and consequences of financial statement fraud. However, limited research has been found in relation to financial statement fraud control and reduction. The components of financial statement fraud control and strategies of prevention, detection and response are practically important for enhancing the reliability of financial statements. These contributions would be of value to business as the research suggests ways to improve financial statement fraud control. The research results lead to recommendations for improvements to the present practices. The recommendations made by this research provide effective roles for company management to improve financial statement fraud control and thus provide a monitoring tool for commercial companies.

Considering that the management of a company as well as its auditors have to play vital roles in protecting the shareholders’ interests, financial statement fraud control and strategies would create awareness within corporations of financial statement fraud. These strategies will also help businesses (1) to identify fraud in a timely manner and minimize the resulting damage, (2) to enhance the reliability of financial statements and increase shareholder value, and (3) to conduct their business ethically. The contribution of this research would enhance the upgrading of the Standard of Procedures and Internal Control System in organizations that reflect strong management practices towards reducing any financial statement fraud.
1.5 Research limitations and scope

Issues of fraud have been broadly discussed in academic research. There is a limitation that needs to be acknowledged and addressed regarding the research. There are a number of frauds in different disciplines. However, financial statement fraud has been chosen as the issue under investigation. From the various types of financial fraud identified including fraudulent financial reporting, misappropriation of assets, revenue or assets gained by fraudulent or illegal acts, expenses or liabilities avoided by illegal acts, expenses or liabilities incurred for illegal acts and other misconduct (KPMG, 2006a), the research is concerned with financial statement fraud, which is also known as fraudulent financial reporting. This is due to (1) to the importance of financial statements as a reliable tool for decision-making purposes, (2) the need to safeguard the interest of shareholders and (3) the fact that companies have incurred a high cost due to financial statement fraud.

1.8 Research ethics

The ethical implications have been fully considered throughout the research process. In the context of research ethics, the research looks at the quality of the research actions. In relation to this, the research is concerned with two main ethical issues. Firstly, the need to obtain the consent for interviews from the case study companies, independent bodies, regulators and participating individuals. Secondly, the research is concerned with the confidentiality and the sensitivity of the information from both case study companies (see chapter 3, subsections 3.3, 3.4 and 3.4.1).
CHAPTER TWO

LITERATURE REVIEW

2.0 Introduction

This research has reviewed the relevant issues of financial statements and financial statement fraud controls from the academic literature and reports from professional bodies. The following chapter discusses the relevant theories in understanding financial statement fraud control, the importance of financial statement information issued by commercial companies, the explanation of financial statement fraud, the types, indicators and perpetrators of financial statement fraud, the importance of financial statement fraud measurement, the profiling of previous financial statement fraud cases and the impact of financial statement fraud.

To further explore the control in relation to financial statement fraud mitigation, the research discusses internal controls and the internal controls for financial reporting, the role of internal and external auditor, and the prevention, detection and response strategies for reducing financial statement fraud. The research also discusses the issue of corporate governance in relation to financial statement fraud control. The focus of corporate governance in the context of the UK practice of corporate governance is due to the more in-depth reporting and information concerning corporate governance.

2.1 Financial statement control and relevant theories

The research aims to explore internal control strategies of financial statement fraud control in two case study companies in Malaysian public interest entities and thus provide improvement in regard to financial statement fraud control. In addition to the discussion of financial statement and the relevant issues of financial statement fraud, the research also looks at the relevant theories from empirical studies to support the issues of financial statement fraud control.
Theoretically, financial statement fraud control is necessary to ensure the reliability of financial information issued to a company’s stakeholders, particularly the shareholders. The previous financial statement fraud cases have shown the importance of commercial companies issuing reliable financial statements and highlighted the rights of companies’ stakeholders to be given a true and fair view of the companies’ financial activities and position. In relation to this, the research discusses agency theory; stakeholder theory and theory of the firm to support the above issues and the research aims. To look at what is being designed in regard to internal control system, the research explores the internal control strategies in relation to financial statement fraud control and contributes the required improvement in financial statement fraud control in public interest entities.

Financial statement fraud cases have had a great financial impact upon the shareholders, as the value of their investment will usually be reduced as a result of the fraud. Thus, stringent control in regard to financial statement processes is required to avoid the distortion of the economic wealth of the company due to financial statement fraud. From the perspective of agency theory, directors and managers have a responsibility to ensure that true and fair financial statements are issued. The oversight roles by the directors towards the quality of financial information and the ethical operation of financial statement processes are essential in their agency relationship with the company shareholders.

Berle and Means (1932) view the separation of shareholders and board of directors in the context of principal-agent theory. They identified the separation of ownership and control as being the key problem at the root of undesirable corporate behaviour in the USA. In the context of agency theory as proposed by Ross (1973), the agent, who is the manager, is supposed to act in the interest of the principal, who is the shareholder. In relation to that, in fulfilling its role of achieving the firm’s objectives, the management of the company is supposed to provide reliable financial statements to the shareholders. In this aspect, sufficient internal control in regard to financial statement fraud control would enhance the soundness of the internal control that could mitigate the financial statement fraud.
In respect of shareholders, the company’s owners provide capital and bear the risk of business, which includes the financial fraud risks. These risks are beyond their control if they are not involved with the business operations. The responsibility to ensure all risks are mitigated lies with the management of the company, who might or might not include some or all of the shareholders. Management’s role is to further the interests of the company and hence, if the company’s objects include making a profit, indirectly it increases shareholders’ wealth.

Eisenhart (1989) states that the agency theory is concerned with two problems that arise from (1) the conflict of interest between the principal and the agent in relation to the company’s goal and inappropriate behaviour of the agent, and (2) the different attitudes in response to risk due to the different risk preference. Ross (1973, p.134) describes agency as the prescribed relationship between the principal and agent in ‘essentially all contractual arrangements’. However, the agency problem is recognized in this relationship, which requires the principal to instruct the agent to perform a particular act.

Financial statement fraud also shows the failure of company directors in delivering their duties towards the company’s shareholders. In this case, the financial figures are altered and the true performance is not reported to stakeholders, regulators and financial institutions. The manipulation of financial figures in some cases is used to inflate reported profit, minimise reported losses, circumvent borrowing restrictions and enhance management performance (Whelan & McBarnet, 1999). In the case of merger and acquisition, the inflation of assets might give a misrepresentation of a company’s valuation while the understatement of profit by the misreporting companies to evade tax could cause the lower income generation to the revenue authorities. Financial statement fraud may also be conducted to produce favourable profitability statement to attract new investors and retain existing investors.

The research clearly distinguished financial statement fraud (section 2.4, page 19) and errors by reference to intention. Errors made in financial statements are not considered as
financial statement fraud but errors caused by human fallibility. In the meantime, public
interest entities in certain circumstances manage their earnings to achieve the anticipated
financial outcomes for upholding their positions and to exhibit apparently sound earning
growth (Lev, 1989). In this aspect, agency theory is not related to errors and earnings
management.

The previous accounting scandal may help to prove an agency problem has existed. The
problem may arise due to opportunistic behaviour of an agent and thus the breach of agency
relationship that distorts the maximization of the company’s wealth due to financial statement
fraud. According to Jensen and Meckling (1976), the opportunistic behaviour of an agent is
able to create the agency problem. Jensen and Meckling (1976) further suggest that the
alignment of principal and agent interest would reduce the agency problem. In the same
spirit, the present research conjectures that the opportunistic behaviour of agent has created
the agency problem which manifest in the form of financial statement fraud.

The present research suggests one way to reduce the agency problem which can be
achieved by making improvement in financial statement fraud control. The research
investigation on the internal control strategies in regard to financial statement fraud control is
useful to look at the present practices of financial statement process control. The
improvement in financial statement fraud control is considered a significant mechanism to
reduce financial statement fraud cases. However, this requires greater roles of audit
committees, internal and external auditors. The greater control of financial statement fraud
may increase the agency cost with regard to monitoring cost that should be borne by the
residual claimants.

The agency problems arising between the principal and the agent are associated with the
theory of the firm, which includes managerial behaviour, agency cost and ownership
structure (Jensen & Meckling, 1976). Jensen and Meckling (1976) also state that the agency
relationship is a contract between these two parties that devolves some decision giving
authority to the agent. In this case, the principal is supposed to establish relevant monitoring procedures for the agent to ensure the agent is performing within its power.

In relation to the theory of firm, Dodd (1932) considers the responsibility of the company management to perform their best to the company shareholders. Dodd (1932) also views the organization of the firm as an “economic institution which has a social service” and is concerned with public but not purely private matters. Financial statement fraud committed in companies would affect the public fund, in particular the generating income for tax authorities. The misrepresentation of financial statements which is submitted to the tax authorities was perhaps intended to evade tax. Therefore, this type of financial statement fraud would affect the public fund and decrease the income for tax authorities. The incidence of financial statement fraud is not consistent with the theory of firm which considers the responsibility of company management to perform their best to the company shareholders. In particular, the incidence of financial statement fraud has given a huge impact to company shareholders due to companies’ losses and hence diminished the firm’s value and reputation so as to decreasing the public fund.

In addition to the relationship between agent and principal in the Agency theory and the responsibility of company management in the theory of firm, the research discusses the stakeholders’ theories in the context of business ethics, financial statement fraud issues and control. Freeman (2010) views the stakeholder theory as organizational management’s theory that emphasizes the morals and values in business organization and emphasizes responsibilities of company management to balance the shareholders financial interest against the interest of stakeholders. In relation to this, the present research is concerned on the stakeholders’ theories in the view of what companies are supposed to deliver on the best interest of duties to the companies’ stakeholders. The stakeholders are defined as any individual agency (Gray et al., 1996), shareholders, employees, creditors, bank, government and communities (Gamble & Kelly, 2001). Smith (2003) asserts that company management has duties to ensure the ethical rights in business conduct and ‘balance the legitimate interests of the stakeholders when making decision’. However, the cases of financial
statement fraud have had an impact to the stakeholders through the harm causes of misleading financial information provided by the fraud companies. For example, the assessment of financial performance is not reflected in the actual financial position and this contributes to the major problems of government tax, credit assessment by the company’s creditors and investment decision by the company’s shareholders.

Smith (2003) views the previous accounting scandal and financial statement fraud cases as the failure of the Shareholder theory. The Shareholder theory emphasizes a responsibility of company management to maximize the shareholder returns (Friedman, 1970). Smith (2003) states another responsibility of company management is to ensure the balance of financial interests of shareholders and other stake stakeholders. In the meantime, Friedman (1970) emphasises that the objective of companies is achieving the optimum profit. He states, “there is one and only one social responsibility of business - to use its resources and engage in activities designed to increase profits so long as it.... engages in open and free competition, without deception or fraud”. The deceptions of fraud in financial statements have had a huge impact to the company shareholders and stakeholders (Smith, 2003). The alteration of figures in financial statement has also led to misrepresentation of financial position; therefore, misleading the companies’ stakeholders to make decisions, in particular investment decisions.

According to Friedman and Miles (2006), the normative behaviour of companies practice can be achieved by changing management attitudes that is due to the fiduciary relationship. As such, the improvement in financial statement fraud control to mitigate FSF is considered significant for the benefit of companies’ stakeholders. In accounting and finance framework, the applicability of the Stakeholders theory has been argued on the question of the unawareness of moral underpinning it (Freeman et al., 2010). The previous financial statement fraud cases also revealed the involvement of company directors which indicate unethical conduct and immorality of company’s directors. Thus, financial statement fraud is in contrast with the concept of stakeholder theory on the accountability of company management to report the true and fair view of financial statement to the company’s
stakeholders who have rights to be acknowledged of the true and fair view of financial reporting.

This research further explains the stakeholder behaviour in regard to the dissemination of financial information by looking at the Communication theory. Gabor (1952) views Communication Theory as "communication system that sells information capacity" and aims to provide understanding of communication process and improvements in information dealing (Gabor, 1952). The present research relates the theory of communication in the context of the efficiency of dissemination of financial information to accounting users. Thus, the controlling of financial statement process is one mean of improving the dissemination of financial information efficiency. Kuhn (2008) supports the responsibility of company management to issue reliable financial information that is based on the actual financial results of operation. Kuhn (2008) also states that a communication theory of the firm practically hypothesizes the existence and the action of firm and views the perspective of communication on the structure of the firm’s operation towards achieving the firm’s objective.

The present research also relates the communication theory through the dissemination of financial information through financial reporting as one mean of public communication on company’s financial position. One of the financial information dissemination purposes is to attract potential investors to make investments decision. In the case of previous financial statement fraud cases, the misleading of financial position is erroneously communicated and delivered to the public and companies stakeholders. The stakeholders, in particular the company’s shareholders, do not receive any bad indicator of financial performance before the collapse of the fraud companies. In this case, the untrue financial statements are issued to the stakeholders until the financial statement fraud cases are discovered.

As a conclusion, agency theory, theory of the firm, stakeholder theory and communication theory are used to explain the importance of commercial companies issuing reliable financial statements, the responsibility of company directors for the reliability of financial statements and the rights of company’s stakeholders to receive true and fair financial statements.
Financial statement fraud is deliberately used to reduce the reliability of financial statements and the possibility of financial statement fraud therefore increases agency risk.

2.2 The Fraud Triangle

The fraud triangle would possibly justify the motivation of fraud, particularly financial statement fraud. The research further explained the fraud triangle in the context of a financial statement fraud case. According to Bell and Carcello (2000) the previous financial statement fraud cases include the three elements of fraud triangle. The idea of the “fraud triangle” was first conceptualised by the American criminologist, Cressey, in the 1950s (Reinstein et al., 2006). The theory describes the three elements of opportunity, rationalization and pressure.

Firstly, the opportunity mostly relates to inadequate internal controls in a company and audit inefficiency functions (Reinstein et al., 2006). Therefore, it provides the opportunities for individuals in a company to engage in misbehaviour and fraud. Mostly the controls come from the top; therefore, ineffective corporate governance also provides the opportunity for committing fraud. It may include an ineffective audit committee and duality of the position of the chairman and chief executive of the company (Goldschmidt, 2004; Razaee, 2002). Albrecht et. al (2009) explains that ineffective corporate governance and inadequate internal controls are able to confuse the fraud behind the complex transaction.

The second element of the triangle is pressure or incentive. Individuals in an organization possibly commit financial statement fraud when certain pressure or incentive exists in a company’s environment. The pressure to commit financial statement fraud arises from internal and external factors. According to Elliot and Elliot (2009), the internal pressure is due to the need to meet the company’s earning objectives that reflect the management compensation. The company’s management is likely to commit financial statement fraud to achieve the earnings objective as targeted by the company. Carcello and Palmrose (1994), Dechow et al. (1996) and Lys and Watts (1994) identify the external pressure that exists when a company has financial distress and exhibits poor financial performance. Therefore, a
company tends to commit financial statement fraud in order to portray a good instead of poor financial performance to the company's shareholders. The third element of the fraud triangle is rationalization or attitude. The perpetrators are able to rationalize their behaviour for committing financial statement fraud. They possibly have some insight that such fraud has to be committed to achieve certain objectives, for instance, to maintain or to increase the share price. They rationalized by assuming that the financial problem is provisional and would be counterbalanced by forthcoming outcomes (Skousen et al., 2008). Hernandez and Groot (2007) found that financial statement fraud is due to the bad attitude of the company’s management. Most financial statement fraud causes are due to dishonesty and lack of integrity from the company’s top management.

The justification for financial statement fraud through the fraud triangle can be summarised by three dynamic issues that exist: (1) company’s controls, (2) pressure from the internal and external environment, and (3) value from the company’s individuals.

2.3 Significance of financial statements

Accounting is an information-processing system that records monetary transactions and presents the financial results through financial statements. The financial statement is the summary of transactions and events affecting the company’s financial position. There are three main elements of financial statements, namely, (1) the profit and loss account (P&L), (2) the balance sheet, and (3) notes to the financial statement (Notes). Collectively, the company will also prepare the cash flow statements of the company (Kwok, 2005). The main objective of financial statements is to provide information about the company’s financial position, performance, and changes in financial position. Financial statements are very important to a wide range of internal and external users in making economic decisions, particularly investment decisions (Gordon et al., 2005). Chapter 2 of the UK Companies Act 2006 requires every company to keep adequate accounting records that sufficiently explain the accuracy of company’s transactions. Any failure to comply with this provision will be
liable to an offence under section 389 of the Act. To provide reasonable assurance concerning the accuracy of the financial statement to the company’s shareholders, Chapter 4 of the Act further requires the external auditing of the financial statement. In this case, the company’s shareholders rely upon the reported financial position to assess the company’s performance.

In relation to this, the duty of the companies to keep sufficient accounting records is considered as significant as financial statements demonstrate the results of the company’s economic transactions. The management of the company has responsibility for reporting the outcome of the economic events for the resources through the financial statements. Generally, the financial statement users will make economic decisions by evaluating the company’s ability to generate cash. The economic resources are important because they will affect the financial condition of the company, including the company’s liquidity and solvency.

The issue of financial statement fraud has been focussed upon by the public, investors, regulators and practitioners due to the huge losses from the reported fraud worldwide. The collapse of a number of large companies, such as Enron Corporation (Moncarz et al., 2006), WorldCom (Thornburgh, 2006), Global Crossing (Gomez, 2008) and Adelphia (Barloup et al., 2009), affected the confidence of investors and resulted in a loss of market capitalization. Consequently, three questions were raised from these accounting scandals in the US. The first question concerns the reliability of financial information in the US financial market. The second question concerns the severity of market misconduct in the US and the third involves the responsibility of auditors in relation to financial statement fraud detection (Razaee, 2002).

In relation to this, the financial statements prepared by every company should contain reliable financial information to provide the best tool for investment decisions. The statements are expected to be free from any material misstatements. The statement plays an important role in keeping the capital market efficient. There are a number of studies in
relation to financial statement fraud that address the trends, determinants and consequences of financial statement fraud. The previous studies also discussed the responsibility for preventing, detecting and remediating financial statement fraud.

The attention to financial statement fraud is possibly due to the increasing number of global financial statement fraud cases (PWC, 2005). Research done by Skousen et al. (2008) explored whether financial statement fraud relates to a group of people that has adequate pressure and opportunity, as this might allow them to behave unethically. Observably, financial statement fraud cases relate to weak internal controls. The previous cases and studies of financial statement fraud also relate to a number of factors that contribute to financial statement fraud. Besides these reasons, the research differentiates between the two major types of financial statement fraud.

The first type of financial statement fraud committed by top management involves misleading the company investors, which results in large losses that will diminish the company’s reputation and the accounting profession. Generally, the second type of financial statement fraud might be committed by top or middle management, which concerns fulfilling the company’s expectations, particularly in terms of bonuses and compensation.

According to the KPMG Fraud Barometer (2009), the UK nationwide losses brought to court in 2008 were reported to be £1.1 billion (KPMG, 2009). This figure indicates the importance of bringing fraud losses under stricter control. These corporate frauds are presumably the transformation of white-collar crimes that have increased the volume of victims and losses. Specifically, Slotter (2004 cited in Telberg, 2004) notes a trend of corporate scandals and fraud that started with the savings and loans scandals in late 1980s, followed by the health care insurance fraud in the late 1990s, and the popularity of financial restatement fraud in the late 2000s.
2.4 Financial Statement Fraud explanation

Financial statement fraud has been identified as a financial crime, which the UK Financial Services and Market Act 2000 defines as any offence involving (1) fraud or dishonesty, (2) misconduct in, or misuse of information relating to financial market, or (3) handling the proceeds of crime. The research has viewed financial statement fraud from the perspective of both legislation and academic literature.

The UK Fraud Act 2006, based on one element of financial statement fraud, states that “a person is guilty of fraud if he breaches any sections listed in subsection (2), which includes (2a) false by representation, (2b) fraud by failing to disclose information and (2c) fraud by abuse of position”. The UK Theft Act 1968 defines false accounting as “where a person dishonestly with a view to gain for himself or another or with intent to cause loss to another, which includes (1) destroys, (2) defaces, conceals or falsifies any accounts or any record or document made or required for accounting purposes; or (2) in furnishing information for any purpose produces or makes use of any account, or any record or document as foresaid, which to his knowledge is or maybe misleading, false or deceptive in a material particular”.

In respect to financial statement fraud allegations, section 2 of the UK Fraud Act 2006 is presumably relevant. Fraud in financial statements comprises (1) false numbers or representation, (2) inaccurate information that may relate to fraud by failing to disclose the correct information and also (3) involvement of company’s directors or top management. Therefore, it could be charged as fraud due to an abuse of position. The above sections are entirely relevant to financial statement fraud allegations as they involve the falsification of accounts and records, which, ultimately, misleads the financial statement users. In the meantime, the UK Financial Services and Market 2000, part VIII subsection 7 states that market abuse is recognized when “the behaviour consists of the dissemination of information by any means which gives, or is likely to give, a false or misleading impression as to a qualifying investment by a person who knew or could reasonably be expected to have
known that the information was false or misleading”. In this case, the false financial reporting can be associated with market manipulation through which the manipulation of financial figures is achieved to mislead the company’s investors.

From an academic perspective, Grazioli et al. (2006) define financial statement fraud as an intentional process of deception by the company management. Another definition of financial statement fraud made by the National Commission on Fraudulent Financial Reporting (1987) defines financial statement fraud as reckless conduct by act or omission that results in materially misleading financial statements.

However, KPMG (2005) explains that financial statement fraud occurs when financial records have been falsified or manipulated or altered. Therefore, the disclosure will definitely be false. Spathis (2002) and Razaee (2002) add another way that a company may commit financial statement fraud, that is by misapplication and misinterpretation of accounting standards or by manipulating the accounting practices.

In the meantime, KPMG International (2006) views ‘fraud’ as a broad legal concept that generally refers to an intentional act committed to secure an unfair or unlawful gain. Beasley (1996) argues that financial statement fraud is limited to two types of fraud. Firstly, financial statement fraud occurs when ‘management intentionally issues materially misleading financial statement information to outside users’, and, secondly, financial statement fraud is due to ‘misappropriation of assets by top management that includes the chairperson, vice chairperson, chief executive officer, president, chief financial officer and treasurer’. Another issue of financial statement fraud is explained by George (2012) who views financial statement fraud as ‘intentional misstatement or omission of financial data in financial reporting’. Financial statement fraud also involves intent and deception by the top management of the company with a set of well-planned schemes.

The schemes of financial statement fraud may involve the six activities of (1) ‘falsification, alteration or manipulation of material financial records, supporting documents or business
transaction, (2) material intentional misstatement, omissions or misrepresentation of events, transaction, accounts or other significant information from which financial statements are prepared, (3) deliberate misapplication, intentional misinterpretation, and wrongful execution of accounting standards, principles, policies and methods used to measure, recognize, and report economic events and business transactions, (4) intentional omissions and disclosures or presentation of inadequate disclosures regarding accounting standards, principles, practices and related information, (5) the use of aggressive accounting techniques through illegitimate earnings management and (6) manipulation of accounting practices under the existing rules-based accounting standards which have become too detailed and easy to circumvent and contain loopholes that allow companies to hide the economic substance of their performance’.

2.5 Motives for financial statement fraud

Although there are a number of motives for financial statement fraud, the most common is due to the weak financial conditions of companies. Reinstein et al. (2006) document that financial statement fraud begins with financial and moral problems in the company in which the company’s control environment becomes lacking, which encourages inefficiency within its auditing procedures.

These findings were supported by Carcello and Palmrose (1994), Dechow et al. (1996) and Lys and Watts (1994) who found that financial distress and poor financial performance are the most important reasons for the occurrence of financial statement fraud. Therefore, companies have a propensity to mislead in terms of their financial information and the probability of financial statement fraud is raised. Brennan and McGrath (2007) state that one of the motives for financial statement fraud is aimed to gain external capital by falsifying the financial figures on financial statement as an attraction. In addition, the AICPA (1987) found that financial statement fraud is used to delay the reporting of financial problems by violating the debt covenants. Another incentive of financial statement fraud is achieved through the
companies’ stock option (Watts & Zimmerman, 1990). Oppenheimer (2011) argues that corporate manipulation of companies’ stock options was prevalent between 1993 and 2005. The manipulation of a company’s stock options has been widely used as one of the methods of financial statement fraud.

Besides Beasley et al. (2010), Crawford and Weirich (2010) reported that company committed financial statement fraud in order to (1) window dress the financial performance and thus evade reporting a pre-tax loss, (2) improve the value of the share price to attract the company’s investors, (3) meet the earnings expectation as set by the security analyst, (4) meet the exchange listing requirement, (5) cover up the asset misappropriation, and (6) hide the company’s deficiencies. The two reasons from Beasley are highly supported by Kellogg and Kellogg (1991) who suggested that the two important reasons of financial statement fraud are to attract the company’s investors and to increase the value of the share price. Razaee (2002) and Abbott et al. (2000) found that a company that commits financial statement fraud actually lacks the effectiveness of corporate governance. Thus, for example, there may be companies in which the CEO also serves as a chairperson and where both the audit committee and audit functions are ineffective.

2.6 Nature of financial statement fraud

A number of financial statement fraud issues have been discussed in previous literature. The Federal Bureau of Investigation (FBI) (FBI, 2010) and Telberg (2004) classify the improper revenue recognition or profit inflation as the most common form of financial statement fraud. In particular research, improper revenue recognition or profit inflation is also known as fictitious revenue, which occurred widely in previous financial statement fraud cases. Fifth (2005) states the fraud companies create fictitious supplier and customers in order to achieve fictitious revenue.

The fraud companies were also overstating revenue and thus inflating the company’s profit, which resulted in a share price increment. The previous financial statement fraud cases have
proven that public listed companies have committed financial statement fraud to increase share price and attract company investors by inflating the company's profit (Kellogg & Kellogg, 1991). Other common types of financial statement fraud are delay in financial disclosure and including false information in the company’s prospectus (Razaee 2002; Cheng et al., 2006). Such fraud not only breaches the Listing Requirements but also misleads the existing and potential company’s investors. In relation to this, the motives of financial statement fraud are mainly found to (1) increase the share price to attract the company’s investors and (2) "window dress" the company’s financial performance to meet the Listing Requirements (Beasley et al., 1999).

According to Chen et al. (2006), general financial statement fraud includes the (1) failure to disclose information, (2) delay in disclosure, (3) profit inflation, (4) false statements and information in the prospectus, and (5) false statements in the financial reports. These types of financial statement fraud will have a serious impact on the users of financial information as well as the company’s shareholders. Another type of financial statement fraud is improper revenue recognition. FBI classifies improper revenue recognition as one of the top schemes of financial statement fraud that begins with financial restatement in a company's financial reporting. In this regard, half of the US Securities and Exchange Commission cases involved improper revenue recognition that has affected market capitalization. The COSO research on fraudulent financial reporting for year 1998-2007 of the US public companies found that the most common financial statement fraud techniques are revenue recognition, overvaluing assets and figures manipulation but not theft. Another type of financial statement fraud is earnings management in which a company manipulates the actual earnings figures in order to provide a better, if false, public view of its earnings. Therefore, a company will disclose false information in financial statements in relation to the company's earnings to achieve its objectives. Xu and Liu’s (2009) study recognizes another source of fraud in financial statements. According to the study, the fraud in the financial system could exist in the computer system, network and the key person who is responsible for providing access to
the financial information in the accounting system. Financial statement fraud is possibly the integration of financial fraud, computer fraud and Internet fraud. In relation to these findings, the detection methods through financial auditing or any statistical model would not be effective in discovering financial statement fraud.

2.7 Indicators and perpetrators of fraud firms

The COSO research on fraudulent financial reporting for the period 1998-2007 in US public companies shows that the alleged perpetrators of financial statement fraud are brought to the attention of the company’s chief executive officer and chief financial officer. The named fraudsters were found to meet the analyst's expectation, conceal the deterioration of financial performance and purposely for debt and equity offering. Chen et al. (2006) found that previous fraud cases show that the conditions of the firm that have a poor performance, suffer more losses, lower growth and lower stock return. The research findings by Tillman (2009) indicate the perpetrators of financial statement fraud are from the company’s management. They consist of the chairman, directors, general manager, auditors, chief accountant and supervisors. This situation was supported by the survey done by Ernst and Young (2012) and the research findings by Brennan and McGrath (2007). Both findings show that the perpetrators of financial statements mainly consist of top management personnel, namely, the Chief Executive Officer (CEO), Chief Financial Officer (CFO) and the top executives from the fraudulent company. According to Tillman (2008), financial statement fraud cases are found to arise from collusion or deceit among the top management, which definitely requires some effective mitigation measures and greater oversight by the company management.

2.8 Measures to control financial statement fraud

Albrecht (2003, 2005) notes that ‘financial statement fraud causes a decrease in market value of stock of approximately 500 to 1,000 times the amount of money’. In one case, a $7 million fraud caused a drop in stock value of about $2 billion. In relation to this, the research
found the need for every commercial company to find ways to mitigate financial statement fraud. Financial statement fraud control possibly reduces the impact of financial statement fraud; therefore, it provides cost savings to organizations. In addition, public awareness towards financial statement fraud control is considered important to reduce financial statement fraud cases. The study of Insurance Fraud in Nigeria indicates the little concern of fraud issues by public has created a worsen problem in managing fraud control in Nigeria (Yusuf & Babalola, 2009).

In relation to financial statement fraud control measurement, the research found that improvements in governance are possibly effective in reducing financial statement fraud cases in Malaysia. On the recommendation of Shim (2006), the profound collaboration between the government, regulators and private sector, embraces certain measures of governance practices and enforcement. However, transparency of financial reporting and accountability of company management towards financial statement fraud control are two important principles that help to reduce financial statement fraud in all organizations. As previous financial scandals have established, a lack of transparency and accountability create the incentive for top management to commit fraud (Gilsinan et al., 2008). Considering the contextual fundamentals of corporate culture, top managers are seen as a major cause of corporate crime, thus ethical top management possibly reduces corporate crime, particularly in relation to financial statement fraud (Clinard, 1983). In this case, control among the top management is found to be important in reducing the case of financial statement fraud in commercial companies.

Albrecht (2002) also proposes that fraud policy should be one in which the tone is set at the top and that it must be clear that the rules will apply to all employees, including management. In addition, Farrell and Franco (1999) highlight the responsibilities of management for creating the anti-fraud programmes and controls. According to the auditing standard, SAS 99, auditors and management have the ultimate responsibility for establishing the controls and procedures to protect the organization’s assets. The most important
elements consist of (1) creating and maintaining a culture of honesty and high ethics among the employees, (2) evaluating the risks of fraud, and implementing risk mitigation in relation to the financial statement, (3) and developing an appropriate oversight process by internal and external parties towards financial statement fraud.

According to the AICPA (2008), the most effective way to implement measures to reduce wrongdoing is to base them on a set of core values. This will provide a platform upon which a more detailed code of conduct can be constructed, giving more specific guidance about permitted and prohibited behaviour, based on the applicable laws and the organization’s values. Hence, management needs to clearly express that all employees will be held accountable for acting within the organization’s code of conduct. The document should identify the measures an organization should take to prevent, deter and detect fraud. However, Dion (2008) suggests that the corporate codes of ethics are not sufficient to strengthen the ethical behaviour due to the lack of self-evidence to identify the right things and perceive rationalization. In order to strengthen the ethical behaviour among the company individuals, the company is supposed to close or minimise the opportunity and rationalization of people to commit financial statement fraud.

The research believes that strategies and controls in relation to financial statement fraud are a necessity in today’s business environment because fraud has always been a growth industry. According to Biegelman (2004), “[a]n ounce of prevention does equal a pound of cure”; therefore, the risk of fraud can be reduced through a combination of prevention, deterrence, and detection measures. According to a recent study by the Association of Certified Fraud Examiners (2012), companies without fraud control have experienced fraud losses of approximately 45% median larger than the companies with fraud controls. In relation to this, it is important for every company to place fraud control, particularly the strategy of prevention, detection and response towards financial statement fraud. The strategy could persuade individuals that they should not commit fraud because of the increased likelihood of prevention, detection and the new punishment.
The research believes there are two parties involved in controlling financial statement fraud, namely, the regulators of the country and the company itself. These two parties have to play their respective roles in order to mitigate fraud. In addition, the audit committee can be a part of the monitoring mechanism to oversee the integrity and quality of the financial statement process. Johnson (2002, cited in Solaiman, 2006) documents that, ‘good legal rules’ are one of the important parameters in the development of the securities market. Johnson indicates that securities regulation and accounting best practices are two important mechanisms for combating financial statement fraud.

The audit committee should be viewed as a value-added oversight function as required by the United States Securities and Exchange Commission. The enactment of SOX 2002 is expected to improve the independence, objectivity, and effectiveness of the audit committee. The empirical studies have suggested the need for independent members of the board of directors (audit committee) to have sufficient financial expertise in scrutinising the financial information (Goldschmidt, 2004; Jayasuriya, 2006; Razee, 2002). In another response to financial statement fraud in the United States, the FBI sought expanded cooperation with the Certified Public Accountants (CPA) in fighting corporate fraud. The FBI believed that the roles, the independence and the integrity of CPAs are uniquely suited to the partnership. Thus, the CPAs will be third party expert witnesses and eyewitnesses for the FBI. The mode of cooperation will be dealt with in the way of (1) handling the scope of the problem, (2) identifying common accounting schemes, and (3) working effectively under the impact of the SOX 2002 and related rules and regulations (Telberg, 2004). In terms of regulations and legislation, all companies’ incorporated under the Company’s Act 1965 are bound by the Act. A number of public companies are voluntarily adopting the SOX 2002 to strengthen their financial reporting control and COSO framework for their internal control design. However, Small and Medium size Enterprises (SMEs) are not bound by Bursa Malaysia for internal audit functions thus the adoption of COSO framework is found to be rare among these enterprises. In the meantime, many independent bodies in Malaysia (KPMG, PWC and Ernst
and Young) provide reports and a perspective on fraud risk issues as an alert for fraud mitigation in all types of companies.

In relation to the company’s action, research by Chen et al. (2006) suggest that a large number of outside directors would contribute to control financial statement fraud in the company. A large proportion of outside directors would be helpful in monitoring the firm’s activities and deterring company fraud. Specifically, Beasley (1996) refers to the outside directors as all non-employee directors. He suggests that the longer the tenure of directors in the company, the better the control and mitigation of financial statement fraud would be. Beasley (1996) supports this argument noting that he had located a company with a large proportion of outside directors with longer tenure and that the company experienced a lower level of financial statement fraud. Deachow et al. (1996) add that directors or chairmen with shorter tenure have less company experience and therefore, they are unable to deter fraud in the company.

Furthermore, Fama and Jensen (1983) recommend that outside directors should increase their monitoring tasks. Therefore, they would not plot with top managers to confiscate the shareholders’ wealth. Fama and Jensen (1983) also discuss what is expected from the external directors. They are supposed to be (1) decision experts, (2) understand the importance of decision control, and (3) able to work with the decision control system in a company.

The board of directors is possibly the most effective internal control mechanism to monitor the actions of top management. Beasley (1996) found that board composition plays a greater role in controlling financial statement fraud. He also reported that the accounting regulators and standard setters recognize the importance of directors as one of the internal control mechanisms for the prevention of financial statement fraud. For example, two reports from the American Institute of Certified Public Accountants (AICPA) contain recommendations for board independency to mitigate financial statement fraud in a
company. Deachow (1996) suggests that the establishment of an internal governance process in every company will be a part of the internal control process in relation to financial statement fraud. The purpose of this is to maintain the reliability of financial statements by controlling manipulation activities. Alternatively, Razaee (2002) suggests that the executives’ compensation packages (stock options and bonuses) should be eliminated, thus financial statement fraud could be prevented in the companies. In this case, the companies’ shareholders should be given proper authority to approve the executive compensation packages to avoid fraud within a company.

Razaee (2002) also suggests a practical monitoring mechanism to control financial statement fraud. This includes direct oversight functions by the board of directors, the audit committee, external auditors, and regulatory agencies. Therefore, the effective role and responsibility of the board of directors in the company should be to set the “tone at the top” and they should not tolerate any misstatements in financial statements. In addition, indirect overseeing functions by a company’s owner/investor, analysts, institutional investors, and investment bankers should also be a part of the monitoring mechanism.

The effective internal control structure and audit functions are found to be important issues in financial statement fraud control. The National Commission on Fraudulent Financial Reporting (NCFR) (1987) documents that the management is responsible for designing adequate and effective internal controls in the financial statement process. Meanwhile, the internal and external auditors must ensure that internal control designs are adequate and effective in preventing, detecting, and responding to financial statement fraud. Internal auditors are responsible for assisting management to design, maintain, and monitor the internal control system, while external auditors are given the responsibility for detecting any material misstatement in the financial statements (Razaee, 2002).

In relation to this, the effective internal control structure and audit functions are found to be important mechanisms for controlling financial statement fraud. NCIR (1987) documents that
the management is responsible for designing adequate and effective internal controls in the financial statement process. The internal auditors and external auditors have to ensure that the internal controls designed are adequate and effective in preventing and detecting financial statement fraud. In relation to this, internal auditors are responsible for assisting management to design, maintain, and monitor the internal controls system. In the meantime, external auditors have been considered as having the responsibility to detect any material misstatements in the financial statements. Auditors are also expected to be independent in their social role, which will contribute to the accountability of corporate management, and therefore, increase the value of the reported financial information issued by the company management. However, audit practitioners are considered to have failed in their ethical duty if they do not make use of safeguarding mechanisms, such as whistle-blowing, and perform their role as expected by the audit profession (Alleyne et al., 2013).

2.9 Financial statement fraud and case profiles

The collapse of Enron caused about $70 billion losses in market capitalization while WorldCom is the biggest bankruptcy caused by financial statement fraud in US history. Cotton (2002) found that the estimated total loss of market capitalization resulted from financial statement fraud committed by Enron, WorldCom, Qwest, Tyco and Global Crossing is about $460 billion. The profile of fraud cases that are presented below caused a great shock to the financial market during the 2000s. The reported fraud cases wiped a billion dollars off the financial markets in various types of schemes and alternatives. The previous cases of corporate and accounting fraud, such as Enron, WorldCom, Qwest and Sun Beam led the accounting bodies, practitioners and regulators to review the effectiveness of the accounting standards, auditing regulations and corporate governance principles. In fact, those scandals were strongly influenced by the development of new regulations to improve the reliability of financial reporting and to regain the confidence of investors (Ayala & Ibarguen, 2006).
The Enron case involved the most complicated accounting transactions in which the company had used a complex organizational structure to hide the impact of complex transactions. Barboza (2002, cited in Cullinan, 2004) reports that Enron’s financial statements had been misstated by as much as US$24 billion. The fraud schemes that had been committed included (1) hiding the company’s debt, (2) creating the company’s common equity and (3) overstating the company’s earnings. Duncan, who was a partner of Andersen and the auditor of the company, had overlooked the matter and destroyed the key documents of the Enron Company (Reinstein, 2006). As a benefit of the malfeasance, Andersen had received $52 billion for professional fees. Andersen provided both audit work and non-audit work for Enron. Andersen also acted as the internal and external auditor for the Enron Corporation. The auditor of Enron, David Duncan also received a $700,000 salary from the company. Apart from this, the CFO and controllers of Enron were previously executives of Andersen’s (Albrecht, 2003, 2005). Among the causes of the Enron fraud were ineffective audit functions and failure of corporate governance (Razaee, 2002).

As a result, Enron collapsed, filed for bankruptcy and Arthur Andersen was dissolved due to its misconduct, which misled investors about the company’s debt and profitability (Reinstein, 2006). Razaee (2002), in his research, states that Andersen was claimed by SEC to have “knowingly and recklessly” issued false and misleading audit reports for Waste Management for years between 1992 and 1996. The SEC (2001) cited in Razaee (2002) states that Andersen agreed to a fine of $7 million as a settlement for allegations of overstating a client’s profit by almost $1.4 billion. Andersen agreed to the first antifraud injunction in more than 20 years although it did not admit nor deny the offences. Consequently, this fraud case became (1) the largest civil penalty among the SEC enforcement against a Big Five firm, (2) the first antifraud injunctions for more than 20 years and (3) the largest restatement of earnings in US history (Razaee, 2002).

In the late 2000s, the Enron Corporation was the seventh largest corporation in the United States in terms of sales, as it was one of the leading electricity, natural gas and
communications companies in the world. Enron was also named as ‘America’s most innovative company’ from year 1996 to 2000 by Fortune magazine (Petra & Loukatos, 2007). As the group suffered economic losses, the directors of Enron had misreported the financial information in order to maintain its credit rating (Ayala & Ibarguen, 2006). In addition, Enron focused on increasing the Earnings per Share (EPS) and manipulating the accounting data in order to influence the stock price. To secure this purpose, the company hid the existing debt to finance the EPS growth, and finally, to affect Enron’s stock price, which struck a high of $90 per share in mid-2000 and fell to below $1 per share by the year-end 2001.

Enron breached the US GAAP, in which the financial statements did not include the related party transactions. This led to Enron’s bankruptcy on 2nd December 2001 with shareholder losses of $11 billion. Arthur Andersen vanished as an auditing firm after the US Department of Justice accused them of giving an unqualified report for Enron in March 2002 (Ayala & Ibarguen, 2006). The directors and corporate officers of Enron also claimed to be unaware of accounting fraud in the company. Sarbanes-Oxley (SOX) 2002 established corporate responsibility (Section 302) for financial reporting in as much as the management have to sign and affirm certain responsibilities in relation to financial statements (Petra & Loukatos, 2007).

Financial statement fraud in WorldCom was the biggest corporate failure and bankruptcy in US history. WorldCom is America’s second biggest long distance phone company and largest mover of Internet traffic in America. The founder of the company was Bernard Ebbers who started with a small company but made more than 60 corporate acquisitions within 15 years (Tran, 2002). As stated in Dyck and Zingles (2007), WorldCom was another accounting fraud that was revealed in June 2002 after the enactment of SOX 2002. WorldCom was a telecommunications company that had an accounting fraud of $3.8 billion. The case involved top management of WorldCom executives and other employees.
The former CEO of WorldCom was found to be guilty of fraud, conspiracy and filing false documents with the SEC. The WorldCom Case involved an assertive interpretation of GAAP for the classification of expenditure as assets, instead of expenses (Cullinan, 2004). Again, Arthur Anderson was the former auditor for the company. The failure of the public accounting firm and corporate governance in WorldCom decreased the confidence of investors in corporate America. After the huge losses from these two big companies in the US, congress believed that SOX 2002 enactment was really the right decision to reform corporate governance and accounting to restore public confidence.

The next case in the US was Quest Communication International Inc. Quest was a telecommunications operator which was involved in accounting fraud in 2002 and perpetrated by top management – Quest CEO and CFO. They were accused of committing fraud in accounting for their contract with the Arizona Scholl facilities Board contract by inflating the revenue. It was noted that Arthur Anderson was also the former public accounting firm for the company (Stevenson & Gerth, 2002).

In Malaysia, to date, TransmileBerhad constitutes the biggest accounting and corporate fraud. The company had misled the accounting statement by overstating its revenue at RM530 million. According to a press release on 28 October 2011, the two former independent directors of the company were found guilty for the misleading statement. Both of them were sentenced for one year’s imprisonment and a fine of RM300,000.00 (Securities Commission Malaysia, 2011).

2.10 Impact of financial statement fraud cases on the company

Financial statement fraud causes huge losses to a company. The impact of financial statement fraud involves economic and non-economic losses. Other than losses of millions in profit, financial statement fraud also increases the insurance cost and the loss of efficiency that results from the firing and hiring of employees (Farrell & Franco, 2011). Financial
statement fraud also impacts upon the accounting and auditing professions resulting in a public lack of trust and loss of integrity of the accounting profession.

The consequences of financial statement fraud are very severe. Other than decreasing shareholder value, it also has a severe effect upon other factors. Razaee (2002) reports that financial statement fraud might cause a company (1) to become bankrupt, (2) to suffer a decline in stock value and (3) be delisted from the stock exchange. It was further reported that the top executives involved in committing financial statement fraud (1) lose the stock-based compensation value, (2) are forced to resign or are fired, (3) lose the opportunity to serve as officers or directors at any other public listed company as well as being barred by the Securities Commission and (4) are fined or jailed.

Finally, in the previous cases, the company’s auditors had (1) to surrender their audit licence, (2) were placed on a probation period, and (3) received fines. The example of recent cases was Andersen, which was one of the Big Five accounting firms. Andersen was responsible for the audit failures and destroying the audit evidence for financial statement fraud at Enron and WorldCom.

2.11 The management responsibilities in relation to financial statement fraud

There are a number of management responsibilities towards enhancing the transparent financial statement. According to IIA (2001), the board of directors of the company has to play its vital role in being vigilant in terms of the integrity, quality, transparency and reliability of the financial reporting process of the company. The board of directors also has to ensure the adequacy and effectiveness of their internal control structure in terms of preventing, detecting and correcting material misstatements in financial statements as well as in terms of the objectivity of audit functions. In reality, the internal auditors of the company have to promote or encourage the management to develop a detailed fraud prevention programme (Carpenter & Mahoney, 2001). The responsibility of the company management in relation to
financial statement fraud control has been addressed in Section 280 of the Standards for the Professionals Practice of Internal Auditing (2001).

The standards give guidance to company management to deter any fraud and responsibility for establishing and maintaining the control systems. In relation to the assurance of the control, the internal auditors have to ensure that in relation to employee fraud and management fraud, they operate with due professional care. This section would assist the internal auditors in meeting their responsibilities. Other responsibilities of controlling financial statement fraud from the company are gained from the audit committee of the independent directors of the company. The audit committee should be the independent ‘eyes and ears’ of the investors, employees, and other stakeholders. Kang (2001) suggests that the frequency of audit committee meetings would affect the effectiveness of their roles. Their role is to evaluate management’s identification of fraud risk, the implementation of anti-fraud measures and provide the tone at the top that fraud is opposed by the organization. Kang’s (2001) study suggests that more frequent meetings – at least five times a year – would enhance the monitoring process of the effectiveness of the company’s internal control.

The audit committee role has been found to be related to the control of financial statement fraud. According to the Smith Guidance on Audit Committees (2005), the main roles and responsibilities of audit committees include (1) monitoring the integrity of financial statements, (2) reviewing the company’s internal control including financial control and risk management system, and (3) recommending and monitoring the appointment and the independency of the company’s external auditors.

Zhang et al. (2007) found that the effective role of the audit committee is contributing to better internal controls within the company. In addition to the competency of the audit committee, they are also expected to be independent in overseeing the company’s internal control. The audit committee should hire independent auditors to assess and report on the financial health of the company. The report of internal controls designed by the independent
auditors should be presented to the audit committee but not to the management of the company. Zhang et al. (2007) also found a relationship between the external auditor’s independence and the strength of the company’s internal control. The study shows that a good internal control of the company is reflective of the independence of the external auditor.

The audit committee is also responsible for ensuring that management does not engage in fraudulent conduct. Although the entire management team shares the responsibility for implementing and monitoring these activities, the entity’s chief executive officer should initiate and support such control measures. According to Biegelman (2004), all companies, worldwide, must transform security departments into rigorous fraud prevention programmes. They should be staffed with qualified fraud examiners. He believes that “[f]ailed corporations and tougher legislation are forcing entities throughout the world to transform weak, reactive security departments into robust, proactive fraud prevention programmes with one goal: stop fraud before it happens.”

2.12 Internal control as financial statement fraud mitigation in organisation

Altanmuro and Beatty (2010) found internal control to be significant for producing a quality financial statement and preventing financial statement fraud. The Committee of Sponsoring Organizations of the Treadway Commission (COSO) (1992) defines internal control as a process system that affects every level of individual in an organization.

The purpose of the designed internal control is to provide reasonable assurance concerning the (1) business operation and (2) issued financial statement. The internal control in the companies is expected to provide the effectiveness and efficiency of the business operation and the reliability of the issued financial statements. Internal control is also expected to safeguard the company’s assets and its compliance with the laws and regulations in every aspect of business operation. Therefore, effective internal control would assist the company in achieving the company’s goals and objectives (COSO, 1992). The internal control of the
company is expected to achieve an effective system of business operation, the issue of a reliable financial statement by the company and compliance with the laws and regulation. However, the internal control over financial reporting is designed to ensure the specific control of financial reporting of the company.

KPMG (1999) states that the responsibility of company directors is to provide an effective system of internal control in organizations. The responsibilities of the company directors are also expanded to review the effectiveness of the designed internal control. In the meantime, the board of directors normally delegate the management of the company to design and maintain the internal control. In relation to a review of the internal control effectiveness, the board of directors delegate the task to the audit committee of the company, which comprises the independent directors of the company. On behalf of the company management, they appoint internal auditors to provide assurance of the internal control (Haron et al., 2010). According to Carey (2000), the company needs an internal audit function to provide assurance concerning the effectiveness of the designed internal control. The International Professional Practice Framework of the Institute of Internal Auditors (2009) defines internal auditing as independent work, which provides an objective assurance and consults the business entity in relation to the company’s improvement. The internal auditing function is also expected to add value to the company’s operation and improvement of the company’s governance. Fadzil et al. (2005) found that the professional proficiency of internal auditors influences the effectiveness of the internal audit function. In the meantime, the scope of internal audit work has affected the risk assessment aspect of internal control systems.

The conventional duties of internal audit functions include the assurance of the compliance with the operating policies, procedures, laws and regulations as booked by the company management. In addition to these duties, the internal audit function has the responsibility in reviewing the completed financial statement, therefore giving the assurance of reliable financial reporting (Schleifer & Greenawalt, 1996). However, the Statement on Internal Auditing Standard No 3 added new roles for the internal auditors that emphasize fraud
deterrence and investigation. In relation to this, Flesher (1996) suggests that the internal auditor should consider the indicators of fraud, identify the possibility of fraud in business operation, evaluate the control environment and report the recognized fraud to the audit committee.

2.13 Internal control over financial reporting

According to Ratcliffe and Landes (2009), the internal control over financial reporting aims to produce reliable financial reporting. Reliable financial reporting has been defined as financial reporting that has (1) met the financial reporting objectives, (2) used the applicable financial reporting framework and (3) complied with the laws and regulation. To ensure the presentation of true and fair financial reporting, the internal control over financial reporting provides the policies and procedures for every accounting process. The accounting policies and procedures are aimed at correcting any misstatement in the financial statement process and preventing any fraudulent in financial reporting.

Ratcliffe and Landes (2009) also state that reliable financial reporting should be guarded with stricter control on financial statement information in relation to the recognition, measurement, presentation and disclosure of the financial statement. In relation to this, the company management has to give assurance of the following control over the financial reporting process. In terms of recognition control, the company has to ensure that the business financial transaction is existent, accurate and complete in financial recording. In the meantime, the measurement control over financial reporting should be assured in terms of correct ownership of company’s assets and correct obligations of company’s liabilities.

In addition to this, the company has to ensure that the correct accounting period has been adopted; therefore, the profit or loss of the company reflects that accounting period. Finally, the presentation and disclosure of the financial statement should be clearly reported and understandable to the financial statement users. COSO (1992) has identified the five components of effective internal control over financial reporting. Firstly, the control
The control environment is said to be the foundation of the internal control design. The control environment is found to be gained from the top management on the direction of the company’s control and the values that have been inculcated among the company’s individuals.

The second component is the risk assessment component. The designed control should be analysed in relation to the possible risk of material misstatement in the financial statement. Therefore, the identification of a particular risk should be identified for every accounting process. The third component is related to the second component of internal control. Once the risk has been identified and addressed, the improvement of the policies and procedures should be tailored to suit. The control activities are said to be the third component, which involve the approval, authorization, verification, reconciliation, and review of operating performance, security of assets and segregation of duties.

In the meantime, the fourth component relates to the effective communication and information that should be efficiently disseminated among the company individuals. The fifth component requires the on-going monitoring process. The monitoring process is said to be important for ensuring the quality of designed internal control over financial reporting. The company has to consider the new development of business strategy, business size and the current economic performance.

2.14 Internal auditors and the issues of financial statement fraud

The International Standards for the Professional Practice of Internal Auditing defines the internal auditor’s role in fraud prevention and detection. According to the standard, “the internal auditor should have sufficient knowledge to identify the indicators of fraud but it is not expected to have the expertise of person whose primarily responsibility is detecting and investigating fraud”. Baker (2011) further explained the principle of such a standard. It is the responsibility of company management to design a programme for fraud prevention and detection; however, the internal auditors need to play their role in ensuring compliance with
the designed controls. The IIA’s Practice Advisory 1210.A2 further explains that “internal auditors are responsible for assisting in the deterrence of fraud by examining and evaluating the adequacy and effectiveness of the system of internal control, commensurate with the extent of the potential risk exposure in the various segments of the organization’s operation”.

The research findings by Gullkvist and Jokipi (2012) indicate the role of internal auditors is not aligned with the financial statement fraud detection as the internal auditors are more concerned on the misappropriation of asset detection.

In the current economic downturn, internal auditors are called to proactively respond to fraud risk. The internal auditors also need to advise a company to place and design preventive and detective controls accordingly. The role of the internal auditor is to identify and evaluate the company’s risk assessment while building fraud awareness. The findings from Ebaid (2011) indicate that the internal audit function in public listed companies is actually based on conventional functions rather than adding value for good company governance. In relation to this, internal auditors are called upon to be more rigorous and possibly enhance the value of good conduct.

The research conclusion of Hillison et al. (1999) was that the role of the internal auditor was to prevent, deter and detect fraud in an organization. Hillison et al. (1999) support their conclusion with the implementation of SAS No 82 and the passage of the Private Securities Litigation Reform Act 1995, which emphasizes the fraud prevention role of the company’s internal auditors. On the other hand, Handal and Cullath (2005) document the responsibility of auditors in relation to internal control over financial reporting. To assess its effectiveness, the auditors need a thorough understanding of a company’s ICOFR. The auditors have to evaluate whether the management process addresses: (1) determining and documenting controls, (2) evaluating which controls are significant, (3) evaluating the design and operating effectiveness of the controls, (4) determining which control deficiencies are of such a magnitude that they constitute significant deficiencies or material weaknesses, (5)
communicating findings to the external auditor and to others if applicable, and (6)
determining whether findings are reasonable to support their assertion.

Schleifer and Greenawalt (1996) emphasise critical thinking skills within internal auditing
work. Internal auditors are expected to employ critical thinking skills to provide a quality
auditing plan. The relationship between critical thinking and the internal auditor are viewed
by extending the perceptions of the internal auditor functions. In addition to the main
functions of internal auditing, which include examining and evaluating the adequacy and
effectiveness of a company’s internal control, the internal auditor should be competent and
look at different perspectives. In addition to the examination for compliance, the internal
auditors also have to determine the cause and effect of any deficiency found. An internal
auditor is expected to critically evaluate any suspected financial figures and the validity of
the information. Therefore, any controls would be improved and designed according to the
current company circumstances. Perhaps, any financial irregularities would be prevented
and detected.

In terms of internal audit activities, the Institute of Internal Auditors has shifted the
description of the internal auditor’s role so as to include adding value to the company by
increasing the assurance of monitoring, evaluating and improving risk management control
as well as the governance process (Ebaid, 2011). There are three key factors that are
considered important for fraud prevention and detection – internal control, risk assessment
and the management process. These reflect the accountability of internal auditors and
improve the internal audit process as well as the overall governance process (Leung,
Cooper & Perera, 2011).

The position of internal auditors can be seen as trustworthy and independent of a company.
They might be responsible for looking at any irregularities in the financial statement process
and tailoring a better position for the internal auditor as the company’s watchdog. Soh and
Benni (2011) also suggest expansion and a refocus on the role and effectiveness of internal
auditors in meeting the stakeholders’ expectation. Leung et al. (2011) found a gap between
the tasks performed by internal auditors and the internal audit objectives with the exception
of internal control and risks. They also reported a wide range of internal audit objectives and
the Institute of Internal Auditors and internal auditor’s responsibilities. One option to improve
this, the study suggests, is for internal auditors to provide an advisory role in relation to
information technology systems, strategic risks and financial issues.

The findings from Rae and Subramaniam (2008) indicate that the quality of internal control is
closely related to the corporate ethical conduct, conduct of risk management training and the
level of internal audit activity. Further findings indicate that the possibility of fraud
occurrence is higher when a weak internal control is instituted in the company. Therefore,
the company management needs to consider the quality of internal control and ensure an
adequate oversight mechanism for fraud prevention and detection. Budescu et al. (2012)
found the integrated audit on financial statement by internal and external auditor contributes
the quality of internal control over financial statement, thus reduces the audit risk financial
statement auditing. In the meantime, Schneider and Wilner (1990) support the functions of
internal and external auditing for financial statement fraud control in the presence of ‘material
dollar amounts, irregularities of asset overstatements, unambiguous GAAP violations and
less incentive for misstating income’. Furthermore, research finding by Grass-Gill (2012) also
indicates the collaborative audit of internal and external auditors improve the quality financial
statements. Budescu et.al (2012), Bedard et al. (1999) and Chen et al. (2011) suggest the
collaboration of internal and external auditing financial statements to provide more audit
evidence for financial statement fraud control. The increased number of audit evidence from
collaborative of auditing work reduces the audit risk as the increase of audit testing is
achieved on financial transactions. In addition to collaboration of financial statement auditing
by internal and external auditors, the research found the promotion of ethical conduct
appears to increase the integrity of the environment and among the company’s individuals.

2.15   External auditors and issues of financial statement fraud
The role of independent external auditors is found to be significant to ensure that the audited financial statement reflects the true and fair view of the financial statement (PWC, 2013). The objectives of conducting audit financial statements are stated in the International standard on Auditing 200 (ISA 200). The ISA 200 states the external auditing of financial statements aimed “to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, thereby enabling the auditor to express opinion on whether the financial statement are prepared, in all material respects, in accordance with an applicable financial reporting framework; and report on the financial statements, and communicate as required by the ISAs, in accordance with the auditor's findings”. Therefore, the financial information provided by the audited financial statement becomes a tool for investment decisions.

However, previous financial statement fraud cases have diminished the reputation of the audit quality and profession (Kohlbeck et al., 2008; Zhang, 2006). In response to these failures of financial statement fraud detection by the external auditors in the previous financial statement fraud cases, the Standard on Auditing Standard No 99 (SAS 99) was introduced by the AICPA to increase the effectiveness of the auditing process. According to Section 110 of SAS 99, ‘the auditor has a responsibility to plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether caused by error or fraud’. The standard also requires the external auditor to consider fraud in the audit financial statement.

To consider fraud in audit financial statements, external auditors need to obtain an understanding of internal control in relation to financial statement processes (International Standards on Auditing 315 (ISA 315)). ISA 315 also states the need for external auditor ‘to understand the business risks that are relevant to financial reporting objectives, estimating the significance of risk, assessing the likelihood of the occurrence and deciding about actions to address those risks’.
In addition, the International Standard on Auditing 400 (ISA 400) provides guidance to external auditors on achieving understanding on audit risk that includes inherent risk, control risk and detection risk, the risk assessment and internal control in their audit plan. ISA 400 requires the external auditors to assess the audit risk to obtain a reasonable assurance on the given audit opinion which are free from misstatements that might be caused by fraud and error. The International Standard on Auditing 240 (ISA 240) states the auditor’s responsibilities towards fraud in an audit financial statement while ISA 400 states the ‘primary responsibility for fraud prevention and detection of fraud rests with those charged with governance of the entity and management’. According to Cullinan and Sutton (2002), the auditor is responsible for detecting fraud in financial statements. However ‘an auditor conducting an audit in accordance with ISAs is responsible for obtaining reasonable assurance that financial statements taken as a whole are free from material misstatement, whether caused by fraud and error’. In regard to financial statement fraud, ISA 240 clearly states that ‘the risk of auditor not detecting a material misstatement resulting from management fraud is greater than employee fraud, because management is frequently in a position to directly or indirectly manipulate accounting records, present fraudulent financial information or override control procedures designed to prevent similar frauds by other employees’ (International Standard on Auditing 240). Empirical evidence shows that the role of external auditors includes to ‘evaluate the reasonableness of management estimates and judgements in preparing the financial statements to determine if they are indeed “reasonable” (Love, 2012). SAS 99 also identifies the risk factors that include the three components of the fraud triangle (chapter 2, page 28) and the identification of red flags that could assist the auditor to detect fraud in the financial statement. In the meantime, Power (2007) and Knechel (2007) support the importance of business risk auditing methods in audit financial statements as a focus for financial statement fraud control. In business risk auditing, the auditors are required to consider the high risk areas and understand the business environment. The consideration of business risk areas possibly reduces risk in control system. In auditing, the identification of audit risk and business risk possibly expedient for financial statement fraud detection and
Curtis and Turley (2007) state the effectiveness of audit financial statement depends on how in-depth is the auditor in understanding the business process. These enable the auditors to recognize fraud and risk of business. The research includes the findings that indicate the different expectations from management towards the company’s internal auditors and internal auditors’ expectation towards external auditor’s works in relation to financial statement fraud detection and control. The following table summarize the diverse expectations among them:

### Table 1: Different expectation among management, internal and external auditors of the case companies towards financial statement fraud detection and control.

| What management expect of internal audit | The company management of the case companies expects the prevention and control have been done by the internal auditor through the internal auditing work. However the findings show that the scope of internal auditing work is not relevant to the accuracy of the final published financial statement and the detection of financial statement fraud does not appear to be within the scope of internal auditing. |
| What internal audit expect of external audit | The internal auditors of the case companies believe that financial statement fraud detection and control is not their responsibility but they perceive that the external auditor’s responsibilities to include the detection of financial statement fraud. The findings show the scope of internal auditing of both case companies focus on operational compliance concerning the design of the control and the relevant regulations for the financial statement. However, a control test is not adequate in providing assurance of financial statement accuracy and audit testing is only done on a sampling basis. |

Previous research also discussed the presence of external auditing expectation gap (McEnroe & Martens, 2001; Lee et al., 2009; Ebimobowei & Kereotu, 2011), indicating that accounting users in the public domain have a high perception of the audited financial statement, which indicates the responsibility of the external auditor to ensure the reliability of financial statements. The audit expectation gap exists among the accounting users and
external auditors in relation to financial statement fraud. The accounting users perceive that external auditors are responsible for detecting any fraud in the financial statement while the detection of financial statement fraud has not been found to be the legal responsibility of external auditors. In general, Liggio (1974) states that an audit expectation gap exists in the situation in which there is a different expectation of performance between the financial statement users and the auditors. Lee et al. (2007) further explain the audit expectation gap as the difference between the perceived nature and the auditing objectives by the audit users. The research findings of Alleyne and Howard (2005) indicate that an extensive expectation gap exists in respect of the auditors’ responsibility for fraud detection, in that the auditors perceive that financial statement fraud detection is the responsibility of management while the management and the financial statement users perceive it differently. In order to reduce the external audit expectation gap, O’Malley (1993), and Koh and Woo (1998) suggest that greater responsibility should be given to external auditors, including the direct reporting of external auditors to regulators, joint evaluation of internal control system by management and auditors and the involvement of the external auditor with the interim financial statement. In the meantime, the research by Hudaib and Haniffa (2007) in relation to the audit expectation gap in Saudi Arabia shows the need for a review of the regulations to reduce the expectation gap arising from the restricted audit scope and omission of Islamic principles due to the continuous modification of the standards, as well as dealing with unsupportive audit clients. If such issues are not improved, the auditor’s independence and reputation will be endangered.

According to Love (2012), the external auditor has the responsibility for financial statement fraud if there is a failure in the audit work and it is not in accordance with the auditing standards. Earlier research by Humprey and Turley (1993) states that the legislation needs to be developed to determine the auditors’ responsibility for fraud detection due to the greater challenges in the financial services, which leads to a greater assumption of fraud detection responsibility by the auditors. Further research by Hsu et al. (2013) states that a
review of the sufficiency of the auditing standards is required to give clarity to the external auditor's responsibility towards fraud detection in the financial statement. In this case, the clarity of the external auditor's roles and responsibility will be clear within the profession and among the public.

The current auditing standards and regulations in the audit profession are aimed at increasing the independence of external auditors. However, in many cases, auditor’s independence is commonly associated with the financial statement fraud cases (Eilifsen & Knivsfla, 2013). One of the factors that possibly affect the independence of the auditors is when the auditors provide both audit financial statement and non-audit services to their audit client (Larcker & Richardson, 2004). The ICAEW (2004) requires the company management to give a report to the company shareholders of any cases where the external auditors provide the non-audit services. This indicates that the requirement of the professional accounting body in England and Wales aims to increase the transparency of the audited financial statement. Another factor that possibly jeopardises the auditor's independence is the close relationship between the auditors and the audit client. According to Hudaib and Cooke (2005), the close relationship of the auditors and audit client are closely linked to the threat of familiarity and intimidation in the auditing environment, which leads auditors to become unwilling to express their true professional opinion due to such threats within the auditing setting.

Nevertheless, there are a number of suggestions to enhance the efficiency of the audit process, and thereby, to detect fraud in the financial statement. Makkawi and Schick (2003) provide two approaches that can be adopted by external auditors to detect financial statement fraud. The first approach concerns the awareness and concentration of the challenging issues faced by audit clients in different industries. In this case, the fraud schemes might be varied by industries and thus require more understanding of the nature of the industry in respect of the possibility of different financial statement fraud schemes. Secondly, the external auditor needs to give greater attention to the assessment of
management integrity. These two approaches are in accordance with the requirement of SAS 99 in which the external auditor has to consider the risk of material misstatement and fraud within the audit company. Pepper and Spedding (2010) introduced the Lean Six Sigma as a systematic approach ‘to identify and eliminate sources of waste and activities’. In regards to audit activities, it can be focused to the selection of quality audit sample. This approach also can be adopted by external auditors to reduce the possibility of fraud being undetected in the financial statement. Lean Six Sigma is found to be a systematic approach that could contribute to effective external audit work and thus control financial statement fraud. ‘Lean Six Sigma’ was introduced by Pepper and Spedding (2010), and was adopted in the manufacturing industry by using the integration of two approaches; namely, the lean approach and the six sigma approach, which are based on scientific foundations.

In relation to financial statement fraud control, the research has viewed the importance of the integrated approach of ‘Lean Six Sigma’ in the external auditing process rather than the manufacturing process. The lean idea in the manufacturing process is found to be important in identifying the value added and non-value added activities and eliminating the waste. Thus, the idea of ‘Six Sigma’ refers to the statistical measurement of the defect rate within the manufacturing system. In the context of the external auditing process, the research refers to the sample selection among the huge number of accounting transactions. The lean idea is also adapted to the method of measuring the audit risk in the external auditing process.

Other than enhancing the efficiency of the audit process, Jennings et al. (2008) state that under the conditions of strong corporate governance, the integrated audit of financial statement and its internal control would prevent intentional misstatement in the financial statement. This refers to the external audit report concerning the effectiveness of the internal control over financial reporting of public companies as required in section 302 and 404 of SOX 2002. However, Moyes and Hassan (1996) state that the internal and external auditors have equivalent capability to detect fraud in organisations. In this case, the research found
that the integrated roles of both the internal and external seem to be effective in preventing financial statement fraud.

2.16 Prevention of financial statement fraud

According to ACFE (1996), the top five prevention techniques are (1) internal controls, (2) new-employee background checks, (3) regular fraud substantive audits, (4) established fraud policies and (5) willingness to punish. In the meantime, Chang et al. (2009) state that the company management has to evaluate the effectiveness of the internal controls and certify that the financial reports were complying the relevant rules and regulations in order to reduce manipulation of financial statements. In respect of the company’s internal control, Hillison et al. (1999) suggest that the role of the internal auditors is to control fraud within the organisation.

In relation to financial statement fraud, it might be effective for the internal auditor of the company to conduct an analytical review of the financial statement. The analytical review will allow the internal auditor to analyse any abnormal result or performance over a number of years. The horizontal, vertical and variance analysis are expected to reveal irregular reporting. Another substantive audit would be achieved through a review of the contract. The internal auditors possibly detect illegal profit and conspiracies arising between an individual company and the company’s vendor. In-depth investigation of the contract files and bidding contract possibly prevent fraud through the internal auditing process. Peat Marwick (1998) of KPMG suggests that stringent control of the internal audit function would prevent fraud in the organization. The monitoring and the enforcement of job rotation and mandatory vacation of company individuals would prevent and control fraud. However, George (2012) highlights a greater role and quality of audit committee will reduce the probability of financial statement fraud cases. The audit committee is supposed to have financial competence and longer tenure of audit committee in companies contributes to financial statement fraud mitigation.
In the meantime, ACFE (1995) suggests that every company should establish and maintain a fraud policy as a fraud prevention technique. It is advisable that the established fraud policy is separated from the company’s code of conduct or ethics policy. In relation to this, individuals in the company will clearly understand that the organisation will not tolerate any form of fraud.

In this respect, Hillison et al. (1999) add that a fraud policy may be more effective if it is associated with the new staff recruitment process and education programmes of the individual companies. The stringent checking of the applicants’ background may possibly assist the company in recruiting honest employees. Another fraud prevention method that has been suggested by Hillison et al. (1999) is the security of information systems. In relation to financial statement fraud, information technology security is found to be significant. The access security to the computerised accounting system is the most important security aspect protecting financial information. As such, the authorisation process for obtaining passwords may prevent fraudulent financial reporting.

Fraud prevention is a more viable strategy since it is often difficult to recover fraud losses once they are detected. Many companies and their auditors deal with fraud on a case-by-case basis rather than implement a long-term plan. Also, recent legislation, such as the Sarbanes-Oxley Act of 2002 (SOX), does not do much in terms of fraud prevention; instead, the law focuses on punishment and accountability (Bierstaker et al., 2006). In the meantime, Petra and Loukatos (2009) assert that the primary foundation of the Act is important to provide investors and public with better trust in accounting and financial reporting.

2.17 Detection of financial statement fraud

Fraud detection can be accomplished through various means. ACFE (2004) reveals that the most common means by which fraud is detected includes (1) informers from employees and/or external parties, (2) internal audits, (3) by accident, (4) internal controls and (5) external audits. Alternatively, there are also many fraud detection techniques or detection
tools to detect financial statement fraud. These include (1) “Computer-Assisted Techniques”, (2) Digital Analysis, (3) Game Theory and (4) the Strategic Reasoning Concept (Durtchi, 2005; Coderre, 1999; Nigrini, 1999). These techniques are implemented to reduce the possibility of fraud in the financial statement. The detection of financial statement fraud turns out to be even more difficult when the perpetrators, offering large incentives, enlist supposedly independent auditors to become a part of the scheme (Weisenborn et al., 1997; Daniel, 1997). In the meantime, proactive fraud detection involves aggressively targeting specific types of fraud and searching for their indicators, symptoms, or red flags (Albrecht, 2002). In some cases, even though indicators of fraud or ‘red flags’ exist, it has been found that no fraud occurred. For example, in certain cases, ‘red flags’ were found to be due to the carelessness of employees. In the meantime, other cases of ‘red flags’ were found to be due to actual fraud in the organization. Therefore, the possibility of fraud must be investigated to confirm the actual existence of fraud.

A financial ratio is one of a number of accounting tools that is also known as analytical techniques and used to interpret company performance. Basically, financial ratios are used to measure and evaluate a company’s profitability, liquidity, leverage, activities and solvency. These ratios are widely used by the accounting users, such as tax authorities, financial institutions, creditors and other stakeholders. However, in the case of financial statement fraud, financial ratios are arguably not a significant tool for any indication of company performance in the case of unreliable financial information.

Basically, detecting financial statement fraud is not under an auditor’s responsibility. A company auditor is actually responsible for ensuring that the accounting records are properly recorded according to the accounting standards. In this case, there are some issues relating to failure of fraud detection arising from unskilled company auditors. However, a company auditor should have auditing skills to detect any material misleading in the financial statement.
Fraud detection in the financial statement is arguably difficult for new auditors as they have little knowledge and experience (Grazioli et al., 2006). Therefore, sufficient knowledge and high experience of auditors presumably contributes to the efficient financial statement fraud detection. According to Weisman and Brodsky (2011), the issue of fraud detection has attracted great concern and attention by the government, media and public due to large losses in the financial market. In relation to this, the proactive fraud detection implementation and controls could assist the company in mitigating financial statement fraud (Weisman & Brodsky, 2011). The research found a number of financial statement fraud detection techniques that have been suggested from the empirical research. According to Ravisankar et al. (2011), financial statement fraud detection is more effectively done by human experts and experience rather than any detection techniques. However, data mining techniques could assist the auditors in predicting the possibility of material misstatement in financial statements. Data mining techniques provide effective handling of a large number of accounting transactions and financial ratios.

Data mining techniques identify the patterns that are included in an accounting database (Bose & Mahapatra, 2001). Furthermore, the data extraction process is run using statistical, mathematical, artificial intelligence and machine learning techniques (Turban et al., 2007). A statistical technique, namely, Multiple Discriminant Analysis (MDA) was introduced to measure a company’s financial condition and predict any question that might lead to a company’s bankruptcy (Altman, 1968). This technique was widely used in evaluating the credit worthiness of the customers and investment strategies.

MDA analysis is undertaken using the following formula in figure 2:

**Figure 2: Multiple Discriminant Analysis (Source: Atman, 1968)**

\[ Z = 0.012X1 + 0.014X2 + 0.033X3 + 0.006X4 + 0.999X5 \]
The above formula could be explained by the following variables, where Z represents the overall index, X1 is the working capital over total assets, X2 is retained earnings over total assets, X3 is earnings before interest and taxed over total assets, X4 is market value equity over book value of total debt and X5 is sales over total assets.

The application of the formula is based on the value of the overall index, which is represented by Altman’s (1968) study and concluded that a firm applying and having a Z score greater than 2.99 will be assumed to be a non-bankrupt category firm, while a Z score below 1.81 will be assumed to be a bankrupt firm. However, a score between 1.81 and 2.99 will be assumed to constitute a “zone of ignorance” or demonstrate a susceptibility to errors. This technique is expanded from the accounting ratio analysis and is suggested for use in financial statement fraud detection. Ravisankar et al. (2011) state that this technique is also used to detect financial statement fraud. They suggest that the debt structure is considered important in determining fraud indication. An increase in debt structure will likely increase the potential for financial fraud in the company as the risk of owner’s equity is shifted to the debt owner. Another indicator gained from the analysis is about the ratio of sales to growth ratio. Irregular sales values could also be a potential indicator of financial statement fraud. Xu and Liu (2009) propose a subjective and objective method for financial fraud in the financial system. They introduced the framework for a fuzzy AHP method and a rough fuzzy set model to analyse the scenario of fraud. The integrated models suggest that if the degree of fraud in each recorded analysis is bigger than the threshold, the fraud is assumed to be happening in the underlying cases. Dillon and Hadzic’s (2009) research designed financial statement fraud ontology through structured and unstructured data. Financial statement fraud ontology has been introduced to detect fraud in financial statement fraud by capturing and describing the data mining. Therefore, the interpretation of data mining results would assist the company in detecting any financial statement fraud schemes existing in the financial transaction.
Other detection tools for analysing accounting data have been introduced by Durtschi et al. (2004). Benford’s Law is used to detect any large volumes of records of individual transactions but has not demonstrated any application to financial statement fraud. The tool would assist the company auditor in detecting any irregularities in accounting data and the observation can be made through the appearance of a certain number more frequently than other numbers in accounting data. Benford’s law was initiated by Simon Newcomb, (1881). The law deals with the pattern of numbers and the probability of the occurrence of a digit, and therefore, offers digital analysis for irregularities of financial figures in the financial statement.

Benford’s analysis is the most appropriate for examining a set of numbers from a mathematical combination. The accounts receivable and accounts payable are two types of account that are most useful to analyse using Benford’s Law. In addition to accounts receivable and payable, Benford’s Law has also been found to be useful for analysing the disbursements, sales and expenses transactions. The digital analysis of Benford’s Law has been found to be integrated into a number of software packages.

2.18 Response to financial statement fraud

According to KPMG (2006a), the response control is designed to take corrective action and remedy the harm caused by fraud or misconduct. It should involve investigation, enforcement, accountability and corrective action to remedy the harm caused. In the meantime, the three leading bodies in accounting – the Institute of Internal Auditors, the American Institute of Certified Public Accountants and the Association of Certified Fraud Examiners (2008) – state that an effective reporting process should be in place to seek input on potential fraud. The coordinated approach of response control includes investigation and corrective action which is to ensure that potential fraud is being addressed in an appropriate and timely manner. The research found that corrective action would complement the response control. The corrective actions have been described by KPMG (2006b) as actions
by the company to remedy the harm caused by a particular fraud case. The corrective actions are important for every company to examine the root causes of the fraud, and therefore, the particular risk of fraud could be controlled and mitigated.

Communication to individuals in the company in relation to the reported fraud cases is important to show the responsive action of the company’s management and that there is no tolerance for any fraudsters. Therefore, the company would administer the disciplinary action for any fraud cases. Hence, the corrective actions are essential for achieving effective strategies for financial statement fraud control. The corrective action is considered imperative because it supports the prevention and detection strategies.

2.19 Importance of corporate governance in relation to financial statement fraud control

The effectiveness of corporate governance (CG) in every company is perhaps important in controlling financial statement fraud. The Enron and WorldCom cases have proved that financial statement fraud had been perpetrated by company directors and senior management. Therefore, the element of corporate governance will be one of the control mechanisms to control financial statement fraud. An effective corporate governance practice is arguably important to reduce asymmetric information problems between a company’s management and investors, and to increase the transparency of financial statements (Chung et al., 2010). Their findings also reveal that a good CG practice would demonstrate a company’s shareholders protection and disclosure. The researcher has studied the guidance and code of conduct of the United Kingdom.

The Malaysian Securities Commission released the Malaysian Code on Corporate Governance 2012 which aims to enhance the effectiveness of the boards of listed companies in Malaysia. The Code is also intended to boost the commitment and the independency of the company directors. According to Tan Sri Zarina (2012), a good corporate governance practice at the top level reflects the effective management of risk and
internal control (Press release: SC 29 March 2012). In the United Kingdom, the Financial Conduct Authority (FCA) regulates and supervises the firm’s conduct. The FCA is responsible for ensuring the integrity of conduct in the UK’s financial market. It involves investigations and enforcement powers. One of the FCA’s statutory objectives is to reduce financial crime that involves financial statement fraud in order to protect consumers, and increase market confidence and public awareness (Financial Conduct Authority, 2013). In relation to this objective, the Financial Reporting Council (FRC) set up the corporate governance committee to reflect the higher standard of corporate governance in the UK’s listed companies. In order to maintain effective corporate governance and internal control, the FRC provides the UK Corporate Governance Code and associated guidance. It was formerly known as the Combined Code which set the standards of good practice of the board, remuneration, accountability and relations with company shareholders.

According to the Institute of Chartered Accountants in England & Wales (ICAEW) (2011), the corporate governance committee was set up by the FRC in response to the UK cases of BCCI and Maxwell. In addition to this, the FRC aimed to establish the standards of financial reporting and accountability in all companies. In relation to this, the listing companies are required to report on the application of the Combined Code in their financial reporting. The Combined Code was first produced in 1992 by the Cadbury Committee, known as the Cadbury Report, in response to the financial scandals. The committee was chaired by Sir Adrian Cadbury and focused upon corporate governance in relation to financial reporting and accountability. Therefore, the main purpose of this report is to prevent financial fraud and improve the corporate governance of UK companies (Sheridan et al., 2006).

The development of corporate governance was followed by a Code of Best Practice, which was updated to the Combined Code 2003, 2006 and 2008. The new edition of the Code was introduced by the FRC in May 2010, namely, the UK Corporate Governance Code (Schachler et al., 2007). In general, UK Companies are required to apply the UK Corporate Governance Code as their main guidance in corporate governance and associate guidance.
to support the companies in applying the principles of governance code. The associate
guidance concerns (1) Guidance on Board Effectiveness (formerly known as Higgs
guidance), (2) Internal Control: Revised Guidance for Directors (formerly known as the
Turnbull guidance) and Guidance on Audit Committees (formerly known as the Smith
Guidance). The following section will describe the guidance introduced by the Financial
Reporting Council to stem financial fraud and improve corporate governance in UK
companies.

The new version of the UK Corporate Governance Code was issued in June 2010 by the
Financial Reporting Council. The main purpose of this code is “to facilitate effective,
entrepreneurial and prudent management that can deliver the long term success of the
company” (The UK Corporate Governance Code, 2010). In addition to the main principles
and code provisions provided in the UK CG Code, the FRC also published a few reports to
assist companies in applying the CG Code.

The UK Corporate Governance Code remains the classic definition of corporate governance
produced in the Cadbury Report 1992, namely:

...is the system by which companies are directed and controlled. Board of directors
are responsible for the governance of their companies. The shareholders’ role in
governance is to appoint the directors and the auditors and to satisfy themselves that
an appropriate governance structure is in place. The responsibilities of the board
include setting the company’s strategic aims, providing the leadership to them into
effect, supervising the management of the business and reporting to the
shareholders on their stewardship. The board’s actions are subject to laws,
regulations and the shareholders in general meeting.

In general, the UK CG Code describes and promotes the role of the board of directors in
setting the values in a company’s operation. The Code best describes the guide of effective
practicing in a company. Therefore, the directors are expected to discharge their duties
effectively and provide greater transparency in relation to the company's operation. There are four underlying issues in the UK CG code: (1) accountability, (2) transparency, (3) probity, and (4) focusing on the success of a company's long term sustainability.

Sections A and B of the UK CG Code also encourage the company's chairman to attach his own report to the company's annual statement regarding the principles used for implementing the effective role of company directors. The new CG Code 2010 emphasizes the greater accountability from the directors of FTSE 350 companies. This new recommendation is to ensure the effectiveness of the board by accountability. In practice, the UK CG Code emphasizes the "comply and explain" approach, which is highly upheld by both companies and shareholders. This approach is designed as an alternative to effective corporate governance which is based on a rule-based system.

There are two main elements in the UK CG – principles and provisions. The principles are regarded as the core of the Code and included the main and supporting conduct of corporate governance practice. The provisions are provided for each of the sections to add strength to the principle elements. Therefore, the company needs to illustrate and give reasons in relation to the practices of the Code. Thus, shareholders are allowed to dispute and discuss the company's practice. The five sections or principle elements are (1) leadership, (2) effectiveness, (3) accountability, (4) remuneration, and (5) relations with shareholders. Every company is required to apply the main principles in listing the rules, and consequently, report the outcome of the performance to the company shareholders.
CHAPTER THREE

RESEARCH METHODOLOGY

3.0 Introduction

This chapter sets out the research philosophy, research methodology, and research design. The research aims to recommend improvements for financial statement fraud control. Specifically, it evaluates and develops strategies for the prevention and detection of financial statement fraud and actions in response thereto. Therefore, the chapter describes the adopted research philosophy and the applied research methodologies in answering the research questions.

3.1 Research Philosophy

The research aims to recommend improvements for financial statement fraud control and therefore examines the present practices in respect of financial statement fraud prevention and detection and actions in response thereto. A normative point of view is taken by making recommendations for financial statement fraud control. Normative research can be conducted through the examination of human behaviour that is governed by the rules and protocols of the organization (Douglas, 1973) through which improvements to the present practice can be determined. In arriving at the recommendations the research examines the present system of behaviour in the case study companies, evaluates the current standards, regulations and proposed guidelines that have been made by the professional bodies and conducts interviews with the external groups.

The system of behaviour in this context refers to the present practices of financial statement fraud control in organisations. Case studies contribute to an understanding of the current practices to mitigate financial statement fraud. In other words, normative research enables the researcher to point out which part of the controls should be improved through the applied methodologies (Argyris, 1990; Robinson, 2001; Thatcher, 2006). The examination of the
present system of behaviour and the evaluation of standards, regulations and guidelines and interviews of external groups have been undertaken to develop recommendations for financial statement fraud control. The researcher does not intend to match the standards, regulations and guidelines with the present practices but aims to investigate what is actually being practiced in the control of financial statement fraud, and, subsequently, provide recommendations for the improvement thereof.

The research also includes jurisprudential research in the evaluation of standards, regulations and guidelines. The jurisprudential aspect in this research context entails the critical evaluation of the present laws, regulations, proposed guidelines and their enforcement. Jurisprudence is the philosophy of law or method of legal discussion. Jurisprudence in this context does not deal with ‘human feels about human person and their relations’ but deals with the discussion of verbal qualification (Dun, 2009). Accordingly, the research investigates the regulations in relation to financial statement fraud to understand the legal framework as well as the legal practice. The investigation is an attempt to understand the establishment of the relevant laws and standards in addition to the actual practices. Furthermore, the professional guidelines have been examined to understand what the professional bodies have suggested to manage the risk of fraud, thereby enabling the researcher to understand the consequences of actual practices and provide improvements for financial statement fraud control. In addition, interviews with regulators, forensic accountants, external auditors and independent bodies have been conducted to develop an understanding of the protocols of financial statement fraud in Malaysia.

The research employs a post positivist paradigm in understanding the present practices of the case study companies. The post positivism requires an understanding of the actual practices of participants in action (Burrel and Morgan, 1979). Therefore, the research rejects the positivism paradigm that emphasises quantitative methodology, and, hence, is inappropriate to understand the complex problem of research issues (Baker and Bettner, 1997). In this respect, the goals of the investigation in this research are to understand the
present practices of financial statement fraud control, and, specifically, to identify any strategies for the prevention, detection and response that are currently in use and how well such strategies assist financial statement fraud control.

The research takes an inductive approach in reasoning. Goetz and LeCompte (1984) state that an inductive researcher would obtain a concept from the data collected. In addition, inductive reasoning provides rich information gained from the real world (Goel, et al., 1997).

The researcher found that case studies explain the current practices of financial statement fraud controls and can be used as a basis for recommendations for improvements. The output from this research will contribute to controlling the business risk from fraud. Accordingly, a small number of case study organisations were chosen to achieve an in depth study rather than a large volume of organisations. Multiple case studies provide a greater range of outcomes rather than a single case study from the present phenomena in the context of real life (Yin, 1994; Kohn, 1997).

3.2 Research Methodology

A qualitative research methodology is adopted in undertaking the investigation to understand the actual conduct of practices. The qualitative case study assists the researcher to understand the actual practices in the case study companies in relation to the mitigation of financial statement fraud. Qualitative research allows the researcher to investigate the current practices in the research context using a variety of data sources (Yin, 2003; Baxter and Jack, 2008). In addition to case studies, qualitative data was obtained from a review of the standards, regulations and guidelines, and interviews with the five groups of respondents. Hence, the research acquired the primary data from the case study companies and interviews with the relevant group of respondents, and secondary data from the law, regulations, legislation and professional guidelines. Therefore, the findings of the research are a mix of the present practices, respective roles, and perceptions concerning the issues of financial statement fraud control. The research approach attempts to answer the
research questions, which were designed such that the researcher's opinion could not be established by other means.

### 3.2.1 Case study research method

The case study research method is the main research strategy in undertaking the investigation of financial statement fraud control in Malaysian Public Interest Entities. According to Bernama (2013), Malaysia's position in the Corruption Perception index for the year ended 2013 has improved from 54th place to 53. In fact, in ASEAN, Malaysia was in the third place after Singapore and Brunei, while globally Malaysia was being ranked better than some developed countries including Italy and Greece. However, rapid developments and changes in the business environment make many possible types of fraud involving companies’ possible, especially financial statement frauds. This has led to Malaysian government initiatives to curb a level of fraud, bribery and corruptions in Malaysia (Mohamed, 2013).

The aim of the research is to explore the internal control strategies in regard to financial statement fraud in Malaysian Public Interest Entities. The investigation of such controls is aimed at providing improvements for financial statement fraud control in Public Interest Entities. Therefore, the most suitable method is case study research where the research is able to explore and examine the present practices of financial statement fraud control. The research found the analytical case study method is the most powerful technique that could provide rich information for the research objectives. The strengths of case study method allow the research to examine the actual practices and controls adopted by the public interest entities. In addition, Merriam (1988) claims that case study information provides an intensive and holistic explanation of present phenomena. The investigation of financial statement fraud controls in the case study companies assists in understanding the actual practices of such controls and recommending improvements.
a. Purpose of conducting case studies

The research utilised case study research to acquire in-depth information on the present practices and the adoption of any strategies to control financial statement fraud. Stake (1981) states that the reason for choosing case studies is that concrete knowledge and relevant experience can be gained from the real experience in the case study companies. In addition, case study research attempts to answer the research questions, which have been designed as such that the researcher’s opinion could not be established by other means (Neale, 2006). The justification for case study research has been explained by Becker (1968) in which the research objectives could be achieved through a comprehensive understanding and development of the theoretical statements of the group study. Therefore, the case study approach assists the researcher to contribute to the improvement of the issues under investigation (Cohen & Manion, 2000). Guba and Lincoln (1981) however were concerned about the limitation of case study research method. In terms of case evaluation the researcher need to be aware and avoid any biases in evaluation of the case findings. This is very important as it could affect the research results.

b. Two case studies

The research focuses on the present practice of financial statement fraud control in order to identify and develop improvements thereto. In this respect, to answer the research questions, two public interest entities in Malaysia are the case study companies under investigation. Two case studies aid the researcher to understand the present practices of financial statement fraud control holistically. As the practices of financial statement fraud control might differ between the two case study companies, their control and strategies for financial statement fraud control will enhance the rich and in-depth information. The two case companies that have been selected are named as company A and Company B.

Merriam (1998) states that more than one case study provides a better variation. In this respect, the understanding of the present controls of financial statement fraud in Malaysian
commercial companies is best achieved through research case studies. Multiple case studies strengthen the precision, validity and strength of the case study findings (Miles & Huberman, 1994). Therefore, the research uses multiple case studies as the main strategy to enhance the validity of the research findings. The two case study companies under investigation are multinational companies and they are the key players in the Malaysian economy. Company A is a public listed company from the oil and gas industry while company B is a diversified public listed company that is involved in plantations, property, motor vehicles and industrial equipment. Perhaps, as large companies, they are adopting and practicing comprehensive strategies to control financial statement fraud. Consequently, the research found the two case study companies to be ideal for providing the information required for the research.

c. Case study research design

In conducting case study methodology, the research has undergone a number of case study procedures. The systematic procedures for case studies in the research enhance the reliability and validity of the case study methodology.

i. Case study procedures

The research incorporates five case study procedures beginning with the (1) designing of the case study procedures, (2) preparing case study and interview questions, (3) processing data collection, (4) organizing and analysing data, and (5) finally, writing up the case study findings. The following diagram (figure 3) summarizes the whole process of the research case study methodology.
The actual and present practices of financial statement fraud control are the main focus within the scope of the research. Therefore, the research aims to obtain full information of the financial statement process and financial statement fraud control in the two case study companies. In addition to the case study questions, interviews with the relevant heads of divisions were conducted to assist the researcher in gaining an understanding of financial statement fraud controls from other divisions in the case study companies. Accordingly, the researcher interviewed the Head of Internal Auditors, Head of Risk Management and the other divisions suggested by the case study companies. The researcher also aimed to understand the current adoption of standards or policies in both case study companies. Therefore, permission to conduct document observation on the case study companies’ policies and procedures was sought. The conduct of the case study research follows the ethical considerations in relation to both case study companies.

ii. Case study research instruments

In order to understand the present practices of financial statement fraud in both case study companies, the research used case study questions, interview questions and document review (observation). The case study questions were designed to precisely clarify the aim of the research. The case study questions enabled the researcher to determine the present practices for controlling financial statement fraud. The
questions also enabled the identification of any best practices for financial statement fraud control from both case study companies. In addition, the case study questions were designed to identify any weaknesses in the existing control and subsequent improvements thereto. The semi-structured interview questions were posed to the particular heads of division, namely, Head of Accounts and Finance, Head of Internal Auditors, Head of Risk Management and the suggested divisions assisted in developing an understanding of the controls made by the Accounting and Finance Division and other divisions towards financial statement fraud.

iii. Questions designed for case studies

The case study questions were designed to understand the present practices of financial statement fraud control, from which recommendations for improvements to the present control system can be made. Accordingly, eight case study questions were designed to understand the present adaptation of acts and regulations and present practices that could mitigate financial statement fraud. Therefore, a similar set of case study questions was posed to both case study companies. Financial statement fraud control in this research context also focuses on any prevention, detection and action in response to financial statement fraud. The following table 2 shows the case study questions that were posed to both case study companies:

<table>
<thead>
<tr>
<th>Case study questions</th>
</tr>
</thead>
<tbody>
<tr>
<td>1 What is the current level of adoption and application of the Acts and regulations</td>
</tr>
<tr>
<td>in relation to the financial statement process?</td>
</tr>
<tr>
<td>2 What is the current level of adoption and application of the accounting standards</td>
</tr>
<tr>
<td>and guidelines?</td>
</tr>
<tr>
<td>3 What are the current procedures and systems in relation to the financial statement</td>
</tr>
<tr>
<td>process?</td>
</tr>
<tr>
<td>4 How do the companies practice fraud risk governance?</td>
</tr>
<tr>
<td></td>
</tr>
<tr>
<td>---</td>
</tr>
<tr>
<td>5</td>
</tr>
<tr>
<td>6</td>
</tr>
<tr>
<td>7</td>
</tr>
<tr>
<td>8</td>
</tr>
</tbody>
</table>

Table (1) shows the case study questions used in data collection. Questions number one and two were designed to identify the current adoption and application of (1) the Acts and regulations in relation to the financial statement process, and (2) accounting standards. Even though these questions (Question 1 and 2) can be answered from the external auditor’s report, the researcher aims to formalise them through interview and written evidence. For question number three, the research focuses on the procedures and systems in relation to the financial statement process. The justification for this question is to determine any practice of internal control over the financial statement and risk management system in relation to the financial statement process.

Question number four of the case study is assumed to be the main question to this research. The research aims to provide any controls that govern the financial statement fraud. It is also pertains to the fraud risk governance practice with the intention of identifying whether the companies have a well written document as a clear direction to the whole organization to prevent financial statement fraud. In addition, the company’s code of conduct will be examined to establish if there is any in existence. In relation to the financial statement process, the research anticipates identifying the company’s policies in terms of job description and level of authority in company procedures. If the companies have controls, the research intended to identify any assessment made to the controls designed.
In addition, the research intended to identify any affirmation process in relation to financial statement fraud, and the findings will establish if there is any signed document that reflects the understanding and compliance of the respective company’s fraud policy and code of ethics. Another justification for the fraud risk governance question is that the research intends to identify any financial statement fraud schemes recognized by the companies and whether the companies address financial statement fraud risk as a regular agenda item at board meetings.

Question number five of the case study was designed to understand the roles and responsibilities of the company’s board of directors, audit committee, chief financial officer, internal and external auditor and key management staff in relation to the financial statement process and control. Thus, the research will define the division of responsibilities of the financial statement process and financial statement fraud risk mitigation effort. Subsequently, the issues concerning the financial reporting, risk management and internal control of the company will be examined.

For question number six, the research intended to know any particular tools (software or technics) used by healthy company to detect fraud in financial statement. The final questions of the case studies (questions number seven and eight) focussed upon the current prevention, detection and corrective action strategies in relation to financial statement fraud. If any prevention, detection and response strategies have been designed, the research intends to explore whether the three strategies have been documented and monitored by the companies. In relation to the response strategy question, the research intends to understand financial statement fraud reporting procedures, whistle blowing and ethics control centre in the company’s practice. In addition, the investigation procedures will be identified, while, at the same time, any corrective action strategies will be ascertained in response to the strategy questions to understand any financial statement fraud reporting procedures and fraud punishments.
iv. Questions designed for interviews

In addition to the case study questions, semi-structured interview questions were used with the heads of the respective divisions to understand the protocols, issues and financial statement fraud control from other divisions in both case study companies. The research provided interviewees with a pre-read interview pack before the interview session took place. The interview pre-read contained the background of the researcher, purpose of research, interview questions, and process of interview information. Therefore, the interviewees were provided with clear information before the interview sessions were conducted.

The following table (3) shows the interview questions posed to the respective heads of division in both case study companies.

<table>
<thead>
<tr>
<th>Interview questions</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. In relation to the financial statement process, could you describe your role and responsibilities?</td>
</tr>
<tr>
<td>2. What are your responsibilities for ensuring that true and fair financial statements have been prepared by the company?</td>
</tr>
<tr>
<td>3. What controls are associated with your position pertaining to the financial statement process?</td>
</tr>
<tr>
<td>4. From your experience, what are the best practices in a company to prevent financial statement fraud?</td>
</tr>
<tr>
<td>5. What are the best controls that a company should have in place to prevent financial statement fraud?</td>
</tr>
</tbody>
</table>

Question number one of the interview questions aims to provide an understanding of the interviewee’s role and responsibilities. Therefore, the research relates it to the relevancy of the controls in the scope of research. In the case whether the division is relevant to financial statement fraud control, question number two aims to investigate...
the responsibilities of the head of division to ensure that the correct financial statement has been prepared by the companies. Further investigation is made in question number three. The question aims to examine the associated controls with the interviewee’s position in respect of the financial statement process. Questions number four and five of the interview questions aim to identify the best practice and control for financial statement fraud in relation to the interviewee’s experience.

v. Case study data collection process

Consent was obtained from both case study companies prior to the data collection process. The permission given by both case study companies was attained in accordance with the ethical procedures that have been explained in ethical consideration part. In order to obtain the case study information, a number of communication methods were employed through a number of visits to the case study companies – verbal conversation, email messaging and telephone conversation. The researcher gathered all the case study information through the case study questions, interviews and document observation.

Both of the case study companies responded to the case study questions using written answers. The officers responsible for responding to the case study questions were authorised officers identified by the top management of the respective company. To gain a full understanding on each answer, the researcher met with the respective officer to obtain clarification on any short or unclear answers. The purpose of the meeting was to ensure the case study information fits the research objectives.

Through the interviews conducted, the researcher gained an understanding concerning the protocols, perceptions, beliefs, experience and action activities from the respective heads of division at the group level. The interviews were conducted with the highest level of division at the group level. Therefore, the findings reflect the actual practices of the financial statement process at the group level of public
companies. The interview conversations were manually transcribed in response to the interview questions. In order to obtain a clear understanding of each interview question, the researcher used tabulated responses before writing it in the findings sections. The researcher was also allowed to study the relevant documents used to control financial statement fraud. From the observations made, the researcher gained an understanding of the policies and procedures established in the case study companies for controlling financial statement fraud.

vi. Case study data organizations

The case study information gained from the case study questions and interviews provide the evidence for the case study research. The research investigates the two case study companies to understand the practices in at least at two commercial companies. The data collection in case study research involves face-to-face interviews, written feedback, and document observation. The practices of the two case study companies were examined and analysed in order to understand the present practices, and, thus, identify possible improvements to financial statement fraud control. The three types of response were case study questions, interview recordings and document observations.

Firstly, the response from the case study questions are a further process to explain the present practices in the findings section by revealing the actual practices and adoption of current regulations, accounting standards and financial statement fraud control. The researcher constructed an understanding of the present practices in accordance with the research questions. Secondly, the recordings of the interview conversations with the relevant heads of division were transferred to the computer hard disk. The next process was transcribing the interview recordings manually. Due to the unclear pronunciation of the interviewees and noise interruptions during the interview sessions, the researcher had to listen carefully and keep rewinding and replaying a number of times. The completed transcription was then organized using the tabulation responses to obtain the actual meaning of the issues from the
interview questions. The researcher gained benefit from the semi-structured interviews in achieving the objectives. The next step of data organization was the data establishment. The researcher established the information from the interviews and case studies to understand the reasons for such practices, beliefs and experiences. Therefore, the researcher established the assumptions of what was being done in order to identify any best practices or weaknesses.

Thirdly, the observations of the relevant policies and procedures were summarized to explain the adoption of the present standards and procedures of the case study companies. However, the case study companies did not allow the researcher to photocopy the documents. The understanding derived from observation of the documents is explained in the research findings.

vii. **Case study analysis**

In tandem with the research objectives, the researcher designed four strategies for analysis. Firstly, in order to determine how well the present practices assist in preventing financial statement fraud, the researcher examined the adopted controls by both case study companies to understand why such controls have been adopted. Secondly, the researcher attempted to identify the best practices of financial statement fraud control in both case study companies, as well as the internal controls and specific controls in relation to the financial statement process, specifically, the strategies for the prevention, detection and response from the main internal control and any specific internal control over the financial statement process. The outcome of this process was turned into new information and themes. Thirdly, the researcher aimed to identify any weaknesses that have not been previously addressed by anyone. Therefore, further analysis in which the reasoning behind the research was done. In relation to this, the fourth analysis was aimed to identify any methods that could be used to ameliorate the current areas of weakness. The researcher examined what had been designed, understood the reasoning and identified the loop
holes of the controls designed. In addition to the information that had been gathered, the researcher analysed the literature to understand the cases and events, and analysed the system to understand the things that go wrong. Therefore, the whole analysis was to establish the most important factors that could contribute to financial statement fraud control and the setting up of strategies for the prevention, detection and response.

The researcher found that a unified description of case study analysis is more appropriate for conceptualizing the case study information from both companies. According to Merriam (1998), a unified description provides data categorization, themes and typology. The case information from both companies is organized in the data findings chapter. In relation to the case study information, the researcher breaks up the five major themes and categories into (1) corporate governance practice, (2) financial performance of the company, (3) policies and procedures of financial statement preparation, and (4) understanding the perception of the roles and responsibilities of the respective heads of division.

The outcomes of this analysis part will not only reproduce the information that has been gathered but will provide an intelligent comment on the information gathered. As such, the research recommends financial statement fraud controls. Specifically, the researcher evaluates the strategies of prevention, detection and action responding thereto. The researcher explores the issues addressed from the analysis and understands the reasons behind the setting of the current practices from the information gathered. The researcher also uses the information to explore and identify the best practices of the present practice and any weaknesses in financial statement fraud control.
3.2.2 Review of financial statement fraud regulations

In addition to case study methodology, the researcher reviewed financial statement fraud regulations. The aim of reviewing financial statement fraud was to investigate what is actually being practiced in controlling financial statement fraud, and provide recommendations for improvements to the current practices. However the research does not intend to match the standards, regulations and guidelines with the present practices.

Jurisprudential research was used in the evaluation of financial statement fraud regulations and guidelines. In this respect, the research evaluated the present laws and regulations that have been established to control financial statement fraud in Malaysia, the UK and the US. The researcher attempted to gain an understanding of the legal framework as well as the legal practice in actual practice. The focus of the review of the regulations was to understand what is currently being enacted and imposed by law in relation to financial statement fraud control. The review of financial statement fraud regulations provides a clear understanding concerning the legal aspect of company administrative requirements and stock market practice. The review of financial statement fraud regulations in Malaysia is aimed at gaining an understanding of the law and regulations in the home country of the researcher as well as that of where they are based and resident. In addition, the US regulations have been chosen to determine and understand the regulatory response after the Enron and WorldCom cases. The researcher also reviewed the relevant financial statement fraud regulations in the UK due to its practice of a single financial regulation and robust response to fraud mitigation.

The review of the relevant financial statement fraud law and regulations from Malaysia, the UK and US were examined. The relevant Acts and sections were selected to show the relevant control from the regulatory parts. Subsequently, the chosen Acts and sections from the three countries were allocated according to the themes under investigation, as explained in the review of regulations in chapter four.
3.2.3 Review of professional guidelines pertaining to fraud policy

In addition to financial statement fraud regulations, a review of the professional guidelines from the professional bodies for managing the risk of fraud was conducted. The review of the guidelines enabled the researcher to understand the consequences of the actual practices and recommend improvements to financial statement fraud control. The research reviewed the most relevant guidelines of fraud mitigation (IIA et.al, 2007). The guidelines are sponsored by the leading professional bodies, namely, the Institute of Internal Auditors (IIA), the American Institute of Certified Public Accountants (AICPA) and the Association of Certified Fraud Examiners (ACFE). The guidelines were chosen due to the cooperation among the three professional bodies that contribute to the significant recommendations for fraud mitigation guidelines.

The three leading professional bodies have provided fraud policies and procedures to mitigate the general types of fraud in an organization. To achieve the purpose, the proposed fraud policies and procedures were evaluated to develop recommendations for financial statement fraud control. The review of the guidelines provided the researcher with a better understanding of the current practices of financial statement fraud control in the case study companies. The research discusses the review of the guidelines in chapter four of the research.

3.2.4 Interview research methodology

In addition to the case studies, and the review of financial statement fraud regulations and guidelines, respondents from a group of external bodies in Malaysia were interviewed. The interview strategy was designed to support the case study method. The purpose of interviews is to understand the protocols and responsibilities, present practices of the present position, views concerning financial statement fraud, and opinions pertaining to the control of financial statement fraud. Interview research provides in depth information
concerning the research issues. Therefore, the research used the information derived from the interviews to provide novel and significant knowledge of financial statement fraud control.

a. **Group of interviewees**

The interviews have been justified as a supporting method to achieve the research questions. The interview findings assist in achieving an understanding of the present phenomenon and real practices (Gillham, 2005). The interviews were completed in Malaysia with representatives from firms, bodies and institutes that are established and practice in Malaysia. The interviewees comprised representatives from three regulatory bodies, two senior external auditors from top audit firms, two forensic accountants from top audit firms, one professional accounting body, two independent and one representative from independent company management.

b. **Interviews setting**

The interviews were conducted in Malaysia during the period of 1st July 2011 to 25th July 2011. The interviews were conducted in the respective offices of the interviewees during office hours except for the Malaysia Institute of Corporate Governance (MICG) and Bursa Malaysia. The interview with the MICG president was held in the lounge of the Hilton Hotel during the lunch time, while the interview with the representative from Bursa Malaysia was held at Starbucks, Maybank Tower in Kuala Lumpur at 7.00pm after office hours.

c. **Interview questions**

The interview questions were designed to understand the protocols, responsibilities, views of financial statement fraud, and opinion concerning the controls of financial statement fraud. Therefore, open ended questions were prepared to explore the perceptions, beliefs, experience and action activities pertaining to financial statement fraud control. Smith et al. (1991) state that unstructured interviews provide the interviewee’s opinions, experience and beliefs about the actual practice activities. The research prepared different types of
questions for each group of interviewees (interview questions in appendix 1). The first group of interviewees comprise regulators, external auditors and forensic accountants, and representatives from the relevant independent bodies and company management.

In general, the interview questions were purposely designed to gain an understanding of the protocols and responsibilities in relation to the (1) financial statement process, (2) authority and control in respect of financial statements, (3) experience in internal control design, and (4) experience in best practices of financial statement fraud control, particularly concerning the three strategies of prevention, detection and response to financial statement fraud. Six questions were posed to the regulatory bodies. Question number one was designed to understand each of the selected regulatory body’s roles in handling financial statement fraud. Question number two was intended to derive an understanding of the type of company within the regulatory remit of the regulatory bodies. Question number three was designed to recognise the scope of monitoring or compliance with the regulations from the companies.

In relation to ascertaining any powers given by the authority to set standards or any binding regulations, question number four was introduced. Finally, question numbers five and six were used to gain an understanding of the interviewees’ views on current financial statement fraud cases and their experience (if any) in handling financial statement fraud cases in Malaysia. The second set of questions was posed to external auditors and forensic accountants which comprised of twelve questions. However, two interviewees declared themselves as forensic accountants and were therefore reluctant to answer the basic questions on the external auditor’s roles. The research benefited from their extensive experience in answering question numbers eight to twelve.

Specifically, questions number one and two focus on the role of the external auditor in relation to the financial statement process and financial statement fraud control. The research intends to gain an understanding of the procedures in financial statement auditing
through question number three. Subsequently, question numbers four and five were used to gain information pertaining to any action of external auditors in dealing with any material misstatement found in their auditing work and the methods used to control the audit risk. Question number six was designed to gain an understanding of how the external auditor manages any unusual or irregular transactions in their course of the audit, while question number seven concerns the best practice used to control the audit risk. The final questions, from question number eight to question number twelve, focus on the interviewees’ perspective and experience of the control system to prevent financial statement fraud in any company. Specifically, an understanding is sought of the real practices, and prevention, detection and response strategies that should be in place in every company.

The third set of the questions was posed to the independent bodies in Malaysia. The purpose of the questions designed was mainly to understand the protocols of these bodies in relation to financial statement fraud control and mitigation and their views on financial statement fraud issues. The research designed five questions for five different bodies to understand the protocols in preventing financial statement fraud in Malaysia and the procedures that have been taken in relation to financial statement fraud. Question number one to question number three were designed to gain an understanding of the roles of financial statement fraud prevention and whether the bodies have any control over the companies in Malaysia. In the case of the evaluation roles of public listed companies’ financial statements, the researcher intended to identify and understand the procedures implemented in the event of financial statement fraud occurring in the company.

Finally, question numbers four and five were used to obtain their opinion concerning the best practices to control financial statement fraud in each company, particularly in respect of the three strategies of prevention, detection and the response thereto. As independent bodies and professional bodies, the intention was to clarify if any training has been given to their members. Finally, a similar set of questions to that posed to the management of the case companies was presented to an independent Chief Financial Officer. The purpose of this
interview was to ascertain the practices of the Chief Financial Officer from other companies in addition to the two Chief Financial Officers from the case study companies. In relation to this, the researcher interviewed and posed five questions in relation to the financial statement process and financial statement fraud control. Question number one and number two focus on the role of the Chief Financial Officer in relation to the financial statement process and their responsibilities in ensuring that the financial statement has been correctly prepared by the company. Question numbers three, four and five were designed to determine the controls associated with the position of the Chief Financial Officer and ascertain the best practices and controls in place in each company from the Chief Financial Officer’s point of view.

d. Interview procedures

Prior to the interview sessions, the researcher emailed the interview application letter, and, subsequently, followed up the response through telephone calls. A pre-read interview pack was emailed to the respective interviewees once the researcher received the interview date. The interview pre-read contained the background of the researcher, purpose of the research, interview questions, and process of interview information. The purpose of the interview pre-read was to provide the interviewees with a clear purpose of the interview and research information before the interview session takes place. On average, the interview sessions lasted forty minutes to one hour to cover all the interview questions. The interview locations took place in the City of Kuala Lumpur. The researcher stayed in Kuala Lumpur for almost two months to complete all the interview sessions. As such, twenty-six interviewees gave their cooperation to fit the purpose of this thesis.

e. Conduct of interviews

The researcher conducted face-to-face interviews with permission from the interviewees. The interviewees were well prepared to answer the interview questions with the given pre-read interview pack prior to the interview session. A voice tape recorder was used with the
permission of the interviewees to record the interview conversations. According to Gillham (2005), audio tape recording provides rich material from the perspective of the interviewees. It also assists to overcome the ‘writing barrier’ faced by the interviewer. The interview information aids the researcher to understand the research issues behind the interviewee’s feelings and experience.

f. Interview transcription

The researcher compiled the audio files of the interview recordings according to the name of the group of interviewees. The groups of interviewees were labelled as regulators, external auditors, forensic accountants, independent bodies and company management. The next process was transcription of the interviews. The saved audio files gained from the interviews were transcribed manually. The manual transcription process assists the researcher in feeling and understanding the research issues from the perspective of the various groups of interviewees. Gillham (2005) defines interview transcription as the ‘process of producing a valid written record of an interview’. To ensure the correctness of the interview transcribing, the researcher reviewed the completed interview transcription with the audio files.

g. Extraction of interview information

The next process for the information from the interviews was extracting the interview data from the interview transcriptions. The extraction of interview data was done according to the interview questions, according to which the researcher identified the key elements of the issues under investigation based on the responses received from the interviewees. The researcher tabulated the responses according to the interview questions. The actual meanings of the research issues were extracted to achieve the interview objectives. The extraction of the transcribed information is also a reduction process of narrative information. However, the extraction of the actual meaning of the interview information is represented by the actual statements of the interviewees. Therefore the research retains the actual meaning
of the interview information. The next stage of the interview information process was tabulating the responses according to the themes identified. The data tabulating of the responses shows the different responses using the similar themes discussed. The themes were found to be objective with the interview questions. The data found has been further analysed and presented in the findings section.

h. Analysis of Interview information

The interview research aimed to understand the interviewees’ perceptions, beliefs, experience, action activities and financial statement fraud issues from regulators, accounting/independent bodies, and representatives from independent company management. The first stage of interview analysis is to produce the narrative information gained from the interview transcription. In producing the interview narrative result, the researcher used her own words and disregarded the repetition found when transcribing the statement. Therefore, the narrative result is clear and the researcher can easily find the identified themes (Gillham, 2005).

The interview conversations were organized according to the interview questions. In relation to this, the interview responses were tabulated from the interview transcriptions. Two tabulating responses were designed in the research analysis part. The first tabulated responses detailed the interviewees’ response to the interview questions from the single group of interviewees. The second tabulated responses were a combination of the similar interview questions among the different groups of interviewees. The researcher learnt the different views and perspectives in relation to the identified themes of issues under investigation based on the interview questions. The themes identified in the analysis process were mapped out in order to provide an understanding of the entire issue under investigation.

i. Thematic analysis of interviews information

Thematic analysis was used to identify the themes of financial statement fraud issues and financial statement fraud control. Leininger (1985) states that themes are identified patterns
and components derived from the interviewees’ ideas and experiences. In addition, Taylor and Bogdan (1989) state that the themes result from the topics of conversation, feelings or experienced activities. In relation to this, ten identified themes were derived from the conversations with the interviewees. The interviewees’ ideas and experience were transformed into the themes of (1) financial statement fraud explanation, (2) financial statement fraud method and motives, (3) financial statement fraud perpetrators, (4) the influence of financial statement in Malaysia, (5) the role of the chief financial officer, (6) the role of internal auditors, (7) the role of external auditors, (8) the role of Malaysian regulators, (9) the role of independent bodies, and (10) the respondents’ views on financial statement fraud cases in Malaysia. From the ten designed themes, two main issues were identified, namely, financial statement fraud issues and understanding the mitigation protocols of financial statement fraud. Therefore, the ten identified themes were allocated according to the two main issues.

In relation to financial statement fraud issues, three themes were discussed, namely, financial statement fraud explanation, financial statement fraud methods and motives and financial statement fraud perpetrators. In understanding the mitigation protocols of financial statement fraud, the researcher analysed them according to the role of the position in commercial companies and the role of external bodies.

The influence of financial statement fraud in Malaysia was also discussed as a part of understanding the mitigation protocols of financial statement fraud. To analyse the roles of positions in commercial companies, the roles of the chief financial officer, internal auditors and external auditors were discussed. In addition, the analysis of external mitigation of financial statement fraud was derived from the roles of the Malaysian regulators and independent bodies. Finally, the results of the interview analysis are presented in the discussion and analysis chapter. The researcher built valid arguments according to the identified themes by referring to the literature. Consequently, the researcher formulated the theme statements to reflect the research objectives.
j. Interview constraints

The researcher faced a number of constraints during the interview settings and sessions. Most of the interviewees were reluctant to be interviewed as they found that the sensitive issue of fraud would be discussed in the interview session. However, the researcher re-requested the direct instruction from the Chief Executive Officer’s office to cooperate with the researcher. The researcher also received a number of changes for interview dates due to the tight schedule of the interviewees. However, all the planned interviews were completed during the data collection period in Malaysia. Another constraint faced by the researcher concerned the interviewees’ responses to financial statement fraud issues. The interviewees were not familiar with financial statement fraud control mechanisms, and, therefore, the research recognises the relevant controls through what is presently being practiced in the real world. Despite all the difficulties, the researcher obtained full cooperation from all the interviewees in the interview settings.

3.3 Verification of research data

Two data verification processes were conducted with the case companies. Firstly, the researcher verified the case study findings information, and, secondly, verified the key findings of the internal audit expectation gap with the audit committees of the two case study companies. The meetings with the representatives of both case study companies were held in Kuala Lumpur on 4th and 5th September 2012 to discuss the case study findings. The representatives of both companies requested amendment to some of the company information to avoid their companies being recognised in the research. Overall, the case study findings were approved and the research analysis was agreed. The researcher revisited both case study companies in Malaysia on 7th and 8th March 2013 to request face-to-face interviews with the members of the audit committees. However, difficulties were encountered in getting a response from the audit committees due to the tight schedule of the non-executive directors of audit committees from both case companies. In order to achieve the purpose of verification on the issues found, the researcher requested a
written response in relation to the designed interview questions. Given the fact that a key area of the research is internal audit expectation gap, it was important to hear the views of audit committee members, who are in charge of internal audit in public companies. Three questions were posed to the members of the audit committees to determine what they actually think about the role of internal audit in respect of financial statement fraud control, what internal auditors are supposed to do, how they do it and (if not commercially sensitive) whether their expectations are met. The following are the three questions posed to examine the expectations of the audit committee concerning the duties of internal auditors in relation to financial statement fraud control:

Table 4: Interview questions (Board audit committee)

<table>
<thead>
<tr>
<th>Interview questions (Board audit committee)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. What do you regard are the duties of the internal auditor?</td>
</tr>
<tr>
<td>2. How do you expect them to carry out the duties? (Relate to the first question)</td>
</tr>
<tr>
<td>3. Are these expectations always met?</td>
</tr>
</tbody>
</table>

The written responses received from the audit committee members are discussed in chapter seven of the research to support the key findings of the internal audit expectation gap.

3.4 Ethical consideration

The research found that ethical considerations are important to ensure the integrity and the quality of the research. The following sections explain the process of data collection from both case studies and interviews that have gone through the ethical process.

3.4.1 Ethical Consideration for case studies

In conducting the case study approach, the researcher gained consent from both case study companies to acquire in-depth information on the present practices, issues and adoption of any strategy to control financial statement fraud. Prior to the fieldwork, the researcher made
a direct application to the president and the Group Chief Executive Officer of both case study companies. Subsequently, the researcher was asked to attend a meeting at the group companies to explain about the research. The researcher obtained permission from both case study companies and was required to fulfil their requirements in respect of the case study information. The case study information should be agreed by the case study companies before the information is used in the PhD thesis. In response, the researcher was introduced to the relevant division to assist the research. For company A, the researcher was given the opportunity to conduct interviews and observe the relevant documents at the Group Finance Division. The Head of Legal Division assisted the researcher to gain cooperation by contacting the heads of divisions for interviews.

In addition, the researcher gained cooperation from the Special Officer to Group Chief Executive Officer to contact the heads of divisions for interviews. During the visits to both companies, the researcher was given an opportunity to work and observe the documents at the office General Manager of the Group Accounts at company A. In addition, company B allowed the researcher to use the discussion room for the purpose of discussion and document observation. All interviews with the heads of divisions took place at their offices. The researcher allocated 56 days to finish all the interviews and case studies in Malaysia, during which the discussion and interviews at both case study companies were successfully conducted from 1st July to 25th August 2011 in Malaysia.

To fulfil the requirements of the case study companies, the researcher discussed the presented case study information to be agreed, and visited the case study companies in August 2012 to show the case study information presented in the thesis. Both required the researcher to omit certain company information to avoid identification of the companies. However the omission of the information does not affect the findings of the research.
3.4.2 Ethical considerations for interviews

In addition, the interviews with the selected groups of external bodies were conducted in Malaysia. The researcher emailed letters of application together with the brief research proposal to the top management of the selected bodies. After receiving feedback from the top management, the researcher proceeded with the interview appointments with the authorised officers that had been referred by the top management. The interview times were based on a time convenient to them during the data collection period. Prior to the interviews, the researcher emailed the interview pre-read to each of interviewees. The interview pre-read contains the personal background of researcher, the summary of the research information and the interview questions. The interview pre-read enables the interviewees to prepare for the interview session. The researcher also asked permission to record the conversation as evidence of the interview information. Subsequently the interview information was transcribed and analysed. The information gained from the interviews is deemed as valid and reliable as it comes from the highest level of the relevant position at the group level. Moreover, the information gained also refers to the current issues and practices from the bodies and interviewees.
CHAPTER FOUR

THE REVIEW OF FINANCIAL STATEMENT FRAUD REGULATIONS

4.0 Introduction

A review of the regulations is one of the intentions of the research, which aims to understand the information collected from the various sources of data – regulations from the law and guidelines from the professional bodies. The review of financial statement fraud regulations assists the researcher in improving financial statement fraud control and contributing to a financial statement fraud control framework. The research reviews the current financial statement fraud controls that have been enforced by the regulators through the enactment of regulations and legislation. Accordingly, the research reviews regulations in relation to financial statement fraud from three countries, namely the US, the UK and Malaysia.

The review of the Malaysian regulations aims to understand the pertinent laws and regulations in the home country of the researcher. The US regulations have been chosen due to the establishment of the Sarbanes Oxley Act 2002 created in response to financial statement fraud cases in the US. The enactment of the Act also shows the response of the US regulators in relation to financial statement fraud regulations after having witnessed a number of financial statement fraud cases in the early 2000s. In addition to Malaysia and the US, the research also studies the relevant financial statement fraud regulations in the UK due to the worldwide hub of capital markets on the London stock exchange. The following sections further explain the acts and the relevant sections of the acts that were found to be important in reducing financial statement fraud.
4.1 The relevant financial statement fraud regulations in the US, the UK and Malaysia

The review of financial statement fraud regulations in the three countries is found to be useful for the improvement of financial statement fraud regulations. In respect of the named countries, the research has identified the relevant regulations in relation to financial statement fraud, which are summarized in the following table 4:

**Table 4: Financial statement fraud regulations of three countries**

<table>
<thead>
<tr>
<th>Country</th>
<th>Statute</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Malaysia</strong></td>
<td>Capital Market and Services Act 2007 (Securities Commission Act 1993)</td>
</tr>
<tr>
<td></td>
<td>Companies Act 1965</td>
</tr>
<tr>
<td></td>
<td>Financial Reporting Act 1997</td>
</tr>
<tr>
<td></td>
<td>Penal Code 574</td>
</tr>
<tr>
<td></td>
<td>Accountants Act 1967</td>
</tr>
<tr>
<td><strong>United States</strong></td>
<td>Securities Act 1933</td>
</tr>
<tr>
<td></td>
<td>Securities Act 1934</td>
</tr>
<tr>
<td></td>
<td>Sarbanes Oxley Act 2002</td>
</tr>
<tr>
<td></td>
<td>US Criminal Code</td>
</tr>
<tr>
<td><strong>United Kingdom</strong></td>
<td>Financial Market and Services Act 2000</td>
</tr>
<tr>
<td></td>
<td>Companies Act 2006</td>
</tr>
<tr>
<td></td>
<td>Fraud Act 2006</td>
</tr>
<tr>
<td></td>
<td>Theft Act 1968</td>
</tr>
</tbody>
</table>
The research reviews the sections of the Acts and creates a number of themes that are relevant to the mitigation of financial statement fraud. The following sections discuss financial statement fraud regulation in the US, the UK and Malaysia.

4.1.1 The United States financial statement fraud regulations

The research found that the capital market in the US is regulated under the Securities Act and the Sarbanes Oxley Act 2002. The Sarbanes Oxley Act was enacted mainly due to accounting scandals and financial statement fraud in the US. The following sections show the regulations that have been enacted in the US to ensure fair conduct within the capital market and prevent financial statement fraud.

a. The Securities Act 1933

The Securities Act 1933 in the US is also known as the ‘truth in securities’ law. According to the Wisconsin Department of Financial Institutions (2010), the Securities Act 1933 was the first securities legislation after the great Wall Street stock crash of 1929. The Act is administered by the US Securities and Exchange Commission (SEC) and is also known as the ‘sunlight theory of regulation’ with the assumption that the investors can make wise investment decisions when they are given all the necessary information (Wisconsin Department of Financial Institutions, 2010).

The Act is purposely designed to ensure the investors have accurate information for their investment decisions, and aims to restore the investors’ confidence in the US capital market (The Securities and Exchange Commission, 2009). In addition, the Act is also concerned with creating good competition in the financial market (The Securities and Exchange Commission, 2009). In general, the Securities Act 1933 concerns the information in the registration statements and prospectuses. It focuses on the reporting requirements of companies issuing new securities (Nordberg, 2008). Therefore, the Act protects potential investors by requesting full information disclosure in the companies’ prospectuses.
The Act also addresses the complaints from company investors regarding the complicated information in the companies’ prospectuses. In relation to this, the SEC encourages public companies to use plain English in filing documents, particularly within the prospectus. Reinstein et al. (1999) support the fact that the prospectuses of the public companies should be easily understandable, interpretable and well written. Overall, the enactment of the Securities Act 1933 provides the investors with sufficient information before they make investment decisions.

b. The Securities Act 1934

Subsequently, the United States Securities and Exchange Commission was established by Congress under the Securities Act of 1934, which empowers the Securities and Exchange Commission (SEC) with a wide authority in respect of the securities industry. Among the powers delegated to the SEC under the Securities Exchange of 1934 are ‘the power to register, regulate and oversee the brokerage firms, transfer agents and clearing agencies as well as the nation’s securities self-regulatory organizations (SROs) (The Securities and Exchange Commission, 2009).

The main aims of this Act are to identify and prohibit certain types of conduct in financial markets and to provide disciplinary powers over the regulated entities and associated persons. The Act also requires every listed company to periodically submit financial reporting to publicly traded securities. In general, every company with more than $10 million assets, and whose securities are held by more than 500 owners, has to file annual and periodic reports for public accessibility (The Securities and Exchange Commission, 2009). Furthermore, the Act also oversees the disclosure in material used to solicit shareholders’ votes in the annual meetings. The disclosure has to include all important facts relating to the issues on voting and it must be filed in advance to ensure compliance with the disclosure rules (The Securities and Exchange Commission, 2009).
According to Carey (1969), Edwards (1960) and Zeff (1972, cited in Chow, 1984, p. 470), the Securities and Exchange Act 1934 is one of the earliest federal laws regulating financial disclosure practices in the United States. According to Benston (1973), the requirement for financial disclosure is necessary for the fair and efficient operation of capital markets. The 1934 Act shows that the prevention method was possibly put in place in the US regulations at that point to safeguard investors.

Initially, the Securities Exchange Act 1934 regulated the trading of securities in the public market. In order to achieve this objective, a company needs to provide adequate information in financial statements to the company investors (Vernava & Hepp, 2001). Therefore, the company investors could make a fair investment decision from the true and fair view of financial statements provided by the company.

c. The Sarbanes Oxley Act

In response to the corporate and accounting scandals in the United States in the early 2000s, the United States enacted the ‘Public Accounting Reform and Investor Protection Act of 2002’, which is also referred to as the Sarbanes Oxley Act 2002. The Act concerns financial reporting requirements for public listed companies, and is considered to be the most important legislation affecting corporate financial reporting. The legislation aims to improve standards for all United States public company boards, management, and public accounting firms (AICPA, 2009).

The main purpose of this Act is “to protect investors by improving the accuracy and the reliability of corporate disclosures made pursuant to securities laws, and for other purposes” (Library of Congress, 2010). The Sarbanes Oxley Act is mandatory for all public companies in the US, international companies that have registered equity or debt securities with the US Securities and Exchange Commission and the accounting firms that give auditing services to the company (Library of Congress, 2010). The Sarbanes-Oxley Act formed new standards for corporate accountability and new penalties. Briefly, the Act introduced responsibilities for
corporate boards and executives in relation to the accuracy of financial statements. The Act also specifies new financial reporting responsibilities, which involve adherence to new internal controls and procedures intended to certify the validity of their financial records (Library of Congress, 2010). The Sarbanes Oxley Act contains 11 titles ranging from additional corporate board responsibilities to criminal penalties. The Act also covers the issues of auditor independence, corporate governance, internal control assessment and enhancement of the financial disclosure (SOX, 2002).

However, the PCAOB also guides the management of the company and auditors to base their assessment of the effectiveness of the internal control over financial reporting of the company on a suitable and recognized control framework. There are two control frameworks that have been used by the public companies subject to the requirements of the Act – the Committee of Sponsoring Organizations (COSO) ‘Internal Control Integrated Framework’ released in 1992 and Cobit (The IT Governance Institute’s Control Objectives for Information and Related Technology). The target audience of COSO is management while Cobit is intended for management, users and auditors. Cobit specifically focuses on information technology controls (Handal & Cullath, 2005).

Progressively, the COSO also issued the Enterprise Risk Management (ERM)-Integrated Framework in 2004, which defines the essential enterprise risk management components. The integrated framework discusses the key ERM principles and concepts and suggests a common ERM language that provides a clear direction and guidance for enterprise risk management (COSO, 1992). This framework is currently being used by organizations around the world (AICPA 2009). The Sarbanes-Oxley Act 2002 provides both securities regulations as well as imposed penalties against perpetrators.

The substance of corporate governance and internal controls are highly emphasized in order to achieve the objectives. It is expected that public confidence in the financial markets can be restored by improving the quality and the quantity of information provided to the public in
addition to the accuracy and the reliability of accounting information (Chang, et al, 2009). The Act also makes certain that both management and auditors have thoroughly examined the internal controls of the firm with the purpose of enhancing the transparency of corporate financial reporting (Chang et al., 2009).

Section 302 and 404 of SOX 2002 impose significant requirements concerning the areas of assessment and oversight control systems that support external financial disclosures (SOX, 2002). The passage of the Act is clearly designed to protect investors and strengthen the role of independent auditors through a presentation of a true and fair view on financial statements. Ayala and Ibarguen (2006) found that the passage of the Sarbanes-Oxley Act 2002 would prevent financial frauds in the future.

In order to mitigate and control financial fraud in the future, government regulations and monitoring are important. First, the companies have to improve their ethical values to promote responsible corporate behaviour, and, second, the incentives given to managers and audit firm should be changed. It has been reported by Ayala and Ibarguen (2006) that the problems appear when there are the differences between manager and shareholder goals.

The ‘agency problem’ would lead to accounting manipulation in order to gain personal interest. The sections of SOX 2002 discussed above are the sections most related to designing a programme for controlling financial statement fraud. The sections involve the top management of the company and the public accounting firm, which are both responsible for verifying and affirming to stakeholders that the SEC disclosures, including financial statements of the company and all supplemental disclosures, are truthful and reliable (Leech, 2003).

For the audit report, the Sarbanes Oxley Act 2002 requires all financial reports to include an internal control report. This is designed to ensure that the company’s financial information is accurate and that sufficient control has been exercised to present reliable information.
Therefore, the company's financial report must contain an assessment of the effectiveness of the internal controls designed by the company. In this case, the public accounting firm is required to attest to the assessment made by the companies (Library of Congress, 2010).

The objectives of the Sarbanes-Oxley Act are to enhance corporate governance and strengthen corporate accountability. The contents of the Act are designed to (1) formalize and strengthen the internal checks and balances within the company, (2) set various levels of controls to ensure the full disclosure of financial reporting, and (3) ensure that corporate governance is transacted with full transparency (Library of Congress, 2010). The Act extensively raises criminal penalties for securities fraud for any destroying, altering or fabricating of records in federal investigations or any attempt to defraud shareholders. The implications for non-compliance companies are penalties, which include the loss of exchange listing, loss of Directors’ and Officers’ liability insurance to million dollar fines and imprisonment (Library of Congress, 2010). In addition, the Act aims to (1) deter and punish corporate and accounting fraud and corruption, (2) mete out justice to the wrongdoers, and (3) protect the interests of workers and shareholders.

The Sarbanes-Oxley Act is also referred to as “the most important securities legislation since the original securities laws of 1930s” (Stephens, 2005). The Bill was passed after a number of corporate and accounting scandals – Enron, WorldCom, Tyco international, Adelphia and Peregrine Systems. Earlier research (Cherrington, 1942) explained the history of the Securities Act 1933, which forms the backbone of the Sarbanes Oxley Act 2002. In response to the stock market crash in 1929, the Democratic party’s 1932 platform called for protection of public investors and urged the US Congress to pass legislation for regulating the issuance of stock and became the Securities Act 1933 (Baker et al., 2006).

Initially (Karmel, 1982, p.47), the Securities Act 1933 was administered by the Federal Trade Commission before it was transferred to the Securities and Exchange Commission, under the Securities Exchange Act 1934, which is responsible for governing the periodic reporting
of financial information (Baker et al., 2006). The main objectives of the Acts were to mandate all public companies (1) to provide reliable financial information on a timely basis and (2) to treat the investors in the securities market fairly and honestly. In restoring the investors’ confidence in the capital market, the Act also provides greater government supervision of public transactions and companies (Ayala & Ibarguen, 2006).

Baker et al. (2006) cite the example of the earlier financial fraud case of McKesson. The SEC filed charges against McKesson for its violation of Section 32 of the Securities Act 1934. McKesson was filing false information with the SEC with approximately $19,000,000 in fictitious assets included in their financial statement audited by Price, Waterhouse & Co (PW) in 1937. After the events of McKesson the SEC issued revised standards of generally accepted auditing practices and required the accounting profession to determine the appropriate auditing standards (Baker et al., 2006).

d. The US GAAP

The Securities and Exchange Commission has statutory power to set accounting principles in the US. However, the Commission delegates to an independent and private sector for the standards setting process, which is aimed to be more thorough, open and deliberate as well as to ensure the quality of the accounting standards. In relation to this, the Financial Accounting Standards Board (FASB) was established in 1972 as a standard setter. The board designated the Generally Accepted Accounting Principles (GAAP) as an accounting framework in the US (Herdman, 2002)

In addition, the American Institute of Certified Public Accountants (AICPA) is the accounting profession association, and is responsible for setting the ethical standards for the accounting profession and auditing standards for profit and non-profit organisations or companies in the US. In relating to accounting standards, the AICPA has the role to maintain the independence of FASB and the accounting standard process (AICPA, 2012). According to Kinney et al. (1990), the regulators and the accounting profession have addressed the
importance of internal control and the need for the internal control standards in financial reporting. Although the Securities and Exchange Commission has not provided any standards for the effectiveness of a company’s internal control, however the suggested internal control framework have been established in 1992 by the Committee of Sponsoring Organizations (COSO) of the Treadway Commission (Stephens, 2005).

e. The Committee of Sponsoring Organization of the Treadway Commission (COSO)

Briefly, the Committee of Sponsoring Organization of the Treadway Commission (COSO) was formed in 1985 with the purpose of sponsoring the National Commission on Fraudulent Financial Reporting. COSO is ‘a voluntary private sector organization and it is committed to guiding executive management and governance entities toward the establishment of more effective, efficient, and ethical business operations’. COSO also sponsors and disseminates frameworks and guidance based on in-depth research, analysis, and best practices (Committee of Sponsoring Organization of the Treadway Commission, 2010).

Thereafter, the US Congress passed the Sarbanes Oxley Act 2002 to protect investors and improve the accuracy and reliability of corporate disclosures subject to the securities laws (Library of Congress, 2010). This was in response to the concern about corporate accountability arising from the collapse of a number of high profile firms, such as Enron (Cullinan, 2003). The Act aims to enhance corporate governance and strengthen corporate accountability by (1) formalizing and strengthening internal checks and balances within corporations, (2) instituting the various new levels of control, (3) ensuring that financial reporting exercises with full disclosure and (4) undertaking corporate governance with full transparency (Library of Congress, 2010). The establishment of SOX 2002 reflects the importance of affording protection to investors and ensuring auditors’ independence by presenting a true and fair view on financial statements.
4.1.2 Malaysia financial statement fraud regulations

Malaysia is one of Southeast Asia’s most vibrant economies due to rapid changes in industrialization and political stability. Recently, Malaysia enjoyed a significant economic performance owing to wise macroeconomic management and structural reforms (Malaysia Review, 2010). Consequently, Malaysia is able to attract investors internally and externally, and aims to not only attract investors but also to sustain long-term investment in the country. Therefore, Malaysia should develop a systemic investment mechanism to control the environment. In 1993, the Securities Commission Act 1993 was enacted to regulate and monitor the securities industry in Malaysia. The Commission also acts as the competent regulatory authority to oversee the Malaysian capital market.

In order to transform the Malaysian capital market as an efficient source for raising long-term funds to finance economic activity, Malaysia released its ‘Capital Market Master Plan’ in 2002. The objectives of the plan being to improve transparency and promote higher standards of disclosure, as well as provide a comprehensive direction for the Malaysian capital market for the next 10 years (Securities Commission, 2010). The regulators of Malaysia that relate to the financial market are the Securities Commission Malaysia (SC), Bursa Malaysia (BM), Companies Commission Malaysia and the Royal Malaysia Police. They are responsible for supervising and enforcing the disclosure standards based on their own Acts and jurisdiction.

The named regulators are responsible for regulating the rules and regulations in relation to capital market activities and the public domain. In relation to the Securities Act, there are four laws relating to securities in Malaysia, namely, (1) Securities Commission Act and Regulations 1993 (amendment 2007) (Act 493), (2) Demutualisation (Kuala Lumpur Stock Exchange) Act and Order (Act 632), (3) Securities Industry Act and Regulations (Act 280), Securities Industry (Central Depositories) Act and Regulations (Act 453) and (4) Futures Industry Act and Regulations (Act 499) (MDC Publishers).
However, the Act most relevant to the research objectives is the Securities Commission Act 1993. The Securities Commission Act 1993 (as amended) was established on 1 March 1993 under the Securities Act 1993. The Act is currently known as the Capital Market and Services Act 2007. It is a self-funding statutory body in Malaysia with the main aim of protecting investors in Malaysia.

a. The Securities Commission and the Securities Acts

The Securities Commission (SC) has investigative and enforcement powers in relation to the securities industry. The SC has to report to the Minister of Finance and its account is tabled annually in the Parliament (Securities Commission, 2010). The SC’s functions include (1) supervising exchanges, clearing houses and central depositories, (2) registering authority for prospectuses of corporations other than unlisted recreational clubs, (3) approving authority for corporate bond issues, (4) regulating all matters relating to securities and futures contracts, (5) regulating the take-over and mergers of companies, (6) regulating all matters relating to unit trust schemes, (7) licensing and supervising all licensed persons, (8) encouraging self-regulation and (9) ensuring proper conduct of market institution and licensed persons.

The mission of the SC is ‘to promote and maintain fair, efficient, secure, and transparent securities and futures markets to facilitate the orderly development of an innovative and competitive capital market’ (Securities Commission, 2010). Specifically, the SC is responsible for ensuring that the financial information reported by the companies to the shareholders’ and potential investors is transparent and reflective of the true and fair view of a company’s financial position.
b. **The Auditing Oversight Board**

In order to ensure the transparency of financial information in the capital market, the SC formed the Auditing Oversight Board, which is regulated under CMSA 2007. The objectives of the AOB’s formation are to (1) promote and develop an effective and robust audit oversight framework in Malaysia, (2) promote confidence in the quality and reality of audited financial statements in Malaysia, and (3) regulate auditors of public interest entities (CMSA, 2007).

Section 31C of SC Act (Establishment of Audit Oversight Board) describes the matters of the AOB’s formation. According to this section, the AOB consists of an executive chairman and six non-executive members who will be appointed by the SC. The members appointed ‘must possess knowledge and experience in finance, business, or any relevant discipline’. In addition, the board members of AOB must be ‘...individuals of integrity and reputation who have demonstrated commitment to the interests of investors (CMSA, 2007).

The responsibilities of the AOB are further explained in section 31E of the Act. The AOB is responsible for implementing policies and programmes to ‘(1) ensure effective audit oversight system in Malaysia, (2) register auditors of public interest entities for the purposes of this Act, (3) direct the Malaysian Institute of Accountants to establish or adopt, or by way or both, the auditing and ethical standards to be applied by auditors, (4) conduct inspections and monitoring programmes on auditors to assess the degree of compliance of auditing and ethical standards, (5) conduct enquiries and impose appropriate sanctions against auditors who fail to comply with auditing and ethical standards, (6) cooperate with relevant authorities in formulating and implementing strategies for enhancing standards of financial disclosures of public interest entities, (7) liaise and cooperate with oversight bodies outside Malaysia to enhance the standing of the auditing profession in Malaysia and internationally, and (8) to perform such other duties or functions as the Audit Oversight Board determines necessary
or appropriate to promote high professional standards of auditors and to improve the quality of audit services provided by auditors' (CMSA 2007).

To ensure the compliance of auditing and ethical standards, section 31V of the CMSA 2007 Act has given power to the inspection officer of the SC to regularly conduct the inspection. The purpose of this inspection is to ensure the quality of audit reports in relation to the audited financial statements prepared by the auditor of the companies. The Board will discuss the findings of the inspection report with the auditor concerned. Any remedial measures raised in the inspection report should be reported by the auditors concerned to the board of AOB (CMSA 2007). Further power has been given to the AOB to inspect and inquire about the consolidated financial statements of public interest entities as stated in section 31Y of the Act. The Audit Oversight Board has the power to inspect and inquire into financial statements, which includes the accounts, working papers and documents prepared by the auditors of the subsidiaries or associates of the public interest entities (CMSA, 2007).

In such cases as the Audit Oversight Board finds that any person has committed a breach, the board may (1) direct the person concerned to comply with the provisions issued by the Commission, (2) reprimand the person concerned, (3) require the person concerned to remedy the breach, (4) require relevant professional education to be undertaken by the person concerned, (5) assign a reviewer to oversee an audit that is undertaken by the person concerned, (6) prohibit the person concerned from auditing financial statements or the company for a period not exceeding twelve months or permanently, and (7) impose a penalty not exceeding five hundred thousand Ringgit Malaysia on the person concerned (Section 31Z of CMSA, 2007).

The identified case of a breach of law or code of conduct will be further reported to the relevant authorities. To an extent, section 31Z gives authority to the AOB to coordinate and cooperate with any relevant foreign authorities that exercise similar functions to that of the AOB. Such authority is given to promote the confidence in the quality and the reliability of
audited FS. Section 135 provides fines for any destruction, concealment, mutilation and alteration of records. Any person who has the intention to defraud any person or to prevent the investigation can be fined an amount not exceeding ten million Ringgit Malaysia, or ten years imprisonment or both.

However, the general penalty is slightly lower as the punishment for any person who is found to be guilty does not exceed one million Ringgit Malaysia, or imprisonment for a term not exceeding five years or both. In the case of a continuing offence the offender will also face a daily fine not exceeding five thousand Ringgit Malaysia per day for each day after conviction that the offence continues to be committed (CMSA, 2007).

The research provides a clear understanding of the offences by corporate bodies. Section 138 explains the offences by corporate bodies in relation to any person who is a director, a chief executive officer, an officer, an employee and the secretary of the corporate body. They shall be punished with the fine provided as stated in section 137 of the Act (CMSA, 2007). Section 140 of the Act shows the improvements of the section to protect the informers of any breach or misconduct in companies and the capital market.

However, if the information provided is false, the informer will be liable on ‘conviction to a fine not exceeding one hundred thousand Ringgit Malaysia or to imprisonment for a term not exceeding ten years or both’ (CMSA, 2007). In relation to any raised issues or reported breach of conduct from the public companies, section 151 of the Act gives power to the SC to require any person to submit the information, document or book for the purpose of investigation. In this case the information disclosure must be free from any false and misleading statement. In summary, the sections most relevant to the research objectives are those concerned with the formation of AOB, the powers of investigation and the penalties of falsification in financial statement. The next phase of interviews in the research fieldwork provides support of the identified issues.
c. The Companies Act 1965

The next regulator to be reviewed is the Companies Commission Malaysia (CCM). The Companies Act 1965 is regulated under the CCM to regulate all types of company in Malaysia. The CCM is a statutory body that was formed from the merger of the Registrar of Companies (ROC) and the Registrar of Businesses (ROB). The CCM is responsible for regulating the companies and business matters in Malaysia. The CCM is also responsible for the enforcement of the Companies Act 1965, Registration of Business Act 1956, Trust Companies Act 1949, Kootu Funds (prohibition) Act 1971 and the relevant subsidiaries of the Act (Securities Commission Malaysia, 2012).

Section 7 of the Companies Act 1965 gives power to the CCM to investigate any people suspected of violating the Companies Act. Section 9 of the Companies Act 1965 clearly states the requirements of the company to appoint the approved company auditors. The appointed company auditors should not be indebted to the company in an amount exceeding two thousand five hundred Ringgit Malaysia and the auditor must not be an officer, employee or shareholder of the company. Any breach of this section will be penalized for thirty thousand Ringgit Malaysia. Section 45 of the Act imposes civil liability on the current director or the authorized person who is found to be guilty of issuing any misstatement in the prospectus of the company.

The guilty person is liable to pay compensation for such losses. In addition, the person who issues the untrue statement in the prospectus will be charged for 5 years imprisonment and one-hundred thousand Ringgit Malaysia, as stated in section 47. The research considers that falsification of financial information in the prospectus could be charged under this section. The Company’s Act 1965 governs the conduct and affairs of the company, in particular, the companies’ directors. Section 130 gives power to the CCM to remove any company’s directors and officers that have been convicted of any offence in the company’s management, fraud, and dishonesty. The penalty of one-hundred thousand Ringgit Malaysia
or five years imprisonment or both are imposed for any violation of this section. To ensure
good conduct from the company directors, section 130A disqualifies the directors from the
insolvent companies from acting as a director in another company for 5 years from the date
of liquidation.

The section imposes a penalty of imprisonment for three years or ten thousand Ringgit
Malaysia or both for this offence. A further issue for company directors concerns the
disclosure of interest in contracts, property, and offices, etc. Thus, a director of the company
has to declare the nature of his material interests in any contracts, property, and offices at a
directors’ meeting. The director should not have any interest in any contract (1) if the
contract relates to any loan to the company in which he has guaranteed the repayment of
the loan and (2) that is related to the company. The company directors or officers have to
perform their duties honestly and diligently. Section 132 outlines the duties and liabilities of
directors which includes any liability for any damage caused by the company. A penalty of
five years imprisonment or thirty thousand Ringgit Malaysia will be imposed for breach of this
section.

Section 166A of the Act requires every company director to ensure that the accounting
record keeping and the preparation of consolidated accounts comply with the approved
accounting standard. A further requirement in relation to accounting record keeping, section
167, requires every director and manager to ensure that the accounting record has been
sufficiently recorded and would be able to explain the financial transactions of the company.
The accounts should be prepared from time to time for the auditing process, and should
reflect the true and fair view. The penalty for the breach of this section is imprisonment of six
months or five thousand Ringgit Malaysia or both. Subsequently, the audited accounts that
comprise the income statement and balance sheet should be prepared every calendar year
and before the annual general meeting. Section 169 of the Act states that the duty of the
company directors is to ensure the timely preparation of the above financial statements. Any
director who breaches their duty in relation to the company’s accounts and audit will be
charged five years imprisonment or thirty thousand Ringgit Malaysia under section 171 of the Act.

To ensure the independency of audit duties by the company auditors, section 174 of the Act requires the company’s auditor to report on the company accounts annually or before the annual general meeting. The auditor should report whether the company accounts are in their opinion in accordance with the provision of the Act and approved accounting standards. The auditor should report any deficiency and failure found in his audit works. In completing his duties, the auditor has power to access the accounting and other records at any time for the purpose of audit. In respect of any falsification of the books, the five years’ imprisonment or thirty thousand Ringgit Malaysia fine will be imposed upon any officer of the company who destroys, mutilates, alters, or falsifies any books, documents, and accounts of the company.

Other charges will be imposed upon any directors or officers who publish the false and misleading statements that also include the financial position of the company. The penalty of ten years imprisonment or two hundred and fifty thousand Ringgit Malaysia fine, or both, will be charged for any breach of this section. The misleading financial statement fraud also includes the intention to attract potential investors, therefore section 366 of the Act states that it is an offence for any person in the company to use any misleading statement, promise, or forecast in order to attract any person to invest money in the company. In summary, the relevant sections above clearly govern the company affairs and the duties of company directors in relation to financial statement preparation and the issuance of the financial statement to the company stakeholders.

d. **Financial Reporting Act 1997**

In relation to financial statement reporting standards requirements, the Financial Reporting Act 1997 is an Act that was established to provide the functions and powers of the Financial Reporting Foundation and the Malaysian Accounting Standard Board in Malaysia (MASB).
The Financial Reporting Foundation is responsible for (1) providing a view to the MASB, (2) reviewing the performance of the board, and (3) approving the budget of the board.

The members of the Financial Reporting Foundation have been appointed by the Minister of Finance for the purpose of standard-setting process. The members are ranging from accounting practitioners and regulators to members of the accountancy profession. The MASB is an independent authority functioning with the Financial Reporting Foundation and is responsible for the financial reporting framework in Malaysia. The MASB, which is regulated under the Financial Reporting Act 1997, is mainly concerned with developing and issuing financial reporting standards in Malaysia.

Section 7 of the Act establishes the MASB and lists its functions. The MASB is responsible for issuing the accounting standards as approved accounting standards. Therefore, the MASB is accountable for reviewing and dealing with any matters regarding the existing and proposed approved accounting standards. If necessary, the MASB would conduct a public consultation in order to determine the contents of accounting concepts, principles, and standards. In summary, the primary role of MASB is to develop accounting and financial reporting standards as well as to harmonize the financial reporting environment in Malaysia.

e. The Accountants Act 1967 (Act 94)

The certified accountant profession in Malaysia is regulated under the Accountant Act 1967. The Act pertains to the accountant’s registration and any related matters of accountants in Malaysia. It was enacted on 30th September 1967 with the main purpose being to establish the Malaysian Institute of Accountants (MIA). Essentially, the MIA is responsible for approving, supervising and regulating the members of the Institute, such as Chartered Accountants, Licensed Accountants and Associate members in Malaysia. Section 6 of this Act relates to the functions of the MIA. The Institute is responsible for (1) determining the qualifications of persons for admission as members for the institute, (2) providing training
and education to the members for practise in the accountancy profession, (3) approving the MIA qualifying examination, regulating and supervising the conduct of the examination, (4) regulating the practice of the accountancy profession in Malaysia, and (5) promoting the excellence of the accountancy profession and assisting the members of the Institute. In summary, this Act prescribes the MIA operation, rules, and regulations. The most important point that needs to be highlighted is that the MIA regulates the capacity and the qualification of accountants who practice in Malaysia.

f. The Penal Code (Act 574)

Any criminal offence in Malaysia will be charged under Penal Code 574. The Code is an Act in relation to criminal offences in Malaysia. The first Code was enacted in 1936 and the revised Penal Code was enacted in 1997. In relation to FSF fraud or falsification, section 405 of the Act is applicable. The section states that any person who is entrusted with property or responsibility is said to be in breach of trust when he intentionally and fraudulently misappropriates the property or responsibility, and, as a result of the breach of trust, also causes damage to another person.

Any person who is found to be guilty of presenting the false financial statement can be charged with cheating under section 415. The section defines the word cheating as someone who fraudulently or dishonestly induces a person with the intention to deceive to get or retain any property. The cheating would also cause damage or harm to a person’s body, mind, reputation, or property. Other charges that are related to false financial statement are forgery under section 463. The section is an offence in relation to false documents that can cause damage to the public. It also includes the intention to commit such fraud.

False documents produced by companies are considered as fraudulent financial statements. The alteration of financial information in the financial statement can be charged under section 464 of making the false document. Section 477A states that a period of
imprisonment of up to seven years or a fine, or both, may be imposed upon any person in an organisation who defrauds, alters, or falsifies any books, documents or accounts of the organisation. The Royal Malaysia Police is the main law enforcement agency that deals with the Penal Code offences. Among the common offences that relate to the false accounting are criminal breach of trust, cheating and forgery.

4.1.3 The UK: financial statement fraud regulations

In the United Kingdom, there are two regulatory bodies that deal with the issue of financial statement preparation, namely, Financial Conduct Authority and Financial Reporting Council. In relation to financial statement regulations, there are four related regulations: (1) the Financial Services and Market Act 2000, (2) Financial Reporting Standard (FRS), (3) Statements of Standard Accounting Practice (SSAPs), and (4) the Companies Act 2006.

The first regulation discussed here is the Financial Services and Market Act 2000 (FSMA). The objectives of the Act are mainly (1) to establish the Financial Services Authority (FSA), (2) ‘to provide regulation of financial services and market, (3) to provide for the transfer of certain statutory functions relating to building societies, friendly societies, industrial and provident societies and certain other mutual societies, and (4) for other connected purposes’ (The UK National Archives, 2010). In essence, the FSMA is designed to protect the offer of financial securities and consumers in relation to financial matters. In addition to these objectives, the Act was also enacted to increase the confidence in the financial market and services, and to minimise the risk of financial crime (The UK National Archives, 2010).

a. The Financial Services and Market Act 2000

The Financial Services and Market Act 2000 (FSMA 2000) covers the issues of financial services and financial markets. The FMSA 2000 was initiated to ‘reform and strengthen the regulatory system’ by the then Labour government (The UK National Archives, 2010). The enactment of the FSMA replaced the Financial Services Act 1986, the Insurance companies Act 1982 and the Banking Act 1982.
The Act was consolidated and expanded as one of the ‘industry’s most powerful regulatory bodies and contemporary regulatory systems’ (Turkington, 2000). Turkington (2000) also documents that the FSA is an independent and non-governmental body responsible for regulating and supervising the UK financial services sector. Interestingly, the UK was the first country to adopt a single market regulator and integrated regulations. The UK FSA has taken over the responsibilities of more than nine former regulators. In relation to the financial market, the FSA has taken over the role as the UK listing Authority from the Stock Exchange.

Apart from the FSA objectives, there are seven ‘principles of good regulation’ that have to be considered. The six principles concern (1) efficient and economic use of its resources, (2) the responsibility of those managing authorised persons, (3) proportionality of restriction, (4) facilitation of innovation, (5) the internationalisation nature of financial markets, and (6) minimising adverse consequences (Turkington, 2004).

Overall, the FSA’s responsibilities exist to regulate the FSMA with two common objectives of prudential supervision and the conduct of business regulation. Therefore, it would achieve the prevention of systemic risk and investor protection (Turkington, 2004).

b. Companies Act 2006

The United Kingdom Companies Act 2006 replaces the Companies Act 1985 and affects the UK’s company law system. The Act introduced various provisions for private and public companies in the UK including the common law principles and those relating to the directors’ duties (The UK National Archives, 2010). There are four parts in the Companies Act 2006 that are relevant to the financial statement process, which concern (1) a company director, (2) accounts and reports, (3) audit, (4) company investigations and amendments, and (5) transparency obligations. These five key elements are much related to the research objectives.
c. The Fraud Act 2006

The Fraud Act 2006 replaced the fraud offences contained in the Theft Acts of 1968 and 1978 (The UK National Archives, 2010). The sections of the Act also ‘make provision for, and in connection with, criminal liability for fraud and obtaining services dishonestly’ (The UK National Archives, 2010).

The Act concerns three main offence categories: fraud, obtaining services dishonestly and supplementary. The Act imposes a new general offence of (1) fraud by false representation, (2) fraud by failing to disclose information and, (3) fraud by abuse of position. In addition, the Act also imposes new offences for (1) obtaining services dishonestly, (2) possessing, making, and supplying articles for use in fraud, and (3) fraudulent trading applicable to non-corporate traders (The UK National Archives, 2010).

The Fraud Act 2006 revokes all the deception offences in the Theft Act 1968 and 1978. In this new Act, the deception offences have been replaced by a single offence of fraud that may comprise (1) false representations, (2) failure to disclose the obligatory information, and (3) abuse of position (Summers, 2008). The aims of having a single offence for fraud are (1) to clear up the technicalities from the Theft Act 1968 and 1978, (2) to overcome the difficulties in charging the offences, and (3) to update with developing technology (Summers, 2008).

Another measure was introduced in the UK through the creation of the National Anti-Fraud strategy to mitigate fraud. The National Anti-Fraud Strategy is a pro-active and co-ordinated approach for the prevention and detection of fraud in the UK (Summers, 2008). In relation to this, there are three relevant bodies that are responsible for coordinating the strategies of prevention and investigation of fraud: namely, (1) the National Fraud Strategic Authority (NFSA), (2) the National Fraud Reporting Centre and Intelligence Bureau (NFRC), and (3) a National Lead Force for Fraud. The Government Fraud Review also introduced the establishment of the jurisdiction of the Financial Court. Therefore, the different proceedings
from serious fraud cases from criminal and civil arenas can be jointly handled in one court (Summers, 2008). In relation to the comprehensive integration of fraud regulation, it shows that ‘the government is very determined to protect the public from crime and keep the UK an honest, fair dealing place to do business’ (Ussher, 2007).

d. Theft Act 1968

The Fraud Act 2006 was enacted to replace a few sections of the Theft Act 1968. There are three sections that are relevant to financial statement fraud: (1) false accounting, (2) liability of company offences by company, and (3) false statements by the company directors.

False accounting is defined under section 17 of the Theft Act 1968. The section notes that the offence of false accounting is committed by one who (1) ‘destroys, defaces, conceals or falsifies any account, or any record or document made or required for any accounting purpose, and (2) in furnishing the information, it is found to be misleading, false or deceptive and causes losses to another’. The false accounting is also known as falsifying the account or document. Any person, found to be guilty of this offence will be liable for a period of imprisonment not exceeding 7 years.

Section 18 of the Act confirms liability in relation to the management of a company and the corporate body for any offences that relate to false accounting, as stated in section 17 of the Act. Further, section 19 of the Act clarifies that any false statement made by the company directors through a written statement or accounts will be liable for imprisonment not exceeding seven years. The definition of false accounting in the Act is found in the Theft Act 1968. The section is useful for defining FSF from the regulation perspective. The section also creates an offence in respect of financial statement fraud that causes losses to company members and creditors. Moreover, sections 18 and 19 include the liability to the company’s management for such misconduct.
4.2 Summary of financial statement fraud regulations

The purpose of reviewing the regulations is to examine the regulatory requirements in relation to financial statement and financial statement fraud. The study of the statutes in relation to financial statement fraud from three countries (the UK, the USA, and Malaysia) is deemed to be important for understanding the different statutes and jurisdictions.

In relation to the provisions from the above statutes, the research has formed nine themes of statute requirements in relation to financial statement and financial statement fraud: (1) fraud definition, (2) financial statement disclosure, (3) audit and auditor requirements, (4) auditor independence, (5) director and company’s management, (6) accounting standards and procedures, (7) accounting body and regulatory, (8) code of ethics, and (9) investigation, prosecution and penalty. The provisions of these statutes are related to the corporations, directors and management, auditors and regulating accounting standards and procedures.

Every country has its own definition of what constitutes financial statement fraud. Noticeably, false representation, false accounting, breach of trust and cheating are often referred to as financial statement fraud. In order to control financial statement fraud the three countries imposed provisions in relation to financial statement disclosure.

The similarity is the requirement for every company to provide all financial information to their investors. This would be the initial prevention strategy for protecting the company’s investors when they are making an investment decision. Further, the US regulations, especially the Sarbanes Oxley Act 2002 (SOX, 2002), emphasize the financial statement provisions. For example, SOX 2002 added the corporate social responsibility section 302 that requires every company to design a set of internal controls in order to certify all material aspects relating to financial statement disclosure. In respect of the practice in Malaysia, the research has identified the Capital Market and Services Act 2007 as the main financial statement fraud regulation, while the Companies Act 1965, the Financial Reporting Act 1997,
the penal Code 574 and the Accountants Act 1967 are the supporting regulations that allow enforcement in different jurisdictions.

In contrast, the US has established the SOX 2002 as the main financial statement fraud regulation in addition to the Securities Acts of 1933 and 1934. The identified supporting Act to financial statement fraud regulation is the Criminal Code in the US. The research found an improvement of securities regulation in the US since 2002 with the establishment of the SOX 2002. The research found the Criminal Code in the US and the Penal Code in Malaysia are used to prosecute individuals who are committing financial statement fraud in the companies.

In the UK practise, the Financial Conduct Authority was established in 2012 to replace the single regulator of Financial Services Authority in. The two agencies namely Financial Conduct Authority and the Prudential Regulation Authority have been established to give more focus on financial regulations and the conduct of financial institutions. In this case, the Financial Conduct Authority is responsible for regulating the financial market and securities matters under the Financial and Services and Market Act 2012 (FSMA 2012). In addition to the FSMA 2012, the Fraud Act 2006 and the Theft Act 1968 are used to deal with fraudsters including financial statement fraud fraudsters.

The research found Malaysia and the UK have the Companies Acts to ensure the formation of the companies and to ensure that the responsibilities of the individuals within the company have been fully clarified. However the US has a different type of practice in which different policies for different types of business formation are in practice.

In relation to the control of financial statement preparation, the US is fully determined the assurance of control designed. The SOX 2002 requires the periodic report of financial statements (Section 401) that must be in accordance with Generally Accepted Accounting Principles (GAAP) and be accurately presented. This provision is different from those in the UK and Malaysia. In these two countries, the internal control design in relation to the
financial statements process is up to the company. However, the authorities in each country have the power to require any information and conduct inspections to assess the degree of auditing compliance.

In the meantime, the duties of company directors in the UK and Malaysia are well defined in their statutes. The directors are expected to (1) promote the success of the company, (2) exercise reasonable skills and diligence, and (3) avoid any conflict and disclose of any interest with regards to the companies. However, in the US the duties of company directors are not regarded as federal matters.

Another similarity among the three countries concerns the liabilities of company directors when making misleading statements. After experiencing a number of accounting scandals in the early 2000s, the US enacted the SOX 2002 to increase the shareholder’s protection and reliability of corporate disclosures subject to securities laws and for other purposes. In the US, one of the provisions that could increase auditor independence is the establishment of the Public Company Accounting Oversight Board (PCAOB). The main duty of the PCAOB is setting guidelines for the preparation of accurate and independent audit reports for all public listed companies.

Malaysia also established the Accounting Oversight Board to promote and develop an effective audit oversight framework. The board is responsible for promoting investor confidence in the quality and reliability of audited financial statements. In the UK, the Auditing Practices Board (APB) is responsible for certifying public confidence in the auditing process. The APB acts as an independent regulator under the Financial Reporting Council. In relation to the requirements for the company’s financial statements to be audited, the three countries have made the requirement compulsory in law. Audit firms normally provide their clients with a variety of services, for example, (1) auditing, (2) tax planning, (3) management consultancy, (4) investment advice and (5) insolvency work. However, the US places provisions under the SOX 2002, defining the scope of practice of auditors that
prohibits company auditors from providing non-audit services while simultaneously providing audit services to their client company. This provision is included so as to avoid any conflict of interest when providing both services to the client company. Section 203 of the Act requires rotation of the audit partner every five years. In the UK, the professional rules for accountants restrict the audit firm from providing both audit and non-audit services to the same client company to avoid any conflict of interest. Under the Companies Act in the UK and Malaysia, a company auditor must be an independent person. Therefore, the auditors must not be an officer or employee of the company or have any partnership relationship.

In ensuring that the enforcement is effective, there are provisions in relation to investigation, inspection and penalties. For example, the US and Malaysia provide powers to the Securities Commission under the Securities Act to conduct an investigation for any person who has violated the Act. With regards to financial statement fraud penalties, the US imposes the highest penalties against the defrauder. Penalties of $5,000,000 or a period of imprisonment will be imposed for any person who produces misleading statements or conducts financial statement fraud. The UK gives 10 years imprisonment for any person in the company who conducts fraudulent business including providing misleading statements. The penalty of financial statement fraud in Malaysia is slightly lower compared to the US and the UK. Imprisonment for seven years or fine or both is imposed on any person who falsifies any books, documents or accounts of the company. From the review of the legislation the research found some similarities and differences in regulations between the three countries. The similarities are mainly in terms of the requirement for the disclosure of information deemed important in aiding the decision making process of shareholders/investors.

Furthermore, all three countries impose the same liabilities on company directors with regards to making misleading statements. This is to ensure that the interests of shareholders are protected. Whilst all three countries provide the power to conduct investigations in relation to financial statement fraud, the penalties imposed upon conviction differ greatly. The US imposes the highest penalty and Malaysia imposes the lowest
penalty. Another difference is in terms of the duties of the company directors. These duties are well defined in the statutes of the UK and Malaysia but not regarded as a federal matter in the US. However, the US places more stringent rules upon auditors by prohibiting them from providing non audit services simultaneously to the audit services for their client. The auditors are also required to rotate their partners every five years. These requirements are not spelled out by the statutes in the UK and Malaysia. However, the professional bodies in both countries took it upon themselves to warn their members concerning the danger of possible conflicts of interest that could arise in these situations and advise the use of safeguards.

It seems that a lot of legislation has been put in place in an attempt to prevent FSF. Whilst fraud will always exist as long as human greed exists, the governments should play an important role in mitigating financial statement fraud. Perhaps the most significant deterrent could be in terms of penalties imposed for breach of the requirements of the legislation. Therefore, the penalties should be sufficiently stringent to deter potential fraudsters. However, the regulators can only do so much as they need to balance between the needs of the investors for information with the burden on the preparers of financial statements to provide that information. Moreover, it is also not good to have an information overload, which would defeat the purpose of providing the information in the first place.

Hence, the companies themselves should also ensure that fraudulent activities do not occur inside their organizations. This could be achieved by, first, having sound anti-fraud policies that are well disseminated throughout the organizations. Second, companies should educate their employees to recognize the symptoms of fraud and be encouraged to blow the whistle. To this end, the companies must also have adequate whistle blowing channels to ensure that they are done inside the organizations and not to outsiders. Misleading information in fraudulently prepared financial statements may result in wrong decision making by the investors, and, in turn, erode their confidence in the accounting profession. Thus, it is to the benefit of everybody to continually search for ways to predict, identify and
prevent financial statement fraud. Ayala and Ibarguen (2006) suggested new government regulations and severe penalties for the perpetrators of fraud as one approach to generate reliable financial information and to rebuild trust in capital market institutions. They also noted that the key players in securities – board members, officials, investment banks, auditors, and others – should be strengthened through the implementation of ethical values.
CHAPTER FIVE

THE REVIEW OF GUIDELINES FROM PROFESSIONAL BODIES: MANAGING BUSINESS RISK OF FRAUD: A PRACTICAL GUIDE

5.0 Introduction

In addition to regulations, the research has also reviewed and evaluated the guidelines of fraud mitigation namely "Managing the Business Risk of Fraud: A Practical Guide". This practical guide is jointly sponsored by three leading organisations namely, the Institute of Internal Auditors (IIA), the American Institute of Certified Public Accountants (AICPA) and the Association of Certified Fraud Examiners (ACFE). The research used the guidelines to understand the fraud control plan as suggested by the three leading professional bodies. The guideline is mainly provides the practical guide to manage the business risk of fraud. However the research is focusing on how to manage financial statement fraud in commercial companies. The guideline is published by the three leading professional bodies and applicable to all companies however most of the reference practices were referring to the United States and other countries practices. Therefore the guideline is appropriate to be adopted as one of the fraud risk management programme in all corporations.

According to IIA et.al (2007), fraud is ‘any intentional act or omission designed to deceive others, resulting in the victim suffering a loss and the/or the perpetrator achieving a gain’. The recent regulations and legislations in relation to fraud matters were increased the management responsibilities to have the fraud risk management programme. The company’s management were aware that the fraud risk would give a massive impact to the companies. The obvious impact is the collapse of the company. Other impacts include (1) massive investment losses, (2) huge legal cost, (3) imprisonment of fraud perpetrators, (4) loss of confidence in capital market, and (5) diminishing of the company’s reputation and images. The IIA et.al (2007), also stressed the recent accounting scandal all over the world increase the attention by the public and stakeholders to put more effort in mitigating the
accounting fraud. Thus they suggest a good governance principle be applied in organizations. This is an important issue to focus in organization as the previous accounting scandal proved that the perpetrator of accounting fraud were from the top management of the company. Therefore, the high ethical behaviour from top management and all levels of the management of the company is essential.

Consequently, the companies are expected to (1) react in respond to the heightened regulations, (2) have a fraud risk management programme, (3) have a method to identify fraud risks, (4) have a technique to prevent fraud, and (5) have a scheme to investigate and taking corrective actions. The company would therefore have their own fraud risk management programme and could assist the companies to mitigate financial fraud particularly financial statement fraud. The IIA et.al (2007) provides ways in its guideline on managing business risk of fraud and would help the management and internal auditors in preparing their own fraud risk management that suit with their organization.

5.1 The five sections to effectively manage the risk of fraud

The IIA et.al (2007), stressed, financial statement fraud only can be mitigated through diligent and continuous effort. Through this guideline, the five principles have been introduced to manage the fraud risk in all organization. The five principles listed are associated with the effort that the companies should put in place in the companies, namely (1) a fraud risk management programme, (2) a fraud risk exposure, (3) prevention techniques, (4) detection techniques, and (5) investigative and corrective action.

a. Section 1: Fraud Risk Governance

Section 1 introduces the fraud management programme that should be in place in every company. Fraud management programme is a written company policy to prevent financial statement fraud. Therefore it should be well-matched to the company system and environment. The fraud management programme also could provide a clear direction of what action should be taken by every level of company management. Obviously, the main
The purpose of this programme is to provide a clear expectation to the board of directors and senior management in relation to the fraud risk management. Possibly the practice of those procedures would create a good company culture to prevent fraud.

The IIA et.al (2007) emphasise the need for good corporate governance practice in every company. The FRMP would be a part of the company’s initiative as their responsibilities to the company’s stakeholders. Furthermore, the company’s director is responsible for developing a good corporate culture in an organization.

The IIA et.al (2007) suggests the need for a good corporate culture and business ethics in all companies. The corporate culture practices from the US companies, range from (1) agenda of the board ownership, (2) accessibility to all level of management and whistle blower control, (3) independent nomination process, (4) the effectiveness of senior management evaluation, performance management, compensation and succession planning, (5) the specific code of conduct for senior management, (6) the independency and the responsibility of board of directors in relation to risk mitigation efforts. In addition to the company’s board’s roles and responsibilities, the corporate culture also involves the assurance of business ethics in relation to the procedure of employee’s (1) hiring, (2) evaluation, (3) promotion, and (4) remuneration. Apart from this, the relationship with customers, creditors and other business stakeholders also is taken into consideration as part of business ethics.

IIA et.al (2007) state that the previous worldwide accounting scandals that lowered market capitalization required the board and senior management of the company to respond to this situation. The FRMP should be in place in every company as a part of corporate governance therefore would be a part of the company’s initiative as their responsibilities to the company’s stakeholders. Furthermore, it is also an accountability of the company’s director to develop a good corporate culture in an organization.

According to IIA, et al (2007) there is three important steps to implement the effective FRMP. The company’s policies, job description and level of authority should be clearly defined in
relation to the FRMP. In the meantime, the documentation of FRMP should be in place as a control mechanism for the FRMP. The effective FRMP required support from (1) risk management system or programme, (2) company’s compliance, (3) company’s ethics designed, (4) company’s security information technology (IT) and other relevant systems.

While the important roles to effectively implement the FRMP are consist of (1) board of directors, (2) audit committee, (3) management, (4) company’s employee and (5) internal auditing.

The following figure 4 summarizes the effective implementation of company’s FRMP:

**Figure 4: Financial risk management programme (IIA, et al, 2007)**

IIA et al (2007) outlined the important key roles in implementing the FRMP. The board of directors is expected to govern itself to portray the tone at the top. The board is required to (1) govern itself appropriately and act independently. It requires the board to control information inside and outside the company. The board is also responsible for effectively manage the nominating, compensation and audit process and (2) for ensuring the FRMP is documented to encourage a company’s ethical behaviour.
Thus, the board should (a) clearly understand the fraud risk, (b) control the FRMP as a part of company’s risk assessment and strategic plans, (c) address the risk as periodic agenda at board meeting, (d) effectively monitor the management reports on fraud risks, policies and control activities, (f) establish mechanisms that allow the information regarding fraud occurrence to be received in an accurate and timely manner from management, employees, internal and external auditors and stakeholders, (3) monitor the company’s internal control, (4) effectively set the CEO’s job description, hiring, evaluation and planning process, (5) retain and hire the outside expert when it is required and (6) give a full cooperation to external auditors in relation to fraud risk management objectives.

The second important key role is the company’s audit committee. The independent director of the audit committee is required to give oversight control of company’s financial matters. It is required by accounting professional bodies that the audit committee should include one financial expert with an accounting background. The IIA et al (2007) guideline requires the audit committee to meet regularly and sufficiently respond to the risk of fraud. The audit committee should also proactively assess and monitor the company’s fraud risk. Thus, the collaboration between audit committee and internal auditors are considered important to reduce the risk of fraud. Besides the internal auditor, the audit committee should also discuss and plan the financial statement audit with company’s external auditor as an approach to mitigate financial statement fraud.

The third role is undertaken by a company’s management. According to IIA et al (2007), the company’s management is considered to have the overall responsibility for designing and implementing the FRMP. The management should consider the FRMP as a part of company’s internal control and effectively practice as a company culture. Therefore, a company as a whole would not tolerate with any fraud. The FRMP should be followed by fraud evaluation and therefore all the information would be compiled and necessary steps could be taken as a corrective action. The management also need to report the action that
haven taken to manage fraud risk and the effectiveness of company's FRMP to the board of directors.

The fourth role is undertaken by the company's staff or employees. The effective implementation of FRMP requires responsibilities at all levels in company. Therefore, the individuals in the organization should clearly understand (1) the fraud and be aware of red flags, (2) their roles in internal control framework, (3) the job procedures in FRMP, (4) the company policies and procedures, and lastly (5) participate in control environment by reporting any fraud incidence to top management and cooperate with investigation process.

The fifth role concerns internal auditing. The IIA provides a definition of internal auditing as 'independent, objective assurance and consulting activity designed to add value and improve an organization's operation. It helps an organization accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control and governance process' IIA et al (2007).

The above definition of internal auditing indicates the requirement of internal auditor to be independent and responsible for designing an internal control system to accomplish the company's objective where fraud could be mitigated. In the meantime, the internal audit functions in relation to fraud management is considered as significant in giving assurance to board of directors on the sufficient internal control system. In addition, the internal auditing also should review the adequacy and the effectiveness of the system designed, particularly when management override the fraud risk. The implementation of FRMP will be one of the internal auditor responsibilities to mitigate financial statement fraud. IIA et al (2007) provides specific roles of internal auditor in relation to the FRMP.

The internal auditor is expected to (1) investigate any suspicious or reported fraud, (2) study and analyse the root cause of fraud, (3) monitor the fraud reporting and whistle blower hotline, (4) provide adequacy of ethics training to all level of employees, (5) have sufficient skills of fraud schemes and investigation techniques, and finally (6) have adequate access to
audit committee to discuss any reported fraud. IIA et al (2007) suggest the framework of FRMP to be adopted by the companies. The FRMP framework recognized two different course of action as the FRMP components. Firstly the FRMP consists of a comprehensive written policies and procedures to manage fraud risks. The FRMP is expected to cover all aspects of fraud risk management or a fraud control policy.

Basically, the procedures will consist of (1) code of conduct, (2) expense account procedures, and (3) incident investigation standards. The FRMP also need to emphasize the responsible positions in relation to fraud control policy in order to come out with effective business procedures within the company. Secondly, the IIA et al (2007) suggest the fundamental elements that should be integrated in the FRMP namely (1) commitment, (2) fraud awareness, (3) affirmation process, (4) conflict disclosure, (5) fraud risk assessment, (6) reporting procedures and whistle blower protection, (7) investigation process, (8) corrective action, (9) process evaluation and improvement (quality assurance), and lastly (10) continuous monitoring. The following paragraph describes each of the elements necessary for the successful implementation of the FRMP.

i. Commitment

The company’s board of director and senior management should indicate in the company’s principles or code of conduct their commitment to mitigate fraud. This commitment could be portrayed in a document, issued to employees and creditors. It will be an information document that highlights the importance of fraud risk mitigation and a responsibility of company’s individuals to support the FRMP. As a basic foundation of fraud control policy, it is suggested that the company endorse the letter to be signed by new employee and then reissue the letter periodically. This is to ensure that the employees are continuously reminded of the responsibility to mitigate fraud.
ii. **Fraud awareness**

The fraud awareness mechanism will be an effective preventive control in FRMP. The effective fraud awareness should involve an assessment, training and on-going communication. The fraud awareness mechanism should consider the possible types of fraud and the potential fraud perpetrators in FRMP. Therefore, it could assist the company to implement the fraud awareness programme. Other factors that should be considered in designing the fraud awareness are a company’s culture, guidance for solving ethical dilemmas and training needs for board members.

iii. **Affirmation process**

The affirmation process is a document signed by the directors, employees and creditors that declaring the understanding and complying with the company’s code of ethics and fraud policy. The affirmation process is important to a company as it could be a fraud risk if the process is does not exist. This must be acknowledge and accepted by board of directors and senior management. It also suggested the separate agreement between top level management and lower level management.

iv. **Conflict disclosure**

A conflict disclosure process should be implemented to all levels of management. The directors, employees and contractors are supposed to self-disclose any conflict of interest occurring in the company business affairs. A few assessments will be suggested after the implementation of conflict disclosure. The management could (1) ask the individual to leave the company after the conflict has been proved, (2) management could accept the internal disclosure and monitor the situation which was accepted, and lastly (3) management would impose certain constraint on the individual after identifying the potential conflict of interest and ensure there is no possibility of fraud in company. The effective conflict disclosure should be documented and disclosed to legal support as a legal document.
v. **Fraud risk assessment**

The effective FRMP should be managed with the fraud risk assessment. It can be considered as a foundation for the programme. The FRMP components and elements should be evaluated systematically and periodically by appropriate personnel. The fraud risk assessment process would identify the relevant fraud schemes and therefore could establish the circumstances to mitigate the fraud risk. The fraud risk assessment must be overseen by board and senior management to identify any fraud that might be occurred in a company. IIA et al (2007) also suggesting the internal control system to deal with the intrinsic business risk. Thus, COSO’s Enterprise Risk Management – Integrated framework would provide the enterprise risk management components and principles to be adapted by companies of all sizes.

vi. **Reporting procedures and whistle blower protection**

The important issues in reporting procedures are identified as (1) immediate reporting, (2) effective channel reporting, (3) well communicating the fraud issues and (4) an efficient whistle blowing system. The whistle blower protection should be in place to protect the individuals who report the suspected fraud. As another channel to report fraud, the company could establish the ethics page on the website and through a responsible person manage the complaints and problems in a company.

vii. **Investigation process**

The FRMP should include a documented investigation procedure. Therefore, any suspected fraud could be pursued according to an investigation procedure. The key issues in the investigation process consist of (1) authorised individual that will conduct the investigation, (2) rules of evidence gathering, (3) reporting mechanism for the regulatory part and legal action.
viii. Corrective action

According to IIA et al (2007), a policy designed for corrective action should be based on the previous fraud experience. Therefore it will reflect the consequences for any possible fraud activities. The next actions required are post mortem activities. In this case any previous fraud cases should be analysed and examined therefore any appropriate improvements could be made to the present control system. As a response to the fraud activities, the remedial action should be documented systematically. The suggested fraud consequences include (1) termination of employment or contract, (2) reporting to the regulators.

ix. Process evaluation and improvement (Quality Assurance)

The FRMP requires the quality assurance. Thus, the existing FRMP should be systematically evaluated and monitored by the company. It can be improved by providing the case analysis and benchmark. Finally, the report of evaluation process should be reported to an outside oversight body to improve the FRMP.

x. Continuous monitoring

The FRMP should be periodically and systematically reviewed based on the current needs. The continuous monitoring process also represents the management commitment in relation to FRMP. Therefore, the components and elements of FRMP could be visualised as the following figure 5:
5.1.2 Section 2: Fraud Risk Assessment

According to IIA, et al (2007), the effective Fraud Risk Assessment will be a foundation of an effective FRMP for every company. The main principle for FRA is the identification of fraud exposure. The fraud exposure should be evaluated periodically to identify the specific potential fraud schemes. The importance of the FRA has been supported by the regulators and professional standards. The companies should maintain and control the effectiveness of the FRMP in order to mitigate any potential fraud in a company. IIA, et al (2007) also suggested an enterprise risk assessment to be use in a company as a tool to identify and evaluate the fraud risk. The enterprise risk assessment is actually a set of activities in a company to minimize the business risk. In regards to FRA, a company may further tailor the company’s approach to the company’s objective. In this section, IIA et al (2007) highlighted the two key issues in FRA. The first one is the identification of fraud place and the second...
one is the fraud perpetrator. Subsequent to this identification, a company could consider the fraud scheme and internal or external perpetrators that has been illustrated in the following figure 5 below:

Figure 6: Control activities (IIA, et al, 2007)

The control activities that have been emphasized in the FRA include (1) how the perpetrator exploits the control and system and (2) how the perpetrator hides the fraud committed. In relation to these questions, IIA et al (2007) suggesting the three key aspects in order to achieve the control activities namely (1) ‘identifying inherent fraud risk, (2) assess the likelihood and significance of inherent fraud risk and (3) respond to inherent fraud risk.’

Concerning the three aspects given, firstly a company may obtain the fraud schemes and situation by focusing the fraud triangle which consists of opportunity, incentives and pressures. These would assist a company in identifying any inherent fraud risk. Secondly, the fraud risk may be identified through past experience and conducting interviews with key person in a company, thus, the FRA could compile the most significance to less significance of inherent fraud risk. Finally, the response of the fraud risk should be designed with cost benefit analysis as an effective control in FRA.

IIA et al (2007) suggested a structured framework to apply with the fraud risk identification, assessment and response. The framework works with a list of fraud risk and schemes which
are then evaluated to the likelihood and significance of event. Subsequently, the fraud schemes is matched with the potential people or department and then evaluated with the effectiveness of the existing control. Finally a company further identify the residual risks and develop the fraud risk response.

The FRA framework needs to be conducted by FRA team that have accounting and finance knowledge and skills. The combination of an internal and external expert would enhance the efficiency of FRA team. The following figure 7 illustrates the team of FRA in a company.

**Figure 7: Fraud risk assessment team (IIA, et al, 2007)**

<table>
<thead>
<tr>
<th>FRA Team</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td><strong>Accounting and finance personnel</strong>&lt;br&gt;Required skills: Knowledge in financial statement process and internal controls</td>
</tr>
<tr>
<td>2</td>
<td><strong>Non-financial business unit and operations personnel</strong>&lt;br&gt;Required skills: Knowledge of the whole business operation</td>
</tr>
<tr>
<td>3</td>
<td><strong>Risk management personnel</strong>&lt;br&gt;Required skills: Ensuring the FRA process integrates with company’s enterprise risk management.</td>
</tr>
<tr>
<td>4</td>
<td><strong>Legal and compliance personnel</strong>&lt;br&gt;Required skills: Regulatory actions for any fraud occur.</td>
</tr>
<tr>
<td>5</td>
<td><strong>Internal audit personnel</strong>&lt;br&gt;Required skills: Monitoring the company’s internal control and developing the response to any override control.</td>
</tr>
<tr>
<td>6</td>
<td><strong>External expertise</strong>&lt;br&gt;Required skills: The expertise in applicable standards, risk indicator, antifraud methodology, control activities and detection procedures.</td>
</tr>
</tbody>
</table>

According to IIA, et al (2007), the participation from senior management and respective personnel reflected the responsibility of the whole company to mitigate the company fraud risk. In control activities as suggested in the FRA framework, the three processes are identified namely (1) fraud identification process, (2) the assessment of the likelihood and significance of identified inherent fraud risks and (3) the response to residual fraud risks.
IIA et al (2007) documented the need for a fraud identification process to effectively implement the FRA framework. The first aspect that needs to be identified is the potential of risk and control that need to be taken. Firstly, the team has to consider the fraud triangle. The elements of pressure, opportunity and incentives for perpetrators to commit fraud should be evaluated and examined. Secondly, the team should consider the possibility of management overriding the controls and finally, analyse the targeted people and department that highly exposed to the fraud risk. While the other fraud risk identification process also include the regulatory and legal misconduct and reputation risk and IT risk.

The examples of regulatory and legal misconduct risk are conflict of interest, insider trading, environmental violations and theft of competitor trade secret while reputation risk relates to any risk due to company’s fraud. For example, financial statement fraud would damage the company’s reputation, increase the borrowing cost of the company and market capitalization depression. The second part of control activities as stated in FRA framework is the assessment of the likelihood and significance of identified inherent fraud risks. Even though the assessment of the likelihood and significance of fraud risks is very subjective, the company might observe the possibility of certain fraud schemes based on the previous fraud experience. Thus, the assessment of the likelihood and significance of identified inherent fraud risk could be done. According to IIA et al (2007), the likelihood of fraud risk can be categorized into (1) remote, (2) reasonably possible and (3) probable. While the significance assessment is relating to financial statement, monetary significance, organization operation, brand value, reputation as well as regulatory liability.

Subsequent to this assessment, the company could evaluate the potential perpetrator that could possibly expose the company to fraud risk and schemes. The final process in FRA framework is the response to residual fraud risk. In responding to fraud risk, the risk tolerance level is considered. It is relating to how the company address the fraud risk and taking an effort to respond to risk of fraud. To effectively implement the FRA, IIA et al (2007) state the two controls that should be highlighted in management’s documentation
control. These are (1) who is to perform the control, and (2), who is to monitor and assess the effectiveness of the control and the segregation of duties. In regards to this control, the management might reduce the possibility of fraud risk and arguably very significant in designing the company’s FRMP.

In general, the board of directors and senior management are responsible to all shareholders, capital providers and company’s stakeholders. In this regards, anti-fraud control must be matched with the relevant fraud risk and therefore reflected to highest level of control to mitigate the business fraud.

5.1.3 Section 3: Fraud Prevention

According to IIA et al (2007), the fraud prevention is the most important controlling method. Further, the effectiveness of the fraud prevention programme should be continuously communicated and reinforced at all levels of a company. Therefore, every company is advised to apply a fraud prevention method that consists of prevention techniques and procedures to control the business fraud. However, the fraud prevention method should be accompanied with the fraud detection method to provide a strong control over the fraud risk. IIA et al (2007) define fraud detection as a set of a company policies and procedures designed to mitigate fraud and fraud detection as a method designed to detect any fraud occurred. Possibly the fraud prevention method will be the first line of control in every company.

IIA et al (2007) suggest the five main contents in fraud prevention. Firstly the fraud preventive controls should be established in a fraud prevention programme. Within the fraud preventive control, a company should develop the procedure on human resources, transaction level and set the authority limit. It is suggested that the company performs background investigations into new and existing employees and supplier. It will be a part of the human resource procedure to hire trustworthy employees and suppliers. Therefore, the procedures designed must be adequate in assessing all the information for new employee
and promotion employee. It could be further identifying for company’s supplier and customers to gain any issues of financial condition, integrity and reputation.

The second effective procedure in human resource management is providing anti-fraud training. As stated in IIA et al (2007), the human resource department is responsible for planning any fraud training which includes the code of ethics and understanding the fraud risk programme. The purpose of this training is presumably to inculcate the employee into the importance of handling fraud issues. Therefore, red flags and the fraud issue could be understood by all level of employees. The third human resource procedure from this guideline involves evaluating performance and compensation programmes. This procedure is considered as important because of most fraudulent activities or frauds are due to employee’s dissatisfaction in relation to their compensation. In most cases, financial statement fraud also relates to the stock options. The financial statement is tending to be falsified due to a desire to achieve the company’s target for the company’s stock option. This is support by the study of O’Connor, et al (2006) that conclude the financial statement fraud incidences has been influenced by the large stock option grant and the duality position of company CEO.

Finally, the human resource procedures suggested by IIA, et al (2007) include an exit interview. This interview is conducted for resigned and terminated employees to find any issues regarding the company’s fraud and the integrity of management. In addition to the human resource procedures in fraud preventive controls, IIA et al (2007) also suggests the authority limit as a control activity for fraud prevention. The authority limit in this context refers to approval for certain financial transactions, in particular to payment made by the companies. The alignment between authority and responsibility is found to be important in reducing the company’s fraud risk. Therefore the company should design effective authoritative approval levels and segregation of duties throughout the company. This control could be the first defence in fraud prevention. The final procedures suggested in fraud preventive control are transaction level procedures. IIA et al (2007) suggests that the
company review the third party transaction as a front to back measurement. According to this guideline, the previous fraud scheme also involves the third party who includes fake supplier or bogus creditors.

The second content in fraud prevention is documentation of prevention techniques. IIA et al (2007) suggest that every company document the fraud prevention techniques. One of the purposes of this procedure is to ensure that every individual understands their roles and responsibilities. Thus, the documenting processes could be used to monitor and assess the effectiveness of the existing techniques and consequently any improvement could be done.

The third element in fraud prevention is assessing the company’s fraud prevention. Suggested by IIA et al (2007), the overall fraud prevention should be assessed periodically to ensure the efficiency and effectiveness of the company’s fraud prevention techniques. A company also could hire an external expertise to take part in assessing the company’s fraud prevention techniques when possible.

The fourth element of fraud prevention is continuous monitoring of fraud preventive controls. The IIA et al (2007) affirm that, the company’s plan and scope of fraud prevention techniques should be regularly monitored by routine auditor and independent entity. The important issues emphasized in this part include evidence of (1) retaining a company’s responsibility for its fraud management programme, (2) the timely and sufficient corrective actions taken by the management in respect to previous control or fraud cases and (3) planning for on-going fraud prevention success.

**5.1.4 Section 4: Fraud Detection**

Section 4 of the IIA et al (2007) guidelines introduces the fraud detection as one of the principle in managing the business fraud risk. Fraud detection suggests the necessary procedures and techniques to manage the company’s fraud risk. IIA et al (2007) also state that the effective detective techniques would assist the management to provide fraud evidence.
The detection techniques used should be flexible, practical and continue to develop. Therefore it would possibly challenge the various fraud risks. A few types of detection techniques have been introduced however, a company should also consider the cost effective method in designing and implementing the detection controls.

The most common detection techniques identified by IIA et al (2007) include a whistle-blower hotline, process controls and fraud detection procedures. According to IIA et al (2007), even though the whistle-blower hotlines may not be legal or ethical for multinational companies or worldwide basis except for the United States; it is arguably be very significant as a detection measures in fraud risk management programme. To effectively implement the whistle-blower hotline, IIA et al (2007) assert that the (1) the confidentiality of the caller should be kept, (2) that there should be an appropriate and timely response to the reported fraud and (3) direct reporting to audit committee should occur in cases of senior management involvement.

Subsequently, the whistle-blower procedures should be periodically evaluated and effectively implemented in the company’s fraud management programme. The second detection technique identified by IIA et al (2007) is process control. The most common example of process control is audit work which has been recognized as a systematic detection procedure to control the risk.

Another type of process control includes independent reviews, physical inspection and analysis of the company report. The next detection technique suggested by IIA et al (2007) is proactive fraud detection procedures. The proactive fraud detection procedures include any effort to continuously extend fraud detection controls. These include data analysis using the technology tools and continuous auditing to identify any fraud schemes. The example for detection tools to analyse the irregular pattern of accounting transaction is called ‘Benford’s Law’.
However, the technology tools of data mining, data analysis and digital analysis are also recommended as detection tools. These detection tools could allow management to (1) identify the relationship among people, company and fraud scheme, (2) identify suspected transactions, and (3) evaluate the effectiveness of company’s internal control. The detection tools have been recognized by the consulting companies and auditors as mitigating the business risk of fraud. Other than the technology tools used to detect fraud, a company also could get the evidence of fraud through company’s communication. It can be found through the email and backup materials of the company.

After all, the company is recommended to documents the effective detection tools that can be further used to mitigate the business risk of fraud. The required detection processes should include the on-going evaluation and continuous monitoring of fraud detection. These would also improve the fraud detection controls as measures have been taken appropriately. IIA et al (2007) also suggesting the measurable criteria to improve the fraud detection controls as stated in the following table 6:
Table 6: The measurable criteria to improve the fraud detection controls

<table>
<thead>
<tr>
<th>Number?</th>
<th>Known fraud schemes</th>
</tr>
</thead>
<tbody>
<tr>
<td>Number?</td>
<td>Status of fraud allegations</td>
</tr>
<tr>
<td>Number?</td>
<td>Fraud investigations resolved</td>
</tr>
<tr>
<td>Number?</td>
<td>Employees who have signed the corporate ethics statement</td>
</tr>
<tr>
<td></td>
<td>Employees who have not signed the corporate ethics statement</td>
</tr>
<tr>
<td>Number?</td>
<td>Employees who have completed the ethics training</td>
</tr>
<tr>
<td></td>
<td>Employees who have not completed the ethics training</td>
</tr>
<tr>
<td>Number?</td>
<td>Whistle-blower allegations received</td>
</tr>
<tr>
<td>Number?</td>
<td>Allegations received from other methods</td>
</tr>
<tr>
<td>Number?</td>
<td>Message/report of unethical behaviour received from employees</td>
</tr>
<tr>
<td>Number?</td>
<td>Number of vendors who have sign the company’s ethical behaviour requirement</td>
</tr>
<tr>
<td></td>
<td>Number of vendors who have not sign the company’s ethical behaviour requirement</td>
</tr>
<tr>
<td>Number?</td>
<td>Number of customers who have sign the company’s ethical behaviour requirement</td>
</tr>
<tr>
<td>Number?</td>
<td>Number of fraud audit performed by internal auditors</td>
</tr>
<tr>
<td>Bench Mark</td>
<td>Global fraud surveys (fraud experience and average losses)</td>
</tr>
<tr>
<td>Result</td>
<td>Surveys concerning the integrity or culture of the company from employee and other stakeholders</td>
</tr>
<tr>
<td>Result</td>
<td>Resources used by the company</td>
</tr>
</tbody>
</table>

The suggested measurement criteria should be implemented and controls by authorised senior management in order to ensure the effectiveness of the detection controls.

5.1.5 Section 5: Fraud Investigation and Corrective Action

The final principle that has been introduced by IIA et al (2007) is fraud investigation and corrective action. The purpose of this principle is to ensure the fraud allegations
appropriately address and response by the company. The company’s board of directors have to ensure the appropriate punishment and corrective action been taken by the fraud committee. Therefore the fraud investigation and response procedures should be established by the companies. According to IIA et al (2007) the fraud investigation procedures should be clearly defined and communicated to the company’s management. Once the investigation and response processes have been developed, they should be followed by board evaluation approval.

Further, the guideline notifies that for any case that relates to senior management involvement, for example financial statement fraud, the standard and regulations should be notified to and requires the involvement of the audit committee, board and external auditors. Another element that should be considered in planning the investigation procedures can be explained using the following table 7:

<table>
<thead>
<tr>
<th>Time sensitivity</th>
<th>Confidentiality</th>
<th>Legal privileges</th>
<th>Compliance</th>
</tr>
</thead>
<tbody>
<tr>
<td>Notification</td>
<td>Goals</td>
<td>Objectivity</td>
<td>Securing evidence</td>
</tr>
</tbody>
</table>

IIA et al (2007) states the importance of investigation procedures. The fraud allegation should be addressed timely in order to mitigate the potential losses and the allegation needs to be notified to the regulators, law enforcement and external auditors. While the information gathered from the investigation highly need the confidentiality in investigation process. Further the evidence gained from the investigation should be protected for the purpose of legal proceeding. The process of investigation should be clearly complying with the applicable laws in relation to the interview witnesses and gathering evidence. To be specific, the investigation process should be conducted on a specific objective of assessment; therefore the investigation team would focus to the scope of investigation whereby the goals
is achieved. IIA et al (2007) also state the investigation team that may include the (1) legal counsel, (2) fraud investigators, (3) internal auditor, (4) external auditors, (5) accountants or forensic accountants, (6) HR personnel, (7) security or loss prevention personnel, (8) IT personnel, (9) computer forensic specialists and (10) management representative.

The investigation process requires good investigation planning. The proper concern of legal issues, constraints in employee dealing and documentation would contribute to the effective investigation process. IIA et al (2007) further suggesting the four tasks in investigations namely (1) interviewing, (2) evidence collection, (3) computer forensic examinations, and (4) evidence analysis. In regards to these given tasks, the complete documentation should be prepared and followed by maintaining the confidentiality and finally prepare the conclusion based on the data/document analysis. Once the investigation process has been completed, the results and findings should be submitted to the senior management and company’s directors.

The last action that should be taken is corrective active or response to the findings. IIA et al (2007) emphasize that, the management consultation with legal counsel is needed before taking any discipline, civil or criminal actions. The disciplinary action may include staff warning, suspension and termination. While the civil action against the fraud perpetrator could be proceed when the company want to recover the fund. Finally, the criminal action is taking place when the company is required by the law enforcement. The guideline recommends and provides a credible guidance to mitigate fraud in organizations. The guidance provides recommendations for fraud mitigation for directors, senior managements and internal auditors of the companies. However the guidance does not differentiate on how to treat fraud by executive directors and fraud by other employees.

5.2 Summary of review guideline

The research found the five principles introduced by IIA et al (2007) as a guideline in managing the business risk of fraud. These include (1) fraud risk governance where every
company should place a suitable FRMP to mitigate the business risk of fraud, (2) fraud risk assessment as a foundation in FRMP, (3) fraud prevention as a prevention method in FRMP, (4) fraud detection as detection controls in FRMP and finally (5) investigation and corrective actions in relation to fraud allegations. The recommended principles in this guideline however provide conduct to manage the business fraud risk that could be involved a various types of business risk and fraud. In relation to this, the research focuses on financial statement fraud mitigation as the guidelines are designed for general type of frauds in organisation. The focused of financial statement fraud control is explained in chapter seven and eight of the research.
CHAPTER SIX

RESULTS AND FINDINGS OF CASE STUDIES

6.0 Introduction

This chapter presents the results and findings of case study research and compiles the information through case study questions, interviews with authorised personnel and documents observations from both case study companies. The information gathered from case studies has been organized and presented in the following sections of this chapter. The research chose case study research for the purpose of acquiring in-depth information on current issues, practices and adoption of any strategies and/or techniques for controlling financial statement fraud. As such, the two selected case companies, namely, Company A and Company B, support the research investigation, which aims to improve financial statement fraud control and evaluate three strategies – prevention, detection and action to response it.

6.1 Company A

Company A operates in the oil and gas industry. The company has four shared values: (1) loyalty, (2) integrity, (3) professionalism, and (4) cohesiveness, which are practiced across the group and have contributed to the continuous growth of the company globally.

6.1.1 Company’s Corporate Governance

In relation to Corporate Governance (CG) practice, Company A operated its good practice of CG since 2001, as promoted and suggested by the Malaysian Institute of Corporate Governance (MICG). The governance practice has also been documented since 2001. During the earlier stage of implementation, the entire management of Company A was called by the Legal and Secretariat Division to provide an explanation to Legal and Secretariat Division on governance practice.
The company conducts a workshop for its directors every two years to increase the effectiveness of the CG practice among them. The participants come from various segments across the group. The objective of the workshop is to ensure the alignment of the business conduct and the governance perspective as required by the company. The workshop addresses the latest issues and the best practices of CG, and international speakers are invited to talk about CG practices as needed.

The company is creating greater awareness concerning good practices and controls, particularly in respect of the necessary policies that should be created from time to time. Therefore, the company is compiling the input from the business operations of the whole organization. Consequently, relevant policies will be created and the best practices on business conduct will be achieved.

In addition, the company is also conducting internal training regarding ethical conduct in business. The Finance Division, in particular, has conducted ‘finance fertility’ to ensure that individuals are conducting business in the most professional manner. The Company Believes that ethics goes beyond the law and is about morality. As such, the company has given more attention to this aspect. In Company A, the board’s governance framework has been designed to effectively discharge the full responsibilities of the board members. There are three main board committees: (1) audit, (2) nomination/corporate governance, and (3) remuneration. The governance framework used is in accordance with the framework as suggested by the Malaysian Institute of Corporate Governance. The board is responsible to ensure that its transparency and corporate governance practices meet international standards. The board structure also ensures the balance of power and authority with a strong element of independence and governance.

Company A strongly emphasizes a strong tone at the top. The succession of leadership and planning is to enhance the current performance and ensure that the future leaders of the company are able to make a significant contribution to its success. Company A has two
groups of corporate structure – the board of directors and the executive committee. The group of the board of directors consists of the audit committee, nomination/corporate governance committee and remuneration committee. The executive committee of Company A comprises the president and chief executive officer and the four executive vice presidents who are responsible for each of the four main segments – exploration and production, gas, downstream, and finance.

6.1.2 Financial performance

Despite the financial crisis that started in 2008, the financial results for the five-year operations of Company A indicate good performance. The financial results for 2010 show an incremental rise in the shareholders’ fund, while the earnings before interest, taxes, depreciation and amortisation are also in line with the year’s performance.

6.1.3 Company practice of financial statement preparation

This sections report the findings gained from case company A in relation to case study questions (table 1, page 67). The purpose of the case study questions have been explained in chapter three, page 68. In respect of the current adoption and application of the Acts and regulations of the financial statement process (Question number 1 and 2), the company’s financial statement is prepared in accordance with the Malaysian Financial Reporting Act 1997 and the Companies Act 1965. In keeping with the current adoption and application of accounting standards and guidelines, the company adheres to the Financial Reporting Standards issued by the Malaysian Accounting Standard Board (MASB) and various internal guidelines and procedures, as approved by the management. The company strongly believes that the application of the Company Acts and the Accounting Standards and guidelines would provide the necessary preventive controls for financial statement fraud. The company has a Group Accounting Policy and Procedure in respect of the accounting procedure and guidelines of the FS process. In relation to the internal control over the financial statement, the company implemented the Financial Control Framework (FCF) on 1
September 2009. (Question number 3 and 4) The holding company has been a pilot company for the FCF. However, the FCF was implemented at group level on 31 March 2011. Due to the huge size of Company A, the adoption of the FCF by the whole group was achieved on 31 September 2011. The FCF is very similar to the Sarbanes Oxley Act 2002 (SOX). The contents of the FCF essentially follow the principles of SOX 2002. However, the FCF controls are not required to be audited by the external auditors as Company A is controlling financial statement fraud on its own initiative. Conversely, the FCF controls are audited by the authorised personnel from the company itself. The FCF is centrally driven although it has to be adopted by each of the individual companies within the group. The objectives of the FCF are to ensure that the process, control checkpoint and control designs are in place. In summary, the FCF comprises a process and systems check and the company considers the financial control framework as a framework that is relevant to the affirmation process to financial statement fraud.

The FCF contains processes control and narrative documentation in relation to the financial statement process. The company does not have a specific document to prevent, detect or respond to FSF; however, the FCF is considered as documented control for each step and process that has an impact on the financial statement process. For instance, the FCF will detail the steps and controls for the payment of an invoice to a supplier. The process begins upon receipt of the invoice and does not end until the invoice has been paid and cleared. In order to ensure the effectiveness of the controls, the FCF will be tested on a yearly basis. The Group Accounts and Services will report to the management concerning the number of controls passed and failed. In the beginning of the process, each process owner will take ownership and responsibility for the process. After the controls have been tested, the process owner will sign off the report before the Group Chief Financial Officer and General Manager of Accounts and Finance sign the controls tested. The declaration is considered to be similar to the declaration in SOX 2002, in which the Chief Financial Officer of the group company will sign the declaration letter. Apart from the controls in relation to financial statement process, the FCF is also considered as a part of the risk management system in
relation to the financial statement process. Eventually, the internal auditor will perform the system test at year end.

The group accounting policies and accounting procedures are designed to ensure all divisions and businesses comply with the accounting standards (Question 5). For instance, in adopting FRS 101, the company’s accounting policy will explain to the individual companies how to adopt this standard. Therefore, the accounting policies of the company are standardised across the group company. In conclusion, there are two sets of main control relating to the financial statement process, namely, (1) accounting policies and procedures, and, (2) the FCF in Company A. Both controls are considered as major controls for the prevention of financial statement fraud.

In order to ensure the effectiveness of the controls, the group has implemented the group month-end process, through which the group audit timetable is established to ensure a consistent approach and timely year end closing. However, most of the subsidiaries are on the Standard and Procedures system. The subsidiaries’ financial statements are accompanied by a sign-off of the financial control framework by the Group Chief Financial Officer and Group General Manager of Finance to confirm that all the internal control processes have been observed.

The Internal Audit Department has not designed any direct internal control over the financial statement. However, the company is currently embarking on its FCF manually. To improve control and reporting, the company is currently evaluating the system for the implementation of the FCF using their Standards and Procedures (by activating the process control module). Currently, Company A is using the analytical review at every level, the FCF and the internal audit function to detect any financial statement fraud. The analytical review at group level is conducted from the manager level and above from the Group Accounting and Finance Division. The internal audit function conducts the auditing process to ensure that the company is complying with the accounting policies and standards while the external audit is undertaken on the financial statement disclosures.
The accounting standard is the minimum requirement of financial statement disclosure. Therefore, the external auditor will ensure that the company is complying with the requirements of the standard. Otherwise, they will qualify the company accounts. The research found that internal auditors have no specific role in relation to any financial risk management programme. However, the company has a number of programmes in respect of fraud risk governance through the internal audit, the Financial Control Framework, limit of authority and reporting procedures. The company, however, does not have a well written document in relation to financial statement fraud. However, they have designed a blueprint for implementation. The company controls the financial statement process through a process approved by the management that refers to the Group Audit Timetable and the Group Accounting Policies and Procedures. The company believes that GAAP 1 has provided further guidance concerning minimum disclosure as required by the standard and the company’s requirement. In terms of financial statement fraud detection tools, the company has not employed any kind of detection tools as they believe that the role of internal and external auditors are able to detect and control fraud in financial statements (Question 6). The company does not have an ethics office; however, the Human Resource Department will deal with any misconduct of employees (Question 7 and 8). The company issued a code of conduct to ensure appropriate conduct throughout the organization. For top level management control, the signed document reflects the understanding and compliance of the company’s fraud policy and code of ethics. It is also applied to all employees and company’s vendors. The signed documents include ethics procedure regarding the company’s affairs with customers, creditors and other stakeholders. In addition, the company also provides guidelines and procedures issued by the Human Resource Department in relation to the hiring of employees, as well as their evaluation and promotion. In fact, the company has assigned the Human Resource Department to be the centre of control for hiring, evaluation and remuneration. The Skilled Group Adviser is assigned to work with the promotion of the employees. The company also provides the relevant and on-going training for each section that is based on job learning and external courses.
The company describes the position description and limit of authority in respect of the company's policies in relation to the job description and level of authority of the financial statement process. It provides a clear demarcation of roles and responsibility. For instance, the Group Audit Timetable shows a review at the various levels of the company. This is to ensure the integrity and the accuracy of the financial statement.

The following paragraph explains the whole process of the group audit timetable of Company A. To ensure the uniformity of the financial statement process across the subsidiaries and group, Company A issues a standard format for the financial statement and the pro forma without figures to all companies within the group. The group’s financial year ends on 31st March each year. The process begins when the subsidiaries submitting its final accounts to the Group Finance, Services and Accounts. At group level, the Group General Manager of Accounts and Finance ensures the subsidiaries are consistently following the disclosure requirements. The completeness and the accuracy of the group financial statements are achieved via a monitoring process, which have been implemented at every level of subordinate according to the key performance indicators. The final stage of the monitoring process is the responsibility of the General Manager of Group Accounts and Finance to give assurance on the completeness of the group financial statement.

The responsibility of the Group General Manager of Accounts and Finance is to give comments on the draft accounts and ensure that the appropriate contents have been disclosed. Subsequently, the Group General Manager of Accounts and Finance administers the financial statements consolidation and prepares the consolidated group accounts.

Upon completion of the draft consolidated group account it will be escalated to Group Chief Financial Officer for further review and endorsement. To ensure the completeness and the accuracy of the financial statement, Company A places emphasis on the process of verification and validation of the financial statement. The review process is undertaken by the manager, the general manager, followed by the senior general manager, and, lastly, by
the Group Chief Financial Officer. The next process of control is finalising the financial statement with the external auditors. The review session normally takes six to eight hours as line by line reviews are undertaken. The external auditors will ensure the group company complies with the accounting standards and discloses all the material information. In terms of financial statement disclosure, the company has to fulfil the minimum required and ensure the correct facts, and a true and fair view is provided to the company’s stakeholders.

The external auditor, together with the Group General Manager of Accounts and Finance and the Group Chief Financial Officer will discuss the finalised group consolidation account. Normally, they will review each of the financial statements and identify any arising issues. Once the external auditor is satisfied with the accounts, s/he simply confirms that the accounts are completed and that there are no issues arising. The external auditor may submit a management letter if they find any primary or secondary issues during their auditing works. The primary issues are normally those relating to the policies. For instance, the company does not follow a policy that has been set up by the company. In contrast, secondary issues are those relating to the operational part and require the board’s attention. For instance, operational issues include plant turn around that could have an impact on the company in terms of value and money. If the plant turnaround is not done properly, it will have an impact on the plant run. Therefore, it should be reported to the board of directors. Other examples concerning the issues raised include the improper recording of asset impairment, improper adoption of the Financial Reporting Standard and improper collection of debtors ageing collection. Normally the management will accept of the issues raise and provide mitigation plan for the next accounting period. The next process is the submission of the final consolidated group accounts to the audit committee.

Since the Group Chief Financial Officer is one of the board members, he does not attend the audit committee meeting to demonstrate his independence towards the responsibility for the financial statement. Therefore, the Group General Manager of Accounts and Finance will attend the audit committee meeting and he is responsible to answer all questions raised in
relation to the final accounts. The Chairman of the audit committee will deliberate board members on the consolidated group account for their endorsement. Upon deliberation by the Chairman of the audit committee, the board will assign two of its members to sign the consolidated group accounts of which the external auditor will follow suit. Upon the external auditors signed the consolidated audited financial statement, it will published to the public.

One month prior to year end closing, the company will close the accounts in pre-audit activities. The external and internal auditors of the company will discuss any further issues that arise. The internal auditors will raise the issues found during the internal auditing works during to the meeting. During the pre-audit, the subsidiaries activities and the treasury division will be focused on since these activities have a high impact on the group company.

Each subsidiary has to send their audit schedule to their individual auditor by 7th March every year. Subsequently, the tax vetting will be done to ensure the numbers are aligned with the tax requirements.

6.1.4 Understanding the perception of roles and responsibilities

The findings of this section aim to understand the roles and responsibilities of the financial statement preparation process and financial statement fraud control and support the findings of case study questions. The research interviewed five different groups of personnel and divisions at group level. These consist of the General Manager of Group Accounts and Finance, Head of Group Legal and Finance, General Manager of Group Risk Management, Head of Group Internal Auditor and Head of Group Risk Management (Treasury Division). The five interviewees are all responsible for the group level jurisdiction, in particular the group financial statement of Company A.

a. General Manager of Group Accounts and Finance

The General Manager of Group Accounts and Finance is responsible for the financial statement process for Company A. In relation to the preparation of the group financial statement, the company adopts the Financial Reporting Standard, which is issued by the
International Accounting Standard Board. In preventing financial statement fraud, the company strictly applies the Company’s Act and the Financial Reporting Standard. The company also issues its quarterly financial reporting.

This is one of the preventive measures to financial statement fraud as the quarterly financial statement reporting is audited by the external auditors. At the subsidiary level, the completed financial statement will be reviewed by the subordinates at each level of the company. The key performance indicator is used to monitor the completeness and the accuracy of the financial statement. In ensuring the correctness of the financial statement prepared by the company at group level, the Group Chief Financial Officer and Group General Manager of Accounts and Finance are responsible for the completeness and the accuracy of the financial statement prepared by the subsidiaries and the group company.

The completeness and the accuracy of the financial statement are monitored through many layers of review and management letters issued by the external auditors. The completed financial statement will be reviewed by the Group General Manager of Accounts and Finance and the Group Chief Financial Officer, and, finally, the Group Chief Financial Officer will sign the statutory declaration in the financial statement.

Company A also emphasizes the verification and validation at each level of the company, which includes its manager, general manager to senior general manager. In finalising the financial statement, the Group General Manager of Accounts and Finance will check the accounts together with the company’s external auditors. They will review line by line; turning page by page, which normally takes about 6-8 hours to complete. In practice, the signing partner of the audit firm and the technical director of the audit firm are responsible to ensure that Company A complies strictly with the requirements of the company standard. The company has to protect the full interest of its stakeholders by disclosing the correct facts, and a true and fair view of the financial information.
In relation to the specific internal control over financial reporting (ICOFR), the company implemented ICOFR on 1 September 2009 for the holding company. The holding company is a pilot company to have the ICOFR, which is called the Financial Control Framework. The Financial Control Framework adapts the principle of the Sarbanes Oxley Act 2002. Since Company A is not a US listed company, the external auditor does not perform the audit of the company for the relevant section. However, Company A is self-auditing, which is done among peers within the organization.

For the group level, the Financial Control Framework was implemented on 31 March 2011. The implementation of the Financial Control Framework is only partially complete due to the vast size of the company. The company is targeted to widely implement the Financial Control Framework for domestic purposes by 31 March 2011 and its international companies by 31 September 2011. The company aims to implement the Financial Control Framework throughout the group by 31 September 2011.

The Financial Control Framework is owned and initiated by Company A. It is centrally driven and has to be adopted by each individual of the company throughout the organization. In addition, the company has the accounting policies and group accounting policy procedure. The group accounting procedure is to ensure compliance with the accounting standards while the Financial Control Framework is aimed to ensure the control process, design the control in place and check point control.

The group accounting procedure aims to ensure the Operation Procedures Unit (OPU) complies with the accounting standards. For example, in adapting FRS 101, the company’s accounting policy explains each of the relevant issues, and, therefore, it should be adopted by everyone throughout the organization. One method to prevent financial statement fraud is the practice of a clear accounting policy in the company. As such, Company A assumes that the accounting standards should be perceived by everyone as a high level issue. Thus, the accounting policy will clearly explain the common approach across the whole organization.
The company has practiced corporate governance practice since 2001, when it was introduced and recommended by the Malaysian Institute of Corporate Governance. During the initial practice, the company secretary introduced and explained the corporate governance elements to each member of management in 2001.

In order to enhance corporate governance practice among the board of directors, the company conducts a director’s workshop every two years. The participants of this workshop are from the various segments of the company across the whole organization. The objectives of this workshop are to ensure the alignment of the business conduct and the operation from the governance perspective. To achieve the objectives, the company invites international speakers to talk about the corporate governance and the latest best practices.

Overall, the company is at the initial stage of the Financial Control Framework implementation. Therefore, the company is starting to create more awareness concerning the Financial Control Framework. Alternatively, the company is observing the policies and creates the necessary policies as appropriate. To achieve this, the company requires input from the relevant parties.

Another best practice of the company to prevent financial statement fraud is through observing a professional manner. The company ensures the individuals conduct themselves in the most professional manner in any business operation. In relation to this, the company conducts internal training to promote integrity, ethics and professional conduct throughout the organization. The Finance Department also conducts internal courses in respect of finance fertility.

The courses also have an impact on the personnel about the need for business ethics. According to the Head of the Legal Division, ethics is beyond law, albeit the law could possibly prescribe the ethics. Ethics is about morality, which concerns how people behave. The company does not have any written document to confront any financial statement fraud case; however, it considers that the Financial Control Framework, as a written document,
could prevent financial statement fraud. Each step and process in the Financial Control Framework has an impact on the financial statement. For instance, for the payment of an invoice, the framework is written in detail and clearly explains each step and process from the stage of receiving the invoice, paying the invoice and clearing the payment.

Each of the steps in the process has been documented. After documenting the process, there is a control test to ensure the control is in place. If the control is effective, the process is approved and followed. However, if the process is ineffective, the control owner will remediate the control and suggest a new process. To ensure the effectiveness of the Financial Control Framework, the company tests the controls on a half-yearly basis. The results concerning how many controls have passed and failed will be reported to the top management.

The Financial Control Framework requires every process owner to take ownership and sign-off for each testing of the controls result. Next, the Head of Finance for each Operation Procedures Unit and the Group Chief Financial Officer have to sign-off the declaration. The declaration is a similar practise to the statutory declaration of SOX 2002, which the company has adopted. Accordingly, the Group Chief Financial Officer will sign the group financial statement. Prior to that, it is signed-off by each of the individual Operating Procedure Units. The company believes that every process owner needs to sign the declaration before it is signed by the Group Chief Financial Officer.

In terms of detection, Company A has a number of detection tools to detect financial statement fraud. These include (1) analytical review in financial statement, and (2) internal audit function. The internal audit is the audit process to ensure compliance with the standard. If the fraud is referring to undisclosed information in the financial statement, it might be detected by external auditors.

The Group General Manager of Accounts and Finance found that the easiest way is to look at the accounting standards. The accounting standard has minimum requirements of
disclosure that must be disclosed in the financial statement. Therefore, the external auditors have to determine whether the company has disclosed the minimum requirements and complied with the standard requirements. Therefore, the company is willing to disqualify the company’s account if it does not disclose or comply with the minimum requirements.

b. **Head of Group Legal and Finance**

The Head of Group Legal and Finance is responsible for ensuring that the financial statement complies with the Company’s Act and the final group financial statement is presented and approved by the board. However, the Head of Group Legal and Finance has no responsibility and control in ensuring the correctness of the financial statement being prepared by the company. The Legal Division has no associate controls of the group accounts. From the experience of Head of Group Legal and Finance, the best practise of the company to control financial statement fraud is done through four mechanisms, namely, (1) check and balance at the entry point and decision of cost and every level of hierarchy involved, (2) implementation of proper procedures and segregation of duties, (3) independence of check and balance, and (4) audit control. In the meantime, she believes the best control to prevent financial statement fraud can be achieved by the clear policy established by the company. The effective policy should be understood and made aware to all employees of the company. Therefore, the awareness programme should be established to ensure the enhancement of the policy across the group of companies.

c. **General Manager of Group Risk Management**

The General Manager of Group Risk Management is the custodian of the company’s policy framework. The division is a centre of excellence and rolls out risk implementation. The General Manager of Group Risk Management deals with operational risk, which is different from the financial risk. Therefore, the General Manager of Group Risk Management is not involved with financial statement preparation. In this respect, his/her role is ensuring that the financial statement that has been prepared by the company is correct. Although the General
Manager of Group Risk Management is not involved in any control of business accounting transaction, the division deals with the risk controls of insurance, supply chain and acts as a service provider at the top.

From the experience of the General Manager of Group Risk Management, the best practice for a company to prevent financial statement fraud can be achieved through the treatment of accounting data using the accounting standards and regulations. This is related to the importance of accounting knowledge at the top management. Whoever holds the chief executive officer and top management positions needs to understand the basic knowledge of accounting and finance.

They should also understand the accounting treatment as required by the law. Hence, the required training should be given to the top management level. For instance, the basic knowledge of balance sheets and the treatment of inventory. The General Manager of the Group Risk Management realizes this knowledge is important for the top management with non-accounting background. Moreover, the top management should be informed of any changes in accounting treatment and accounting standards.

Meanwhile, the best control of financial statement fraud is accomplished through top management controls. The General Manager of Group Risk Management also believes that collaboration of the internal and external auditors through their auditing works would assist in preventing financial statement fraud. In addition, the internal and external auditor review is also important to ensure the financial statement is free from any misstatements. Overall, knowledge, training and auditing are important as the best practices of the company to prevent financial statement fraud.

d. **Head of Group Internal Auditor**

The function of the internal audit at Company A does not include auditing the financial statement. The company relies more on the external auditor. The internal auditor’s role at Company A is to ensure that the internal controls are in place in Company A. In addition, the
internal auditor has to ensure the accuracy of the company report and therefore provides the comfort to the top management on the controls done. The internal auditors do audit the compliance of procedures and ensure the good practice of corporate governance. The overall internal auditing practise is more on procedures, processes and compliance with the regulations.

Findings indicate the internal auditor of Company A has an indirect responsibility for preventing financial statement fraud. They are responsible for ensuring the establishment and the adherence to the company’s internal controls. The internal auditor has to ensure the company individuals adhere to the company’s processes and procedures. For instance, adherence to the payment processes, contract, procurement, work orders and the treatment for plant and maintenance procedures. The Head Group Internal Auditor also has a responsibility to review the year-end financial statement. However the review work relies more on the responsibility of the external auditors. Although Company A issues quarterly financial reporting, the Head Group Internal Auditor does not review the quarterly report but reviews the final consolidated report, which is the audited report. The quarterly report is audited by the external auditor. In reviewing the final financial reporting, the Head Group Internal Auditor discusses any queries in respect of the financial reporting and requires clarification before presenting it to the audit committee. The Head Group Internal Auditor also attends the meeting with the audit committee.

The Head Group Internal Auditor will highlight the reasonable checks to ensure the accounts are reasonable. Therefore, obvious differences from the prior years could be counted during the internal auditing review. All those differences require clarification to ensure the final financial statement has been reported accurately. The company has adopted the COSO framework as an audit framework. The control environment, control activities, monitoring and communication elements have been adopted as the company’s internal auditing framework.
According to the Head Group Internal Auditor, the controls designed in the internal auditing process indirectly control and minimise financial statement fraud. He also states that financial statement can be manipulated through the manipulation of accounting treatment, double entry and the financial statement preparation, which is under the external auditor’s role. In relation to financial statement fraud prevention, the internal auditing processes include to ensure the controls are in place. He believes once the controls are properly adhered to by the individuals, possible fraud will be minimised and/or prevented. According to the Head Group Internal Auditor of Company A, the combination of various controls could be the best control to prevent financial statement fraud. The established controls should be adhered to by the preparers of the financial statement. In addition, the company should monitor the business transactions that reflect on the financial statement by means of prevention and detection controls. Hence, the internal auditors will ensure these controls are in place and adhered to.

From the experience of the Head Group Internal Auditor, one preventive control that should be placed in a company is preventing the abuses of certain approval which is known as a limit of authority abuse (LOA). The limit of authority abuse will specify the authority to approve certain transactions. Therefore, limitation of authority abuse will ensure people will not exceed the certain limit allowable. In order to go beyond the limit, it requires getting approval from a higher authority even the board approval. Therefore, the board should be aware and approve all large transactions. In terms of detection controls, the Head Group Internal Auditor suggested bank reconciliation and intercompany balances reconciliation as two detective mechanisms. In addition, stock reconciliation between physical and records will be an effective detective control in relation to stocks. Therefore, irregularities could be detected during the reconciliation works.

e. **Head of Group Risk Management (Treasury Division)**

The Head of Group Risk Management of Treasury Division looks at the financial risk exposure. The division has a checklist of key areas that have an impact on the Profit and
Loss Account and Balance Sheet. The division is responsible to ensure the controls are in place. The checking of those controls will be done on a yearly basis in line with the issuance of the financial statement.

Currently, Company A publishes quarterly result performance and the attestation will happen on 31 March. However, the company has changed the accounting year end from 31 March to 31 December. The same year end period has been implemented across the businesses of Company A. Among the check list controls done by the Head of Group Risk Management of Treasury Division is fund management. The Head of Group Risk Management of the Treasury will ask for certain controls in relation to fund management. Basically this concerns the process; however, it could lead to accounting for fund management that has gone through the controls. Therefore, every process owner is responsible for attesting to and checking the controls set up in each process before the consolidation at group level.

There are a number of financial controls implemented by the Head of Group Risk Management of Treasury Division. One of the controls that are voluntarily adopted is from the US Sarbanes Oxley Act 2002. Company A adopted the SOX 2002 two years ago (2009). Even though the adoption of this Act is not compulsory among the public companies in Malaysia, Company A found it to be a useful financial control. Through this control, the group chief financial officer reviews the financial statement and attests that the controls have gone through the financial statement process.

The Head of Group Risk Management of Treasury Division has no specific roles in relation to the financial statement process. However, the division is more focused on operational risk because the treasury exposure represents a significant part of the balance sheet. Therefore, the division is more involved in validating the risk management in terms of disclosure, interest rate risk and currency risk.

The Head of Group Risk Management of Treasury Division is the custodian of the company’s policy and guidelines. In terms of reporting, the division will disclose the notes to financial statement concerning how the company manages the FOREX risk, currency risk
and interest rate risk. The whole group of Company A is governed by the guidelines and policy under the authority of the Head of Group Risk Management of Treasury Division. The company is huge; therefore, each subsidiary and business has their own financial risk reporting. Thus, the Head of Group Risk Management of the Treasury Division looks at the financial risk management at the group level.

The Head of Group Risk Management of Treasury Division reports the controls for operating risk to the top management. The control reported will include the risk indicators. The Head of Group Risk Management of the Treasury Division also controls the governance and any misconduct of the governance will be reported to the division. From the experience of the Head of Group Risk Management of the Treasury Division, intent and culture are the best practices in a company to prevent financial statement fraud. By giving the example of another company, C, which is in the oil and gas industry, the company understated their Triple R and overstated the replacement ratio. The motives of the fraud are unknown and were not revealed by her. It is possible that it was the case of optimism in getting a reserve and being involved in the formula issue. However, the common motives are to maintain the company’s share price and project the optimistic reserve by using the replacement ratio reserve. Commonly, there are some irregularities in regard to those reserves in the financial statement.

The roles of the external auditors are highly emphasized in preventing financial statement fraud. The auditors should be able to detect, raise the issues and inform the management. The previous financial statement fraud case in Enron showed the conflict of interest of external auditors. Therefore, they have to play a greater role in controlling financial statement fraud. In respect of these cases, the US established the SOX 2002 and the PCAOB to increase the independency of external auditors. In fact, Malaysia has also established the AOB to monitor and increase the independency of external auditors in Malaysia.

Company A believes that the practice and adherence to the company’s policy and guidelines will prevent financial statement fraud. Moreover, culture plays a big role in controlling
financial statement fraud. The most important is that the companies within the group have to be aligned to the holding company and practice the same culture within the group otherwise they might be ‘creative’ in doing things. Company A has a very conservative Chief Financial Officer who sets the right tone. Therefore, the whole company is driven to do the right thing. The success of one financial institution in Malaysia shows effectiveness in their management. The company has won the financial statement awards for a number of years. It shows that the tone set by the management is successful. The company has promoted the culture of integrity through the courses conducted by the training centre. The company promotes integrity through the company’s code of conduct and guidelines. The tone at the top is the best way to inculcate integrity among the individuals in the company. The tone at the top is setting the accepted behaviour in the company. For instance, the lower level employees will assume that it is not wrong to accept a gift if the higher level accepts a gift. Therefore, it becomes a culture. From her experience, integrity would be inculcated through the tone at the top. Integrity is about the value of people. The former chairman of the company did advocate the shared value, loyalty and professionalism. Therefore, the individuals in Company A are driven to see the company become better. This is what shared values are about.

6.2 Company B

Company B is a diversified multinational company in plantations, property, industrial, motors, energy and utilities and healthcare. The company is one of the largest listed plantation companies in Malaysia and leading equipment supplier of luxury cars and machinery. In all aspects of business operation, the group highly emphasizes sustainable growth and development.

6.2.1 Company’s Corporate Governance (CG)

The company has been using the Malaysian Code on Corporate Governance as the company’s best practice in corporate governance as suggested by the Malaysian Institute of
Corporate Governance. In this respect, the company has emphasized the requirements to the (1) board of director's composition and responsibilities, (2) director's statement of corporate governance and internal control, (3) role of audit committee, (4) board and shareholders relationship, and (5) auditor's reporting responsibilities.

In relation to the financial statement, by practice, the directors of the company B are required by the Companies Act 1965 to prepare the true and fair view of financial statement each financial year. The financial statement published by the company should be prepared in accordance with the Financial Reporting Standards, as it is also required by the Bursa Malaysia for the purpose of listing requirement. In addition, the company believes that the adoption of accounting policies should be consistently applied and supported by reasonable judgements and estimates by the company. Accordingly, the directors of Company B have to ensure the accuracy of the accounting recording which reflects the real financial position of the company and complies with the regulations. In this respect, the directors of company B have the general responsibility to safeguard the company assets, as well as prevent and detect any irregularities.

For this reason, company B has initiated (1) company corporate culture and company values, (2) management responsibilities for financial statements and letters of representation to auditors, (3) director's responsibilities, (4) conflict of interest (to govern the code of conduct), (5) whistle blowing, (6) corporate disclosure, (7) audit committee, (8) company corporate assurance, and (9) finance policies and procedures at the divisional and group level.

The company has adopted a set of values of corporate culture. This corporate culture guides the company individuals and the company directors, particularly in respect of professional conduct. The set of values of corporate culture includes (1) integrity, (2) respect and responsibilities among the individuals and action, (3) excellence in business and (4)
enterprise when there is a need to uphold the high level of personal and professional values in all business interactions and decisions.

6.2.2 Financial performance

According to the Group Chief Executive, the overall performance of the group for financial year 2010/2011 has improved significantly, as reflected in the robust performance of the group core business. Included in the five-year strategic thrusts, the group company will intensify their effort to (1) increase the operational efficiency, (2) increase revenue and (3) manage cost effectively.

6.2.3 Company practice of financial statement preparation

This sections report the findings gained from case company B in relation to case study questions (table 1, page 67). The purpose of the case study questions can be found in chapter three, page 68. In relation to the current adoption and application of Acts and regulations, the financial statement preparation of company B is governed by the Malaysian Accounting Standard Board (MASB), the Companies Act 1965 and the Securities Commission Act and regulations (Questions 1 and 2). The company also follows the reporting requirements of Bursa Malaysia in relation to financial information disclosure, the obligation of public listed companies to publish (1) the annual financial statements, (2) interim financial reporting and (3) preliminary profit announcements. In relation to fraud risk governance practice, the company’s corporate governance has provided the details of the roles and responsibilities of the board of directors, the subcommittee, internal audit and audit committee.

Company B has embedded various controls in relation to the financial statement process (Questions 3 and 4). In terms of governance structure, the company has formed an independent finance function at the respective levels, specifically (1) operating units (OUs), (2) division, and (3) group level. The dedicated finance managers at each level have been provided with the respective roles and responsibilities. For FS preparation and submission,
the company provides the Standard Operating Procedures (SOPs) for each entity within the
group for completing interim and full reporting. The SOPs set by the company is in
compliance with all the relevant Acts, regulations and internal policies. Once the financial
statement has been completed, the company's external auditor will review and audit the
financial statement. To ensure the controls have been designed in the financial statement
process, the company issues a Statement of Internal Control. The statement outlines the
nature and scope of internal controls of the company. Apart from the financial statement
process, company B has control over the monthly management accounts and operational
reports. The purpose of this control is to check and review the budgeted and actual results.
Therefore, any irregularities in terms of budgeted and actual figures would be detected.

Company B has no specific financial statement fraud awareness. However, the company
highly emphasizes the mandatory session of values and ethics to all employees. The
company provides internal courses of understanding on several key areas including financial
reporting and financial management. It has been organised by the Company's Business
School. Meanwhile, the Finance Department conducts a yearly retreat that also covers
financial fraud. The company believes that the various policies in the company's policies and
authority will create fraud awareness among all the company’s personnel.

In response to financial statement fraud detection, the company does not have any
technology tools to detect financial statement fraud. The prevention and detection of
financial statement fraud have been designed through the company’s policies and internal
controls. The company deals seriously with any fraud or misconduct. Employees who are
found guilty of fraud will be terminated, and, potentially, face a legal charge where
appropriate.

To ensure the fraud issues have been dealt with effectively, the risk assessment is
conducted by the Group Risk Management Division. The risk assessment is governed by the
Group Risk Management Policy. The policy sets out the (1) risk management framework, (2)
governance, and (3) processes. As required by the policy, every stakeholder is responsible for identifying the appropriate risk in relation to each role and responsibility. The four key areas that have been emphasized in the company’s risk management framework are based on the four lines of defence, namely, (1) risk ownership, (2) risk support, (3) risk monitor, and (4) risk oversight.

6.2.4 Policies and procedures in relation to financial statement preparation

The researcher has learned a number of relevant policies in relation to the financial statement process (Question 5). The company has three main group policies, namely, (1) group treasury policy, (2) group accounting policy, and (3) group finance policy. To ensure the consistency of financial statement practice, the entities and divisions across the group are adopting similar group policies. It is expected that each finance personnel should exercise and conduct judgement based on the principles of honesty, integrity and professionalism. In this respect, the Group Chief Financial Officer is responsible to ensure the distribution and adoption of the group treasury, accounting and finance policies to all entities across the group.

The group finance policies identify the (1) financial responsibilities, (2) planning and forecasting, (3) budget monitoring and reporting, (4) financial internal and external reporting, (5) monthly end closing and management financial reporting and (6) year-end closing and group audited financial statement. According to the policy, the Finance Department are supposed to carry out the finance functions of (1) accounting tasks, (2) provision of management information, (3) tax computation, (4) cash flow planning, (5) projection and management, (6) division recommendation and (7) fund management.

Additionally, the Finance Department is responsible for assisting the board of directors and senior management to (1) design the overall financial strategies, in particular, the financial strength, earnings and dividend and cash flows are approved, (2) report the budgeted and financial performance, and (3) carry out the financial analysis to improve the business
The finance policy has structured the financial responsibilities according to the different levels – group, division and entities. The Group Chief Financial Officer is responsible for overseeing the group finance, accounting and treasury matters across the group.

In the meantime, the Group Accounts and Finance department is responsible for setting the group finance and accounting policies of the group. The policy setting should be monitored and updated from time to time. For the financial statement submission at the divisional level, group finance will prepare the group consolidation accounts. Other financial responsibilities include (1) fund management and placement, (2) cash flow projection and planning, (3) tax computation, (4) managing financial risk, (5) monitoring the group budget, (6) group financial analysis, (7) transaction processing and intra group billing and (8) related party transactions.

The financial responsibilities under divisional finance include the roles of (1) consolidation at the divisional level, (2) monitoring the finance activities at the divisional level, (3) financial analysis at the divisional level, (4) cash flow planning and projection at the divisional level and (5) transaction processing and inter division billing.

Meanwhile the Finance Division for each of the entities is responsible for (1) controlling the entity’s financial transactions, (2) preparing the entity’s financial statement and (3) entity’s budget, (4) reporting the entity’s budget, forecast and performance variance analysis, and (5) monitoring the billing, collections and payments. For control purposes, the group finance policy has issued the policy of budget monitoring and reporting. The objectives of budget monitoring are to ensure that the financial performance of the group is properly monitored and reported. In this respect, the monthly comparison of actual financial performance against the approved budget is required at all levels. Any significant variance arising should be reviewed by the Group Chief Financial Officer.

In relation to the financial statement process, the entity’s Head of Accounts and Finance is responsible for ensuring (1) the month closing is prepared at the entity level for the monthly
financial statement, (2) the accuracy of numbers reported in the monthly financial statement, and (3) submission of the entity’s financial statement to the divisional Chief Financial Officer.

Furthermore, the responsibilities of the Divisional Chief Financial Officer are to (1) ensure the entity’s financial statement are submitted timely, (2) review the accuracy and completeness of the entity’s financial statement, and (3) consolidate the entities financial statement prior to submission to Group Finance. At year end, Group Finance has the responsibility for ensuring the timeliness of the financial statement and that it is issued by the divisional level by 1st July. The group consolidation is prepared accurately, completely and timely. Eventually, the Group Chief Financial Officer will review the consolidated financial statement prior to submission to the group chief executive.

Apart from the annual financial statement process, Group Finance also issues the policy of quarter end closing and group quarterly interim financial reporting. The purpose of this policy is to ensure that the group quarterly reporting is made accurately, completely and submitted to Bursa Malaysia within 60 days of the quarter end in compliance with Bursa Securities Listing Requirements. The Group Policy is practicing the interim financial reporting in accordance with Financial Reporting Statement 134 as the submission requirement to Bursa Securities. The interim financial reporting should include, at minimum: (1) condensed balance sheet and net assets per share, (2) condensed income statement and the basic and diluted earnings per share to be presented in the income statement, (3) condensed statement showing all the changes in equity, (4) condensed cash flow statement, and (5) selected explanatory notes.

Accordingly, the Group Chief Financial Officer is responsible for (1) ensuring all divisions have performed the quarterly end closing, (2) reviewing the group quarterly report prior to submission to group Audit Committee and board of directors’ approval, (3) running the group consolidation, and (4) preparing the group quarterly reporting. Eventually, the approved quarterly reporting will be submitted to Bursa Malaysia as required. The subsequent policy is
the year end closing and group audited financial statement. This policy is the principle for year-end closing and the preparation of the group audited financial statement. The objectives of this policy are to ensure the group financial statement is prepared, reviewed and approved by the group audit committee and board of directors in compliance with the (1) content of the group financial statement and (2) timeline of the group financial statement.

The content of the group financial statement should comply with the requirements of (1) Financial Reporting Standard, (2) Malaysia Company’s Act 1965, and (3) Bursa Securities Listing Requirements. In addition, the timeline of the group financial statement includes submission of the group financial statement to Bursa Malaysia within four months of the year end. According to the Bursa Listing requirements, the financial statement should be distributed to the company shareholders 21 days before the Annual General Meeting.

In addition, the group audit committee has to review and approve the group financial statement prior to its submission to Bursa Malaysia and no further adjustments should be made after submission of the group financial statement for approval to the group audit committee and board of directors. The Group Accounting Policy has been issued as one of the major policies in relation to the financial statement process. The Group Accounting Policy defines the overall financial accounting principles and policies adopted throughout the group. The purpose of this policy is to ensure the consistency of the accounting treatment.

The accounting manual issued by the group company is an essential part of the overall control and framework for financial statement preparation.

The policy provides the fundamental guidelines and instructions for accounting and financial reporting within the group. The Group Chief Financial Officer is responsible for establishing the relevant group accounting policies after necessary consultation with the respective divisional chief financial officers. The distribution, application and compliance with accounting policies will be monitored by the group chief financial officer. The third group policy of the company is the Group Treasury Policies. The policies state the overall treasury
policies and principles. The purpose of this policy is to ensure the best practices are consistently adopted for treasury activities throughout the group company. In relation to financial statement fraud detection tools (Question 6), the company has not used any tools except for the functions of internal and external auditors. The company believes that internal and external auditing works would detect any fraud in financial statements and provide controls of financial statement fraud. In response to the strategy of financial statement fraud response (Question 7 and 8), the company views any fraud as a serious matter and exercises no tolerance in respect of fraud or misconduct. Therefore, the board of directors and company employees are called to exercise due care and integrity in their professional conduct. The responsibility of due care and integrity has been stated in the company’s philosophy, which states that the company upholds a high standard of corporate governance, financial management and values high performance.

Additionally, the company has instilled a corporate culture and company values through four elements, namely, (1) respect and responsibility, (2) excellence, (3) enterprising, and (4) integrity. The four elements of corporate culture and values have been considered as the company’s aspiration to attain the best level of corporate citizenship in every country in which they operate. Other policies relating to financial fraud include (1) company finance policies, (2) divisional finance policies and procedures, (3) limit of authority, and (4) human resource policies. The company considers all policies designed as guidance to deal with financial fraud.

6.2.5 Understanding the perception of roles and responsibilities

The researcher interviewed the top level of management at the group level from Company B to understand the perception of the roles and responsibilities in relation to financial statement fraud control. The following subsections explain the results and findings of the interviews with the (1) Group Chief Financial Officer, (2) Head of Group Internal Auditor and (3) General Manager of Group Risk Management. The interviewees are all responsible for
the group level jurisdiction, in particular the group financial statement of Company B. The results and findings of these interviews are in regards to the following interview questions. The purpose of the questions has been explained in Chapter three, page 70 of this research.

<table>
<thead>
<tr>
<th>Interview questions</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. In relation to the financial statement process, could you describe your role and responsibilities?</td>
</tr>
<tr>
<td>2. What are your responsibilities for ensuring that true and fair financial statements have been prepared by the company?</td>
</tr>
<tr>
<td>3. What controls are associated with your position pertaining to the financial statement process?</td>
</tr>
<tr>
<td>4. From your experience, what are the best practices in a company to prevent financial statement fraud?</td>
</tr>
<tr>
<td>5. What are the best controls that a company should have in place to prevent financial statement fraud?</td>
</tr>
</tbody>
</table>

**a. Group Chief Financial Officer**

The principal role of the Group Chief Financial Officer is to ensure the company's financial statement is prepared according to the accounting standards, regulatory requirements and listing requirements, and observes timely reporting. The Group Chief Financial Officer is also responsible for ensuring that the audited financial statement meets the regulatory requirements in terms of announcements to Bursa Malaysia and presents the audited financial statement to the company's audit committee. In addition, the Group Chief Financial Officer is also responsible for informing the board of directors about the company's financial position, financial statement preparation and the key items in the financial accounts, particularly the company's income statement and balance sheet.

Thus, the board of directors will get a clear understanding of the accounting standards used in the group financial statement. The board of directors will discuss any recommendations received from the audit committee meeting before the approval of the final financial statement.
There are several responsibilities of the Group Chief Financial Officer in order to ensure the true and fair view of the financial statement presentation. The responsibilities include (1) ensuring the reporting system has been done from the entity, division and group level, (2) reviewing the financial statement and ensuring a proper review is done at every level of the company, and (3) ensuring any issues raised by the internal auditor and external auditor have been resolved. The controls involve every level of the group of companies. The final accounts at the entity level will be reviewed by the division level while the consolidation will be done at the division level and eventually will be reviewed at the group level. The review work will ensure that the financial statement complies with the accounting standards and reconciliation of movement of the accounts.

From a broad perspective, the Group Chief Financial Officer has control over the finance policy used by the whole group of companies. Therefore, the Group Chief Financial Officer is responsible for ensuring that the finance policy used by the whole group of companies has been approved by the board of directors and reviewed by the audit committee. The second control mechanism used by the Group Chief Financial Officer group is through compliance with the accounting standards. The entity and division levels have to comply with the company’s treasury policy. As such, the financial statement controls can be monitored through compliance with the accounting standards. In this case, the Group Chief Financial Officer highly relies on the company’s internal and external audit functions. Thus, the internal controls and review process are highly trusted.

The third control over financial statement process is through the review process. The review process provides the governance of the company. The accountants for each entity and the divisional level have their own responsibility to ensure that the correct financial statement has been prepared while the Chief Financial Officer at the group level has to ensure that the consolidated accounts are properly prepared. The company provides the group finance reporting to all the entities to ensure the standard template for financial statement preparation.
The next control is the closing process. The company provides a timetable as guidance for the reporting timeline. Therefore, each entity, division and group will meet the required timelines for financial reporting. The control of this process will ensure the consistency of accounting policies and ensure they are aligned with the company's financial and information technology system. In relation to the information accounting system, the company ensures that different accounting systems are used across the group company. In addition, Company B emphasizes the maintenance of the accounting system and the segregation of duties relating to the creation of accounts through the system.

The control over the information system is considered highly important as it allows access to the company accounts. The information technology security in Company B is considered the main control to prevent FSF. From the experience of the Group Chief Financial Officer, the best control that should be in place in the company to prevent financial statement fraud is through system controls. In system controls, the company should hire competent and people of integrity. Therefore, they will achieve the professional conduct of employees. The best system established in any company will not be effective without the existence of people of integrity.

Another control practiced by Company B is shared services. Shared services are established to ensure the check and balance across the company. In shared services, the company has pooled the transaction activities from all businesses; for instance plantation and properties. In this respect, the payment of those transactions will be done at group level while the reporting of those transactions will be made at the division level. Therefore, the company uses different groups of people to process the transactions of the businesses from the group company. Thus, it creates a control in relation to the financial statement process.

b. Head of Group Internal Auditor

Findings indicate the Head of Group Internal Auditor has no direct role in relation to the financial statements process. However, the internal control statements published in financial
reporting is under his control. In relation to the financial reporting process, the head of Group Internal Auditor is involved in the completed financial statement discussion. The Head of Group Internal Auditor has to attend the group audit committee meeting and be involved in financial discussion at the board level. One of the roles of the Head of Group Internal Auditor is to review the adequacy of the provisions that have been tabled by the Group Chief Financial Officer. Any amendments and recommendations made will be brought forward to the group president for approval. The Head of Group Internal Auditor is also responsible to release the information to the Securities Commission as required from time to time.

Normally internal auditors do not design the group internal control. The designing part will be the responsibility of each business unit. The internal auditor will only give assurance on the effectiveness of the design internal control. The Head of Group Internal Auditor also work together with the Group Chief Financial Officer and Group Risk Management to discuss the effectiveness of the designed group internal control. Further, the designed group internal control is reviewed by the audit committee. Once the internal control is reviewed by the Group Audit Committee, it will be recommended to the board committee for approval of adoption. The roles of the internal auditor, external auditor and risk are explained in the group statement of internal control.

Findings also indicate the Head of Group Internal Auditor does not perform any financial statement auditing since it is the external auditor’s responsibility. Normally, before external auditors start their financial audit, the external auditor will discuss with internal auditors on the internal audit report. The internal auditor may also request for guidance from internal audit on areas of concerned which the internal audit found during the internal audit work.

Nevertheless, the ultimate review responsibility is that of the external auditor without the existence of the internal auditor. The internal auditor’s primary focus is the internal controls at the operational level. In relation to the financial statement process, the Head of Group Internal Auditor has to ensure that the proper system of information technology and balance sheet reconciliation has been done on a regular basis and to review the balance sheet. The
Head of Group Internal Auditor will highlight any issues found in the divisional management report and copy it to the Group Chief Financial Officer.

The operational auditing works conducted by the Head of Group Internal Auditor include (1) office operation, (2) processing of creditor’s payment, (3) segregation of duties, and (4) internal controls over the processes. In addition, the Head of Group Internal Auditor will report the results of internal auditing works to the audit committee every three months. The previous issues that have been reported are related to (1) provisions, (2) operational exposure, and (3) any issues that have an impact on the group financial accounts.

The external auditor of the company will discuss with the Head of Group Internal Auditor in relation to monitoring progress and the final result of auditing will be issued by the company’s external auditor. In relation to the audit report, the company has two important reports presented to the audit committee, namely, (1) internal audit report and (2) external audit report. The internal audit report summarizes all the internal audit findings. For instance, any fraud found and the potential fraud exposure. In contrast, the external auditor’s report will summarize the external auditing findings which relates to the accuracy of financial statements. The company’s external auditor is also monitoring the working progress of the issues that have been highlighted in both the audit reports. Based on the experience of the Head of Group Internal Auditor, the control mechanism that should be highlighted to control financial statement fraud is on the information technology architecture. Apparently, the business transaction relies on the electronic world; therefore, the largest exposure is the infrastructure of the information technology architecture.

The preparation of accounts through information technology relies heavily on the integrity of the control application for the entire accounting process. Thus, the controls over the information technology systems should be given priority by the company management, particularly by the board of directors. The company has to consider the reliability of the process accounting information. The accuracy of information might depend on the accuracy
of the information processes through the information technology system. According to the Head of Group Internal Auditor, the biggest challenge of Company B is not having a single solution accounting system across the business. Company B has different systems at the entity and division level.

c. General Manager of Group Risk Management

The General Manager of Group Risk Management of Company B has no direct role or responsibility in relation to the financial statement process. However, the General Manager of Group Risk Management is responsible for ensuring that an effective risk management framework is in place for the whole group of companies. The risk management framework comprises good internal control and governance framework. Although the General Manager of Group Risk Management has no direct responsibility for ensuring the effectiveness of financial statement control, the division is responsible for ensuring that the internal financial control is adequate and effective. The General Manager of the Group Risk Management is concerned about the financial controls due to the risk that might occur if there is a lack of internal financial control. An overall role of the General Manager of Group Risk Management is to provide the framework that governs the risk management, internal control and governance of the group company.

Therefore, he has indirect roles in ensuring the right financial statement process in relation to competent finance staff, adequate number of finance staff and adequate resources. According to the General Manager of Group Risk Management, the best control practice in Company B in respect of control financial statement fraud is through an effective risk management framework. The risk management framework of Company B has been adopted from the risk management model of Ernst &Young (Ernst &Young, 2012)

The adopted model has a combination of three broad areas, namely, governance, people and method and practices. In relation to governance, five components have been considered, namely, (1) tone at the top, (2) policies and procedures, (3) strategies and
objectives, (4) organizational structure and (5) compliance. According to the General Manager of Group Risk Management, good tone at the top is as important as good governance in a company. Using the Satyam case as an example, the company’s records were being falsified by top management. Therefore, a good tone at the top is a part of company governance.

The company should design rigorous policies and procedures for each process performed throughout the organization. As such, it could minimise the risk relating to financial statement in particular. While Company B believes the strategies and objectives are important to guide the company’s mission, without clear strategies and objectives, the company might be exposed to risk. In addition, an appropriate organizational structure is important for good company governance. An appropriate organisational structure will facilitate the segregation of duties to avoid any conflict of interest. In relation to financial statement fraud control, the segregation of duties is considered highly important as a prevention strategy.

The final component in the governance area of the risk management model of Company B is compliance. Company B will ensure that an adequate compliance framework is in place in the company. The compliance framework is used to identify, assess the regulatory records and their compliance. According to the General Manager of Group Risk Management, the perception of people on the unimportance of regulatory requirements would contribute to financial statement fraud. The General Manager of Group Risk Management believes that the components in the risk management model would assist in controlling financial statement fraud in a company.

From the perspective of the General Manager of Group Risk Management, dealing with people in organization is important to control financial statement fraud. Therefore, a company should hire the right and competent employees, as this will reflect the good culture, performance, responsibility, coordination and communication of the company. The method and practice in the third component of the risk management model is viewed from the risk
management perspective as having a good risk identification and assessment. Therefore, the monitoring process is important to ensure the practice and methods are being implemented effectively throughout the organization. In this case, the internal auditor roles are important to ensure the operational systems are running well. Together with a good reporting framework on the model of risk management, it will complete the prevention strategies for fraud risk. By using the Satyam case, the general manager of group risk management believes the tone at the top, strong policies and procedures, good compliance, competence of people and segregation of duties are the best prevention practices to prevent financial statement fraud in particular.

From the point of view of the General Manager of Group Risk Management, the most effective detection tools to detect financial statement fraud include a mechanism for whistle blowing and a hotline. From previous financial statement fraud cases, fraud has been detected through the whistle blowing mechanism. Other tools that have detected financial statement fraud include the internal auditor and external auditor. The General Manager of Group Risk Management also added that another way to detect fraud is through holding the finance position for a long time since fraud was detected after he had left the position.

The General Manager of Group Risk Management identified culture as a response to the question concerning how to inculcate the value of integrity among the top management. According to him, the acceptance of good values and integrity in business conduct varies among the countries. For instance, the culture of integrity in business conduct in Malaysia and Australia are different and has different implications. Therefore, it depends on how the company is inculcating good culture in their business conduct.

The General Manager of Group Risk identified culture as a response to the question concerning how to inculcate the value of integrity among the top management. There are two important solutions to inculcate integrity among the top management. Firstly, the honesty and integrity of the company’s Chief Executive Officer, and, secondly, to tighten
control from the company’s audit committee. Since the previous financial statement fraud cases have been perpetrated by the top management, the most effective way is through strengthening the role and oversight of the audit committee. Another way to control financial statement fraud is to review the remuneration of the finance staff. Obviously past accounting fraud was due to dissatisfaction with the remuneration system among the key finance staff. Finally, the General Manager of Group Risk Management considers that the combination of governance, methods and procedures, and compliance in the organization will be supportive measures to prevent financial statement fraud.
CHAPTER SEVEN

RESULTS AND FINDINGS OF INTERVIEWS

7.0 Introduction

In addition to case studies (discussion of the case studies is explained in chapter six), the researcher designed an interview strategy to support the case study method. Thus, this chapter presents the results and findings of the interviews. The purpose of the interviews is to understand the protocols and responsibilities, current practices, views concerning financial statement fraud, and opinions pertaining to the control of financial statement fraud. Interview research provides in depth information concerning the research issues.

The research compiles the information from the interviews gathered through the interview questions that were posed through face-to-face interviews using the audio tape recorder. The interviews were conducted with the authorised personnel at the top level of the organisations. The research used semi structured interviews to facilitate detailed insights and understanding concerning the perception of roles, responsibilities, beliefs and financial statement fraud issues. The information gathered from interviews is organized and presented in the following sections of this chapter. The findings of this research aim to improve financial statement fraud control and evaluate the three strategies of prevention, detection and action.

7.1 Interviews findings

In the research, five different groups of respondents – Malaysian regulators, independent bodies, company management, forensic accountants and senior external auditors – were interviewed. Different types of question were designed based on the research questions (interview questions in appendix 1). The purposes of the questions are explained in chapter three (research methodology), page 76-80.
The next section discusses the results of the interviews’ findings. The issues of financial statement fraud are discussed under financial statement fraud explanation, financial statement fraud method and motives, perpetrators of financial statement fraud and the influence of financial statement fraud in Malaysia. In the meantime, the perceptions of roles and responsibilities of company’s chief financial officer, internal auditor, external auditors, Malaysian Regulators and independent bodies are also discussed. Finally, the research discusses the suggested control system to prevent financial statement fraud from the perspective of respondents in the last section of this chapter.

Due to confidentiality agreed, the research has not presented any quotes in relation to the themes adopted and the overall research findings. Instead, only a summary of respondents’ answers in relation to issues in financial statement fraud control is reported.

7.1.1 Financial statement fraud explanation

The main capital market regulator in Malaysia defines financial statement fraud as a fraudulent misstated financial statement published by a public listed company in which the financial statement information does not reflect the true position of the company. As the body is responsible for investor’s protection, any financial statement fraud case will be an offence under section 369 of the Capital Market and Services Act 2007. Bursa Malaysia also has a similar section for any financial statement fraud cases that breach its Listing Requirements.

Another respondent correspondingly describes financial statement fraud as (1) falsifying figures in the group company financial statement, (2) delaying in reporting the company’s losses and (3) disclosing the material information that finally gives effect to company’s financial position. The most common method of financial statement fraud from the previous cases was inflating the company’s revenue, which lead to the creation of fictitious trade receivables.

From the respondents’ point of view, there are two different motives for financial statement fraud. Financial statement fraud cases that have been perpetrated by the public listed
companies are mainly to impress the company’s performance and thus increase the company’s share price. In contrast, financial statement fraud perpetrated by a public company and other types of company are mainly to achieve (1) company bonuses (2) company objectives and evade the taxation where two sets of financial statement are prepared.

7.1.2 Financial statement fraud method and motives

From the forensic accountant’s perspective, previous financial statement fraud cases involve huge losses and complex manipulation. His past experience also found that the most prevalent method used by the fraud companies included increasing the company’s profit by inflating the company’s revenue. Another method of financial statement fraud is through fictitious invoices that are created to establish the sales transactions. In this respect, the company creates fictitious customers or debtors in order to fit the purpose and reflect higher profit in the income statement. One option to achieve this financial statement fraud method is the collaboration between operating employees and top management through given instructions. There are several motives according to the respondents’ experience. According to forensic accountants, the company may increase the profit to convey a better impression of the company’s financial performance. Therefore, the company would increase the share price to meet the analysts’ expectations and attract company investors.

7.1.3 Perpetrators of financial statement fraud

The forensic accountants and external auditors found that financial statement fraud is more difficult to detect and prevent if it has been committed by the top management of the company. Financial statement fraud could be committed by the board of directors and middle management. In some cases, financial statement fraud has been committed by the top management without the involvement of middle management. The involvement of top management in financial statement fraud cases is caused by the ineffective roles of the internal and external auditors of the company. From the respondents’ point of view, financial
statement fraud still occurs even when the best controls have been put in place as all controls are governed by the top management.

7.1.4 The influence of FSF in Malaysia

The respondents from the interview sessions have identified two contributing factors of financial statement fraud in Malaysia:

a. Enforcement and penalties

The enforcement in relation to FSF in Malaysia should be improved in terms of penalty and compensation. The relevant authority should increase the penalty to company’s directors for any FSF case committed. Tightening the control of enforcement and the increment in penalty might possibly be an effective tool to mitigate FSF in Malaysia.

b. Audit work issues

There are three main issues raised by the external auditor in respect of the failure of audit works. Firstly, it is suggested that the audit fees in Malaysia be reviewed as the external auditors face audit pressure due to high risk and bigger size of the business. In this respect, the audit firm allocates less senior audit staff compared to junior audit staff. A high number of inexperienced audit staff would contribute to ineffective audit work.

7.1.5 The roles of Chief Financial Officer

The research found that the general role of the Chief Financial Officers is to ensure that the financial reporting process complies with the (1) financial reporting requirements as set by the authorities, (2) accounting standards, and (3) Bursa Malaysia Listing Requirements. In particular, the responsibility of the Chief Financial Officer is to ensure that the financial statement has been prepared in a timely manner as required by the securities regulations and that the financial information is accurate.
The published financial statement should be free from any material misstatements as the Chief Financial Officer has a responsibility to the company’s stakeholders. The completed financial statement will be presented by the Group Chief Financial Officer to the company’s audit committee to seek advice, comments and recommendations. The completed financial statement is also presented to the company’s board of directors to inform them of the application of accounting standards and any changes in accounting techniques. The completed financial statement will be audited and the Group Chief Financial Officer will pick up any issues raised and found by the company’s internal and external auditors. The Chief Financial Officer is also responsible for ensuring the adequacy of the financial reporting control and the competency of the finance team. The Chief Financial Officer is responsible for reviewing the periodic and yearly financial results.

7.1.6 Role of internal auditor

The research found that the main role of the Group Internal Auditors includes ensuring (1) the company’s internal controls are in place, (2) compliance with the company’s policies, procedures and regulations throughout the organisation, and (3) the practice of corporate governance at the board level. In addition, the Group Internal Auditors focus on the operational audit in relation to compliance with the company’s internal control.

In relation to the financial audit, the Group Internal Auditors are not responsible for the audit financial statement. However, financial statement fraud would be prevented through the implementation of the company policies and procedures and code of ethics, which include the internal controls design and monitoring. According to the current practice, financial statement fraud is not expected in a company if all the transactions follow the procedures and controls unless there is manipulation of the accounting treatment under the external auditor’s accountability. The internal auditor’s role in operational audit includes (1) internal control process, (2) control on information technology system, (3) the reconciliation of the
balance sheet on regular basis, (4) processing on creditors payment, and (5) segregation of duties.

A report containing audit results will be prepared for the company’s audit committee. The audit result will be discussed with the Group Audit Committee, Group Risk Management and the Chief Financial Officer. Thus, the adequacy and improvement of the related controls will be tabled. The internal auditor is also responsible for presenting the group financial results to the Group Audit Committee before the financial statement is published to the public. Accordingly, any comments would be suggested to the board of directors. The internal auditor works with the Group Chief Financial Officer, Risk Management and Finance officer, in preparing the yearly Group Statement of Internal Control before submitting it to the audit committee for review and recommending it to the board for approval. According to the Institute of Internal Auditors Malaysia, an internal auditor does not have a primary responsibility to detect and investigate any fraud in the financial statement. However, part of the internal auditor’s responsibility is to look after the controls that assist in preventing financial statement fraud. Therefore, the internal auditor should understand financial statement fraud indicators or red flags in their audit work. In terms of internal auditing work, the role of internal auditors varies from one organization to another. Certain audit functions play a major role in the financial statement process. The role includes (1) quarterly review of the financial statement and (2) assist audit committee. However, certain audit functions do not cover the financial statement process. Most probably, they only audit the accounts payable, receivable and Finance Department. The task of the internal auditors in relation to the financial statement depends on the competency of the internal auditor in the financial statement process.

7.1.7 Role of external auditor

From the interviews, the research found that the general role of the external auditor is examining the company's financial statement by performing the audit work. The auditor will
give their opinion on the audited financial statement after completing the audit methodology. However, the true and fair view opinion from the external auditor does not reflect the 100% accuracy of the financial statement. The external auditor’s role is governed by the Companies Act 1965 in Malaysia in which their role is to audit the financial statement prepared by the company and express their opinion concerning the audited financial statement. The auditing task of an external auditor is also guided by the International Standards of Auditing.

In relation to fraud in the financial statement, an external auditor’s role is not primarily to detect financial statement fraud; however, they have to report any fraud found during their auditing works. In order to be effective in their audit work, they have to design effective audit procedures that might be able to detect any fraud in the financial statement. A further issue concerning the external auditor in preventing financial statement fraud is the understanding of which motivation method arises in relation to the components (income, expenses, assets and liabilities) of the financial statement. However, the external auditors have to understand that fraud motivation is due to different types of company by industry. The following are examples of the external auditor’s experience in understanding fraud motivation:

a. A company that is selling consumer goods and is driven by sales will tend to manipulate their sales figures. They will increase the number of items sold at the year end, and, consequently, record it as sales returns at the beginning of the year.

b. A company may manipulate through the accrued accounting method. The company may increase the revenue by using the accrued revenue and expense balance. Therefore, it has implications on the company’s profit.

c. A company may conceal bribes or corruption by recording it as company’s travel expenses or commission.

From their auditing experience, the external auditors believe that they have to increase fraud awareness and recognize financial statement fraud red flags in their auditing work. The research posed a question that could reflect the procedures involved in financial statement
auditing. There are three stages of audit work, namely, (1) audit planning, (2) audit execution and (3) audit conclusion. Under the audit planning stage, an external auditor will understand the client’s business, prepare the assessment and strategize the audit plan. The next stage is audit execution. The external auditor will execute the audit work that includes the test control and the analytical review. Finally, the audit conclusion will be reported by the external auditors.

External auditors have their own audit methodology or approach. Different audit firms have a different audit methodology. In relation to determining the significant figures in audit work, the external auditor will consider the significant threshold level in their auditing work. The auditing work depends on the test basis on the selected size and it does not have 100% verification. The sample size will be determined to ensure sufficient coverage in the audit work.

To relate to fraud in the financial statements, the research focuses on how the external auditor deals with any material misstatements in the audit work. It is required under the International Standards of Auditing (ISA) for every external auditor to understand any material misstatement found in the course of the audit work. From the real practice, the external auditor will question their audit client and discuss any material misstatement found. Therefore, the audit client will be asked to do the adjustments to the relevant account before the audit report is signed off by the external auditor.

A further issue pertaining to this is related to audit risk control. From the real practice, the external auditor controls the audit risk through (1) an effective audit plan, (2) auditor’s knowledge competence, and (3) auditor’s experience. In order to assess the various types of risk and design the appropriate audit planning, the external auditor should have a thorough understanding of the client’s company and industry. To support this, the ISA requires every external auditor to assess the audit risk before the engagement of an audit job. This would be the first defence for the external auditor. For existing audit clients, external auditors need
to do an annual review before starting the audit work. After reviewing the audit risk, the external auditor will assess the risk and examine the controls involved by understanding the different risks of the company in the different types of industry. Finally, they will design the audit methodology in which the risk will be identified and the test the risk identified.

The research has gained insight into a number of experiences from the external auditors concerning what they think would be the best practice in controlling the audit risk. The best control of audit risk can be controlled by experienced auditors, as experienced auditors will understand the business operations and the risk involved, particularly in business segments. From an auditor’s perspective, the greater involvement of a senior auditor in audit work reflects the effectiveness in controlling audit risk, as the partner will be more involved in auditing the client’s work.

7.1.8 The role of Malaysia’s Regulators

The capital market regulators play a vital role in maintaining market confidence and investor protection. In relation to financial statement fraud, the research has grouped four different types of regulators that are associated with the issues of financial statement fraud in Malaysia. These are as follows:

<table>
<thead>
<tr>
<th>No</th>
<th>Regulators’ responsibility</th>
<th>Regulators</th>
<th>Act</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Capital Market</td>
<td>The Securities Commission Bursa Malaysia</td>
<td>CMSA 2007</td>
</tr>
<tr>
<td>2</td>
<td>Company/Corporations</td>
<td>Companies Commission Malaysia</td>
<td>Companies Act 1965</td>
</tr>
<tr>
<td>3</td>
<td>Auditors</td>
<td>Auditing Oversight Board</td>
<td>ISA CMSA 2007</td>
</tr>
<tr>
<td>4</td>
<td>Public (Law Enforcer)</td>
<td>Royal Malaysian Police</td>
<td>Penal Code</td>
</tr>
</tbody>
</table>
a. The role of the Securities Commission

The Securities Commission (SC) is considered as the main regulator in relation to financial statement fraud. The SC of Malaysia is a statutory body with investigative and enforcement powers to protect investors under the CMSA 2007 Act. There are two bodies governed under the Securities Commission jurisdiction, namely, Bursa Malaysia and the Auditing Oversight Board.

In relation to financial statement fraud, the SC is responsible for ensuring that the financial statement published by any PLC reflects the true and fair view of business conduct. Therefore, the SC is responsible to regulate all matters relating to the information stated in the company’s financial statement. Consequently, under the SC purview, Bursa Malaysia is the front line regulator of the Malaysian capital market. Bursa Malaysia has a duty to maintain fair conduct of PLCs on the stock exchange.

The body will monitor the compliance and take enforcement action for any breaches of the rules of Bursa Malaysia. Any public company has to follow the Listing Requirements before they are listed on the stock exchange. In relation to financial statement fraud, Bursa Malaysia will monitor the financial statement disclosure published by the PLCs. In addition, the second body under the SC purview is the Auditing Oversight Board, which was established to regulate the auditors in public interest entities.

In respect of financial statement fraud, the researcher has gathered information from the Financial and Corporate Surveillance and Investigation departments of the SC. Financial statement fraud cases will be investigated and action will be taken based on two sources of information: (1) report and proposal by Bursa Malaysia and (2) report by public and whistle blower. One option to understand the role of the regulators in controlling financial statement fraud is the research focus on the financial reporting disclosure and financial statement. Therefore, the first layer of financial statement fraud control is under the authority of Bursa Malaysia.
Any company that is going to be listed on the Malaysian Stock Exchange will be monitored by Bursa Malaysia. Under CMSA 2007, Bursa Malaysia provides Listing Requirements that have to be met by the PLCs. The financial statement disclosure is the main issue of concern that is monitored by the body. The examples of financial statement fraud cases that have been detected by Bursa Malaysia include (1) misleading information in financial statement and (2) inaccurate accounts presented by the PLCs. Therefore, Bursa Malaysia is looking at the companies that breach the Listing Requirements and are not practicing good corporate governance.

The Corporate Surveillance department of Bursa Malaysia monitors and detects any irregularities in the financial statement. The department also monitors the trend of practice in order to find any malpractice or unusual trend of PLCs. The common procedures of this department include monitoring, detecting, and analysing and taking action against the relevant PLCs.

The department has two different types of detection method: (1) financial red flags and (2) non-financial red flags. The financial red flags that have been taken into consideration include the (1) suddenness of account receivables, (2) significant amount of provision, (3) impairment charges issued, (4) consecutive losses for at least three years, (4) negative cash flow, and (5) substantial borrowing that is not in line with industry practice. Meanwhile, the non-financial red flags include (1) resignation of the company’s auditor, or independent directors and or the audit committee, (2) changes in company’s financial year or accounting period, and (3) delay in submitting the financial reporting or financial statement.

Once the matters of concern have been detected, the department will analyse and investigate the issues and take appropriate action. There are four different types of action – (1) private reprimand, (2) public reprimand, (3) both private and public reprimand and (4) fine – taken by Bursa Malaysia, which depend on the severity of the fraud. The breaches of private reprimand are not severe and are only disclosed to the company itself. It is
considered as a warning from Bursa Malaysia of such misconduct. The Bursa takes action on private reprimand for any PLC that (1) delays in announcement and the delay does not have an effect on the share movement and (2) the breach is not material to the company and its investors.

Public reprimand is the action taken when the companies are found to be in breach of the listing requirements. Public reprimand is given for the severe breaches that could have an impact on the companies and its investors. If the breach is more severe, the company will be fined. For the case of directors who breached the Listing Requirements and caused losses for the company, the directors have to make compensation for the amount of loss. It also includes the involvement of the directors in gaining benefit from the fraud. The public reprimand will be disclosed to the public due to the severe breach. Previous cases that have been handled by Bursa Malaysia involved financial statement fraud schemes, for instance, the imbalance of sales amount and receivables amount. Responding to this case, Bursa Malaysia asks the company to breakdown the amount of receivables and discuss with the company’s external auditor and audit committee. In certain circumstances, Bursa Malaysia might ask the company to appoint a special auditor to undertake the inspection.

Bursa Malaysia has the authority to set the relevant standards and bind regulations with the approval of the SC. The body will monitor the malpractice and discuss the suggested policies at the committee level of the Bursa before applying the approval from the SC. This also indicates how the policies and regulations have been tightened up by Bursa Malaysia. The Malaysian Securities Commission plays a major role in controlling financial statement fraud and provides the second layer of protection in the capital market in particular. There are 975 PLCs under the Commission’s supervision. For the basis of monitoring, the respective department of the Commission will pick the number of companies on the basis of risk approach and the top 200 PLCs. The Commission has allocated its power to two departments, namely, Financial and Corporate Surveillance Department and Investigation Department.
The core role of the Financial and Corporate Surveillance Department is to ensure that Malaysia’s PLCs comply with the financial reporting standards as provided by the Financial Reporting Act 1997. Another responsibility is monitoring the corporate behaviour of Malaysia’s PLCs. In respect of surveillance, the department will examine the financial statement of the PLCs to ensure compliance with the financial reporting standards. Any irregularities of financial information will be based on the company’s track performance and the industry ratio consistency. In regard to corporate behaviour, the department will monitor through any announcement made by the PLCs to their shareholders.

The significant information that needs to be reviewed includes (1) the appointment of new directors and (2) the announcement of new business ventures. Consequently, the department will discuss with the company’s external auditors and the independent directors any irregularities found during their examination. The facts, figures and issues found will be reported to the heads of departments. Consequently, the case will be passed to the Investigation Department when the case has been identified by the Head of the Surveillance Department.

Two common actions that have been taken include two types of case: (1) breach of the Securities law, and (2) non-compliance. The breach of the Securities law cases will be further investigated by the Investigation Department while the non-compliance cases will be further discussed with the company management. The second department of the Securities Commission that is responsible for handling financial statement fraud cases is the Investigation Department. The Investigation Department is responsible for investigating any case that breaches the Securities Law under the CMSA 2007 Act. The department handles all cases that are referred to it by (1) Bursa Malaysia, (2) Financial and Surveillance Department, (3) whistle blower, (4) third party, (5) media or the public. Consequently, the department will investigate and gather all the evidence to prove the case.
Criminal action will be taken against any individual who commits financial statement fraud but not the company. From the previous case, the Securities Commission will charge the company directors and the Chief Financial Officer who are responsible for financial statement issuance. There are a number of processes in respect of the investigation process. When the department obtains the case from the respected sources, the department will ask the company’s external auditor to further report to the Securities Commission. This is because of the duty of the external auditor to report to the Securities Commission for any breaches of the Securities Law under section 320 of the CMSA 2007 Act.

The department will refer the reported case to the Financial and Surveillance Department to check on any non-compliance issue. Thus, the Investigation Department will gather the evidence and refer the case to the Prosecution Department. The evidence presented by the Investigation Department will be reviewed by the Prosecution Department before it will be presented to the Chamber Judges. The case will be brought forward to the court after obtaining consent from the Chamber Judges, and, therefore, the respective individual will be arrested.

Previous financial statement fraud cases commonly involved profit inflation. The fraud companies increased the profit by inflating the company’s revenue. The research was informed that the department used document analysis and reviewed the relevant document from the various departments of the company in order to gather the evidence. Departmental investigation was also conducted concerning customer’s confirmation to verify the amount of sales and the existence of the customers. The Malaysian Securities Commission collaborates with the International Organization of the Securities Commission for any fraud involving foreign companies. However, the SC is considered the main regulator in the capital market, and, therefore, it has the power to set standards and legally binding regulations in relation to capital market.

b. The role of the Malaysian Auditing Oversight Board
The Auditing Oversight Board (AOB) in Malaysia was established on 1st April 2010 under the Securities Act 1993. The establishment of the AOB is one of the efforts of the Securities Commission to strengthen the oversight of financial reporting in Malaysia. The AOB is responsible for overseeing the auditors and for promoting confidence in the audited financial statements of public interest entities. However, the body has not experienced any financial statement fraud case in the past two years of operation.

To achieve this, the AOB is accountable for (1) registering the practice of auditors, (2) conducting inspections and monitoring programmes to assess the compliance issues of auditing and ethical standards, and (3) regulating the auditors and the audit firm within its jurisdiction. The objective for all these responsibilities is to ensure that the financial statement has been prepared in accordance with the relevant financial reporting framework and reflects the true and fair view. Therefore, the financial statement information will be free from any material misstatements arising from fraud and error.

The AOB has the power to sanction any audit firm that has failed to comply with the auditing standards and practice. The body has the power to instruct the audit firm to conduct certain processes and procedures, besides suspending and revoking their registration. In order to promote the good conduct of the auditing profession and strengthen the auditor's regulatory framework in Malaysia, the AOB also collaborates with a number of regulatory agencies, namely, (1) the Companies Commission Malaysia, (2) Bank Negara Malaysia, and (3) Malaysian Institute of Accountants.

In respect of the auditor's responsibility, the research found that external auditors do not have any direct roles in detecting fraud in financial statements. However, they have to consider the possibility of fraud in the financial statement before the issuance of audit opinion. To support this, the International Standard of Auditing (ISA) also highlights the needs of the auditors to focus on fraud in financial statement. The ISA presumes that revenue recognition is a fraud risk and a significant area that could be exposed to fraud in
the financial statement. Therefore, it is important for auditors to design an effective audit plan that enables irregularities to be found and respond to any fraud indicator. In relation to the improvement of accounting and auditing conduct in Malaysia, the AOB has a residual power to collaborate with the MIA in setting the auditing and ethical standards for the MIA members.

c. The role of the Companies Commission Malaysia (CCM)

The CCM is one of the regulatory bodies that regulate corporations, companies and businesses in relation to the Companies Commission of Malaysia Act and Companies Act 1965. In respect of business conduct, the CCM is responsible for encouraging and promoting the proper conduct of the company’s directors, secretaries, managers and officers. Therefore, the business activities will be conducted in good corporate governance. To relate the roles of the CCM and controlling responsibilities of financial statement fraud, the research found that any unsuited provisions or offences of PLCs from the Securities law will be passed to the jurisdiction of the CCM. For instance, any person who is declared bankrupt and has been appointed as a director and found to commit financial statement fraud, will be charged under section 125 (1) of the Companies Act 1965. For any other type of business or company, the CCM will use the following section to investigate and enforce the law. The most relevant section is Section 366, which is relevant to any person who fraudulently invests and causes the deception. Other sections that are relevant include (1) Section 364 (2) false and misleading statement, (2) Section 132 – financial duties and (3) Section relevant to conflict of interest. Furthermore, the CCM has the power to set any relevant standard or rule concerning company matters.

d. The role of the Royal Malaysian Police (RMP)

The (RMP) is a public regulator and law enforcer that is responsible for investigating any breaches of the Penal Code. The RMP is also responsible for all criminal cases in Malaysia. In respect of financial statement fraud cases, the RMP will investigate any reported breach
of cheating and trust by any individuals in the company, in general, and the company’s
director, in particular. As financial statement fraud has been reported as a growing form of
economic crime (ACFE, 2009), the RMP has established a Forensic Accounting Department
to assist the accounting fraud investigation.

Thus, the Forensic Accounting Department of the RMP will assist the investigation officer in
understanding the reported accounting fraud cases. Eventually, financial statement fraud
case with solid evidence will be recommended to the Deputy Public Prosecutor for further
action and charges. The RMP has experience in investigating a number of previous financial
statement fraud cases in Malaysia with the authority to search, seize, arrest, detain and
interrogate the person involved. However, the RMP has no power to set any standards or
binding regulations in relation to financial statement fraud due to the jurisdiction of the SC to
maintain the fair capital market in Malaysia.

7.1.9Roles of independent bodies

The research has interviewed a number of independent bodies that are relevant to the issue
of financial statement fraud in Malaysia, namely, (1) The Association of Certified Fraud
Examiners (ACFE), (2) The Malaysian Institute of Accountants (MIA), (3) the Institute of
Internal Auditors (IIA) and The Malaysian Institute of Corporate Governance (MICG).

a. The role of the Association of Certified Fraud Examiners (ACFE)

The Association of Certified Fraud Examiners (ACFE) is the world’s anti-fraud organization
that provides anti-fraud training and education to its members. The ACFE’s objectives are to
reduce the incidence of fraud and increase integrity and public confidence. Thus, the ACFE
provides (1) qualifications for certified fraud examiners, and (2) a code of conduct and ethics
for the ACFE members. To understand the roles of the ACFE in controlling financial
statement fraud in Malaysia, the research found that the ACFE in Malaysia is one of the
chapters of this body. The ACFE has received a number of private assignments from
companies and individuals to investigate the falsification of financial documents. The ACFE
members consist of accounting expert investigators. The case will be investigated and a report will be prepared in relation to the fraud case. The body is continuously promoting the integrity and increasing confidence within the public domain. The body has organized a number of financial statement fraud conferences and seminars in Malaysia. The ACFE has also collaborated with the MIA and the Malaysian Anti-Corruption Commission (MACC) in reducing the incidence of fraud and corruption. The ACFE also provides on-going training, and updates the prevention and detection skills and information for ACFE members.

b. The Malaysian Institute of Accountants (MIA)

The second body is the Malaysian Institute of Accountants (MIA). The MIA is a statutory body that was established under the Accountants Act 1967. The MIA’s responsibility is to regulate the accountancy profession, in general, and accountants and auditors, in particular. Therefore, the MIA has three different roles in upholding the accounting profession that specifically focuses on (1) building the foundation and promoting the accountancy profession, (2) setting a quality benchmark of quality performance, and (3) ensuring professional performance and enforcing the regulations.

The body enforces the regulations to qualified accountants and auditors who are responsible for preparing and auditing the financial statement. The MIA, through the Surveillance and Enforcement Division has been implementing three different surveillance functions to ensure the enforcement of regulations in the accounting profession. There are three surveillance functions, namely, (1) market surveillance, (2) practice review, and (3) FS review. Firstly, market surveillance is done to ensure the integrity of financial reporting. The division will monitor any accounting irregularities and financial reporting deficiency in PLCs through the media release. For any issues found, the MIA will require the auditors to explain the issues concerned. Secondly, the practice review to the practiced MIA members is aimed to increase (1) public trust, (2) the confidence in accounting profession, and (3) the best auditing
practices. Consequently, the MIA is offering its commitment to the high quality of audit work in public practice.

Next is the financial statement review surveillance function. The division works together with the Financial Statement Review Committee to (1) monitor the quality of the published financial statement and (2) review the financial statement cases as referred by the SC and Bursa Malaysia. The MIA also conducts an educational training programme and continuing professional education for MIA members. Apart from the surveillance role, the MIA also conducts financial statement review on selected PLCs and government owned companies on a random basis. In order to improve the best practice of financial statement preparation and auditing works, the MIA will give a response on the financial statements reviewed to the company’s management and auditors.

The MIA will take disciplinary action for any irregularities found in the financial statement and breaches of any auditing standards in the reviewed financial statements. In promoting the transparency of the financial statements of PLCs, the MIA requires the chairman of the Audit Committee to be a qualified member of the MIA (Chartered Accountant) in addition to the independent director of the company.

c. The Institute of Internal auditors Malaysia

The third independent body is the Institute of Internal Auditors Malaysia (IIA). The IIA is an organization that is responsible for promoting the development of the internal audit profession in Malaysia. The institute has a number of roles to promote the best practice of internal auditing. The IIA is a professional body that regulates the internal auditing profession. Therefore, the institute provides a (1) professional educational programme, (2) practice and guidance, and (3) certification programmes to its members. The IIA also organizes educational programmes and training in respect of the appropriate role in risk management, governance and control.
The institute does not have any direct role in preventing financial statement fraud in Malaysia. However, the institute provides a number of awareness programmes to help prevent and detect financial statement fraud. The relevant training that has been provided to the IIA members includes (1) financial statement fraud issues on prevention and detection, and (2) the impact of the International Financial Reporting Standards to internal auditors. In relation to internal auditing works, the research learned that the internal auditor is not responsible for detecting fraud in financial statements. However, according to the International Auditing Standards of Internal Auditing, an internal auditor should have sufficient knowledge to evaluate the risk of fraud in financial statements.

In relation to financial statement evaluation, certain internal auditors of the companies evaluate the company’s financial statement. This is due to the lack of accounting process competency of internal auditors. However, they should be involved in quarterly auditing of financial statement fraud submission.

d. The Malaysian Institute of Corporate Governance

Fourthly, the researcher interviewed the Malaysian Institute of Corporate Governance (MICG). The MICG is an association that is responsible for promoting the good conduct of corporate governance among Malaysian companies and organizations. Even though the MICG does not have any direct role in controlling financial statement fraud, the MICG is responsible for highlighting the roles of company directors. The body also promotes the roles of independent directors in monitoring the company’s internal control. In upgrading the good conduct of company directors, the body provides corporate governance education to the corporate sector and business.

7.1.10 Respondents view on financial statement fraud cases in Malaysia

According to the capital market regulators of Malaysia, there have only been a few financial statement fraud cases in Malaysia. The recent cases that shocked the public are Transmile Berhad and Megan Media Berhad. The cases have had a negative impact on reputational
risk and raised questionable issues concerning corporate governance practice among company directors. For the past five years, the authority has received less complaints and reports from auditors and the public in relation to financial statement fraud. According to the regulator, this is either because the company directors are getting smarter at concealing fraud or the effective deterrents by the regulators and the company itself. However, the majority of the previous financial statement fraud cases have been charged for criminal offences and civil action has been taken by the Securities Commission against company directors. The previous financial statement fraud cases were charged due to financial statement manipulation by inflating the revenue and complex manipulation in the financial statement. Financial statement fraud is viewed as management fraud and is different from employee fraud.

Financial statement fraud cases have involved huge losses and complex manipulation in accounting transactions. The respondents have experienced previous financial statement fraud cases perpetrated by the top management of the company including the chairman, executive directors, managing directors, chief executive officer and chief financial officer of the company. The perpetrators were actually the persons running the company, and, therefore, comprised dependent directors. The instruction from the top management is considered as collaboration with the operating employees in order to create the fictitious figures and documents.

However, financial statement fraud can also be committed by the top management without the involvement of the middle management and operating employees. According to the respondents, financial statement fraud can still occur even when the best controls have been put in place due to the full control by the top management. Therefore, financial statement fraud cases will be more difficult to detect and prevent while the roles of the internal and external auditors become less effective. In this case, the respondents highlighted the importance of the role of the independent directors in preventing financial statement fraud through communication with both the internal and external auditors.
The previous financial statement fraud cases have been subject to civil and criminal action, albeit most of the offences are criminal charges. However, in recent years, the number of reported financial statement fraud cases has been decreasing. This is possibly due to the effective deterrents by the regulators or because the company’s directors are getting smarter in concealing fraud. One of the external auditor respondents viewed the less effective role of the external auditors as being due to the three issues: (1) audit work pressure compared to the audit fees received, (2) the number of senior and junior audit staff in audit engagement, and (3) experienced and inexperienced audit staff engaged in the audit work. Another issue posed during the interviews concerns the matter of enforcement in Malaysia. The penalty for financial statement fraud perpetrators should be increased and the compensation should be improved. The improved enforcement matters would possibly be a deterrent to mitigate financial statement fraud in Malaysia.

7.1.11 Control systems to prevent financial statement fraud

In order to prevent financial statement fraud, the research recorded five different controls suggested by the respondents. The control systems vary from the top level to the whole organization specifically focusing on (1) effective governance practice, (2) audit structure, (3) control framework, (4) fraud risk plan, and (5) minimising the fraud triangle. In relation to effective governance practice, the research found that the tone at the top would provide high integrity throughout the organization. Therefore, every company should have a very strong tone at the top in order to create a good culture in the company. As identified by all respondents, the role of independent directors is vital. The control system will be more effective by having more involvement by the independent directors. The independent directors should be more involved in the financial statement discussion before the issuance of the financial statement.

With regard to the organization’s controls as a whole, the control framework should be designed and implemented across the company. There are four control frameworks
suggested as a mechanism to control financial statement fraud, namely, (1) code of ethics, (2) code of conduct, (3) policies and procedures, and (4) whistle blowing mechanism. The control framework should be understandable by the whole organization while the whistle blowing mechanism should be independent in terms of practice so that any fraud or misconduct in the company will be reported by the employees.

As a fraud control mechanism, the company should design a fraud risk strategy that includes fraud risk assessment and a conceptual fraud plan. As suggested, the fraud risk assessment would assist in identifying and evaluating the fraud exposure in each part of the financial statement process. In addition, the conceptual fraud plan will further assist the company to deal with the identified risk of fraud. The roles of both the internal and external auditors are important in preventing financial statement fraud in every company. Internal auditors are found to be essential to determine that the control mechanisms conform to the planned arrangements. In addition, the controls should be effectively implemented and maintained. Moreover, the main role of the external auditors is to ensure the financial statement prepared by the company is true and fair view.

Therefore, the research found that effective structures for both auditors are vital in preventing financial statement fraud. It is suggested that the internal auditors be knowledgeable so that any weaknesses can be detected in any controls designed. They should be the main person in a company who is able to detect any misconduct and financial statement fraud in particular. The external auditors have to play their role in preventing financial statement fraud during their audit work. To be more effective, the reporting line of both auditors should be independent and clearly structured.

The control system could also be achieved through an effective audit methodology by external auditors. Even though an external auditor is not responsible for detecting the company’s financial statement fraud, an effective audit methodology through auditing works would be able to detect any irregularities and fraud in the financial statement. The fraud
triangle approach has been suggested as one option to control financial statement fraud. Financial statement fraud can be controlled by minimising the three elements of the fraud triangle – pressure, rationalization and opportunity – that arise in the company.

There are four elements that constitute pressure for individuals to commit fraud in a company. The elements are from the company's (1) goals, (2) compensation system, (3) operational procedures, and (4) external expectation. In order to minimise the pressure to commit financial statement fraud, firstly, the financial goals set by the company should be realistic and suitable with the current market condition. In addition, the company should also avoid any excessive pressure on the company’s individuals. Secondly, the compensation system should be reviewed and updated according to the current economic value so that any pressure in relation to this system will be minimised. The third is the operational procedure that should be reviewed to avoid any delay in respect of effective performance. Lastly, is discouraging the extreme external expectations of corporate performance.

The second element of the fraud triangle that should be minimised is opportunity. The opportunities for individual to commit financial statement fraud arise from four sources, namely, (1) accounting system, (2) business transactions, (3) security system, and (4) company’s employees. The accounting system should be clear and understandable to the finance staff while the accounting recording system must be properly completed, maintained and accurate. In order to maintain an effective accounting system, a strong supervisory control on the accounting procedures enforcement should be in place. Since financial statement fraud involves complex transactions and manipulation, the business transactions should be monitored, specifically, on credit customers and suppliers. In relation to company employees, the company should do background checking on new employees and maintain an accurate personnel record. Eventually, the security systems of the company that involve Information Technology Security systems and other security system for valuable assets should be established in order to minimise any opportunity of people to commit financial statement fraud.
Eventually, the rationalization of people committing financial statement fraud can be minimised through (1) policies and procedures, (2) rules and punishments, and (3) values. To minimise rationalization, the company should clearly define the designed policies and procedures governed by the company. The rules and punishment of any misconduct and financial statement fraud should also be clearly communicated to show that the company does not tolerate any misconduct or fraud. In order to promote a good culture within the company, the values of honesty, integrity and ethical conduct should be inculcated among the company individuals. This might be achieved by conducting regular training on ethics and integrity and providing an ethics hotline to report any misbehaviour.

7.1.12 Prevention, detection and response strategies

In relation to financial statement fraud control and mitigation, the research has compiled three strategies of prevention, detection and response as suggested by the interviewed respondents.

a. Prevention Strategies

Prevention strategies are found to be important in controlling financial statement fraud in a company. The respondents found that prevention is better than detection. In relation to prevention strategies, most of the respondents highlighted the value of integrity among the individuals as the most effective method to prevent financial statement fraud. According to the regulators, the value of integrity is the best prevention control even though it cannot be legislated. Therefore, a company should hire good people and inculcate the value of integrity as the company’s culture. As suggested, the company could increase the value of integrity by (1) education, (2) enforcement tools, and (3) instilling the fear of God. Most of the respondents state that the best system in the world will not be effective without the value of integrity among the company individuals. The Securities Commission has suggested that companies use enforcement tools to increase integrity among the company’s individuals. As
such, the punishment and compensation would portray that the company does not tolerate any fraud and misconduct.

Another prevention method that was highlighted during the interviews is setting the tone at the top. From the perspective of the Malaysian Institute of Corporate Governance, the company should appoint a capable and honest leader to lead the company so that the culture of integrity is established throughout the organization. Furthermore, the MIA has proposed that the company conducts an evaluation of directors among the board of directors for the purpose of renewal. In this respect, the corporate governance (CG) practice should effectively govern the role of company directors. This is found to be an effective prevention tool at the top level. Even though the practice of the CG is not mandatory in Malaysia, the Listing Requirements of Bursa Malaysia requires it to have an audit committee, which is needed to implement the CG practice in a company.

In recent times, the roles of the independent directors and audit committee are found to be important as a financial statement fraud prevention tool. According to the regulators, the independent committee should understand the report that has been presented by the company. In fact, they have to challenge the company’s management on any issue that has been highlighted by the auditors. Consequently, they have to be more proactive and competent in accounting matters. The SC is currently promoting the strong role of independent directors and audit committee as a prevention tool to prevent financial statement fraud in Malaysia.

Further issues concerning methods of prevention include the company procedures and systems. The external auditors and the MIA have highlighted the importance of the code of conduct, and policies and procedures. The policies and code of conduct should be clearly communicated across the organization. The written procedures would assist employees to understand the whole process and system of the company. The external auditor should also highlight a clear policy for every aspect of the accounting process. Moreover, internal control
over financial reporting (ICOFR) is found to be a significant tool to prevent financial statement fraud. The MIA states that the company’s ICOFR should be designed by an accounting expert or accountant. In line with the accounting information system, the importance of an information technology security system was stressed. As such, the internal control over financial reporting should consider the IT controls in accounting recording. The risk management programme is one preventive tool that appears to be effective in preventing financial statement fraud. One of the respondents from the Malaysian Institute of Corporate Governance suggested that a company should have an effective risk management programme, which should be implemented across the company.

For the auditing part, the external auditor also highlights the effective audit work of the internal and external auditor. The Forensic Accountant of PWC suggested that a company should hire a very competent and experienced internal and external auditor to assist the company to prevent financial statement fraud. In terms of monitoring system, the financial statement should be continuously monitored through the internal control even after the completed audit work. The external auditor found this to be a crucial stage in preventing financial statement fraud and to avoid any changes in the financial statement information. The research also identified the importance of hiring the right people for the right job. As such, they should be accounting competent to do the accounting jobs. Training is important to update the knowledge and skills. Thus, the company should provide regular training on new accounting updates and standards. In addition, regular training on integrity and ethics should be done in order to create good practices and culture. In relation to this, the company individuals will always be reminded of the value of integrity required by the company.

KPMG suggested minimising the three elements of the Fraud Triangle to prevent financial statement fraud. The elements of pressure, opportunity and rationalization should be minimised in order to control financial statement fraud in a company. In addition, the MIA suggested that the company could minimise the opportunity of committing financial statement fraud by having good internal control over financial reporting, segregation of
duties, and good working place. At a higher level of financial statement fraud control, the company should emphasize the role of the board of directors, integrity among the top management and the role of the audit committee.

One of the company management found that variance analysis could be an effective tool to prevent financial statement fraud while the accountants and auditors should also highlight the materiality concept in accounting and auditing work. In order to prevent financial statement fraud, a company should provide effective reporting channels to report any fraud in a company. Therefore, whistle blowing system and hotlines are suggested to be a prevention method for financial statement fraud. The company should provide protection for informers, so that individuals in the company are more confident to speak up and report any fraud or misconduct. It is suggested that the hotline be channelled directly to the Securities Commission and top management. Other aspects include (1) good practice, (2) good working environment, and (3) job satisfaction, which would prevent any fraud and financial statement fraud in particular. Thus, it creates a good culture within the company.

b. Detection Strategies

The second strategy of the anti-fraud programme is detection. According to the Forensic Accountant of PWC, the Transaction Risk Investigation Analysis (TRIA) is a type of software being used to detect suspicious transactions. The accounting preparer has to set the threshold amount so that the system would flash up any amount beyond the threshold. This software is recommended as one of the detection tools to detect financial statement fraud. PWC’s Forensic Accountant also suggested that financial statement fraud could possibly be detected by an experienced internal auditor. According to him, it is not the responsibility of the external auditor to detect financial statement fraud during the auditing work. However, the external auditors should pick the right samples that enable the detection of financial statement fraud. The external auditors are not trained to investigate as they are not the
forensic accountants. However, any suspicious transaction detected should be reported to the audit committee.

In addition, the Forensic Accountant of KPMG Malaysia recommended the whistle blowing mechanism and hotline as an effective tool for detection. Whistle blowing is an effective tool to control any misconduct among the top level of management while the hotline procedure should be established to support the whistle blowing mechanism. These detection tools are considered significant methods to report fraud where the fraud is perpetrated by the top management. Whistle blowing and hotlines have become more effective as the SC has provided protection to the informers under the CMSA 2007 Act. Furthermore, KMPG also recommends effective monitoring of the FS process as a detection tool to detect financial statement fraud. One of the Group Chief Financial Officers said that the company may use the variance analysis to detect any irregularities in financial statement and financial statement fraud in particular. The different detection mechanisms suggested by the ACFE is the establishment of the investigation unit that work under the audit unit. The company may also hire a forensic accountant to deal with the accounting investigation where appropriate.

c. Response Strategies

In relating to response strategies that should be developed in every company, the Forensic Accountant from KPMG proposed the integration of response and corrective actions as one of the response strategies in preventing financial statement fraud. The response strategy is the action taken when fraud happens in a company. It can also be considered as an interval process of investigation and protocols. A company is found to have a duty to lodge a report to the authorities for any misconduct. Thus, it shows a tighter control and people cannot rationalize to commit financial statement fraud.

In addition, the response strategy would also control the opportunity for people to commit financial statement fraud. In relation to the response strategy, KPMG has suggested that companies design a fraud control plan. The control plan should include the procedures
action, and authorised persons or departments that are responsible to be in charge of the investigation. Once the investigation is in progress, the company should determine any procedure for forwarding the issue to either the audit committee or board of directors. Eventually, the company should determine the appropriate action to be taken in respect of the fraudster and inform the whole organization. It may be informed through any training or any other medium of communication. The response strategy should include the corrective actions. The corrective action is considered as an action taken by the company management to remedy and tighten the controls. Two types of corrective action are suggested by KPMG. Firstly, the action taken by the company to voluntarily discloses the investigation result to the authority where appropriate. The company also has to remedy the harm caused by financial statement fraud by measuring the fraud cost.

Another corrective action is examining the root cause of the breakdown in control, which might possibly be due to the lack of segregation of duties and supervision. However, effective response strategies should have a strong tone at the top and good enforcement mechanism. According to the Forensic Accountant of PWC, the response strategy should be designed once the company has implemented the fraud risk management and anti-fraud programme. The response strategy will provide details of the investigation procedure, responsibilities, tasks and the communication channel. The company should also consider the protocol of the investigation when the investigation is being carried out while the business operation is still running.

The response plan should include corrective actions for previous fraud cases through which the company may set new controls to prevent a particular type of fraud. In this respect, the company should consider the practicability of the internal control designed. The internal controls should be periodically assessed to the adequacy of controls designed. Moreover, the internal controls should be updated due to the business changes in activity, division and globalisation. The company must be aware of the complex business environment that requires a comprehensive internal control.
From the external auditors’ perspective, the response strategy is clear written guidance to respond to financial statement fraud. The company should understand the internal and external response processes. For the internal response process, a company has to form a response committee and an investigation committee. The committee may involve representatives from various departments – Legal, Human Resources and Finance. Where appropriate, the company may hire an external expert to investigate financial statement fraud. For asset misappropriation case, a detailed methodology should be established for asset recovery and securing the evidence. According to another external auditor respondent, the response strategy depends on two types of financial statement fraud. The first is financial statement fraud that harms the investors, and, secondly, financial statement fraud that harms the company where it has been committed by the company management to achieve the bonuses of the company. For the first type of financial statement fraud, the company misrepresents the financial statement information to show good financial performance of the company.

This financial statement fraud is committed by the top management to mislead the company’s investors. The situation of this financial statement fraud is more complicated as the top management has all the controls. To respond to this type of financial statement fraud, PLCs, in particular, have to improve the role of the independent directors and audit committee. They have to be more involved in business communications. As such, the independent directors have to understand the whole situation to understand the company’s financial position. The audit committee should have good communication with the accounting preparer. The second type of financial statement fraud is less complicated from the first type of financial statement fraud. Since it has been committed by the company management, the company has to improve on the (1) process of financial statement, (2) control of financial statement, (3) increase the monitoring of financial statement process, and (4) increase the checking process before the company publishes financial statement fraud.
CHAPTER EIGHT

DISCUSSION AND ANALYSIS OF CASE STUDY AND INTERVIEW FINDINGS

8.0 Introduction

The aim of this chapter is to discuss the results of the case studies, thus answering the research questions as designed and stated in chapter one. The research supports the research discussion with the results from the interviews of the group interviewees and review of the regulations and guidelines. The analysis of the research findings provides a deeper understanding concerning the present control of financial statement fraud in commercial companies. The research claims that the case study findings reflect the actual practices of financial statement fraud control in the two case companies in Malaysia, which are subject to the requirements of practice in Malaysian commercial companies. The research aims to make recommendations to improve financial statement fraud control, specifically, examining and investigating the present practices of financial statement fraud control. Therefore the research questions of the present research mainly focus on acquiring and investigating the present practices of financial statement fraud control in both case study companies. The case studies and interview information are gained from the top level of management from both case study companies and institutions, which, although challenging, are reliable and useful in return.

The research fills the gaps in financial statement fraud research issues for which previous researchers and professional reports used quantitative and secondary information. In addition, the research provides new knowledge of financial statement fraud and improvements to financial statement fraud control based on the actual and present practices of two large commercial companies in Malaysia. In relation to the present practices of financial statement fraud control, the research contributes new issues and knowledge to the internal audit expectation gap. The results of the internal audit expectation gap indicate the need to review the internal control and the internal audit functions in order to minimize the
identified gap. The enhancement and development of internal audit functions possibly increases the mitigation of financial statement fraud in commercial companies. Finally, the research contributes to academic theory in relation to theoretical concept of financial statement fraud control, the theoretical concept of internal auditing of financial statement and regulators and standard setters. The following sections provide the basis of these contributions and thus answer the research questions. Specifically, the research focuses on the following five research questions in subsections 8.1 to 8.5, and as explained in chapter one of the research.

8.1 What, if any, prevention, detection and response strategies are in use in relation to financial statement fraud?

The first research question examines the present practices of financial statement fraud control and evaluates any prevention, detection and response strategies that are in use in the two case companies. The following subsections discuss the results of the present practices at both case study companies and the analysis of the results in this section are used to provide improvements in financial statement fraud control in commercial companies.

8.1.1 The prevention strategies

The research findings indicate that the prevention strategy is considered the foremost strategy among the detection and response strategies. In relation to the present practices of financial statement fraud control at the two commercial case companies, the research findings indicate that neither case study company is highly concerned about the issue of financial statement fraud control. Therefore, the findings concerning financial statement fraud control and the strategies of prevention, detection and response are typical of those in practice. From a practice perspective, both companies rely highly on their internal control to mitigate financial statement fraud. In relation to this, the research examines the present practices of internal control and how the present control system is used to mitigate financial statement fraud.
a. Internal auditing and the role of the internal auditor in relation to financial statement fraud control

In conformance with the present practices of the case study companies, which are highly reliant on the internal control system to prevent and detect fraud in financial statements, this section discusses and examines the internal audit work and the role of the internal auditor in relation to financial statement fraud control. Presently, the focus of the internal audit functions in both case study companies is on the operational audit with particular emphasis on corporate risk. The research findings indicate that the scope of the internal audit work is not primarily concerned with the accuracy of the financial statements but with the risk of losses to the companies. In addition, the role of the internal auditor in both case study companies is to ‘ensure’ the design of the company’s internal control and to ‘assure’ its compliance with the company’s policies and procedures and regulatory requirements. In addition, the internal auditors are also responsible for reviewing compliance in relation to the corporate governance code at the board level of the company (Chapter 5, page 18).

In respect of the internal auditing of operating procedures, the internal audit work provides assurance of their compliance with the accounting and finance policies and procedures, accounting standards, and regulatory requirements. Both the case study companies have something in common in respect of the internal auditing in relation to the financial statement process. The internal auditors aim to assure the conformance and timeliness of the procedures applied in all departments. Examples of internal audit work in relation to the process of financial statements at both case companies comprise auditing (1) the access control on information technology system, (2) the regularity of reconciliation of the balance sheet, (3) segregation of duties in the finance department, (4) the adherence to payment processes, contracts, procurement and work orders and (5) treatment of plant and maintenance procedures. In accordance with the above findings, the case study companies perceive that the present internal controls are able to prevent any fraud including financial statement fraud. From the perspective of the head of internal auditors, compliance with the
present controls would prevent financial statement fraud, unless the fraud is manipulated through the accounting treatment and thus should be detected by the external auditor. The research findings indicate that the control of financial statement fraud risk is inconsequential in the context of the scope of internal auditing of both case study companies.

c. External auditing and the role of the external auditor in relation to financial statement fraud control

The research further discusses the present role and practices of the external auditing and external auditors in relation to financial statement fraud control. The research findings indicate that both case study companies appear to perceive that another control of financial statement fraud is achieved by the external auditing function. Further, the internal auditors and company management are under the impression that the external auditors are responsible for detecting fraud in the company’s financial statement during their audit work. However, the external auditor perceives that the general role of the external auditors does not include financial statement fraud detection as its primary role. What the external auditor practises at present is providing an opinion based on the audited financial statement at every accounting year end. However, they will report any fraud found in the course of the external audit work. The research further discusses the responsibility of financial statement fraud detection and control in the context of the perceived responsibility of the company management, and internal and external auditor.

d. Financial statement fraud detection and control responsibility

In this subsection, the research discusses financial statement fraud detection and control responsibility in tandem with the companies’ perception concerning internal and external auditing as the key control of financial statement fraud. In this context, the company management perceives that the control of financial statements is achieved from the internal and external audit work. The control of financial statement fraud in this context includes the
prevention and the detection of fraud in the financial statement in the course of internal and external auditing.

Clearly, the management of the company is responsible for ensuring that sufficient controls are in place in the organization and to ensure that any error, misconduct or financial statement fraud, in particular, have been measured and detected. In addition, the role of the internal auditor is to review the present control, report and recommend the effectiveness of the controls designed in the companies through the internal audit functions, while the external auditor is responsible to audit the completed financial statement and provide an audit opinion concerning the audited financial statement. The audit opinion refers to whether the presented financial statement gives a true and fair view in accordance with the International Standards of Auditing framework (International Standards on Auditing 200, 2013).

Furthermore, in relation to the financial statement process, internal auditing in both case study companies provides assurance concerning the compliance of the accounting and finance policies, procedures, accounting standards, and the relevant rules and regulations. However, neither company provides any assurance concerning the accuracy of the final published financial statement. Therefore, the scope of the internal audit work does not involve any detection procedures to detect any error, irregularity or fraud in the financial statement except for compliance with the operating procedures. In addition, the external auditors of the case study companies provide the assurance of the accuracy of the final published financial statement through the external auditing functions.

However, the research findings indicate the different perceptions that emerge between the internal and external auditor concerning the responsibility for the detection of financial statement fraud. The external auditors believe that the internal auditor of the company is responsible for detecting fraud in financial statements in the course of internal auditing. From their perspective, the internal auditors of the company are supposed to be the first defence
of the company who give assurance concerning the company’s operating systems including financial systems. In contrast the internal auditors of the company believe it is the responsibility of the external auditor to detect financial statement fraud in the course of external audit work (Chapter 5, page 20).

Conversely, the understanding of the internal auditors is that the external auditing of the financial statement should detect any financial statement fraud, as the internal audit procedures have already given assurance concerning the compliance of the accounting policies, accounting standards and regulatory requirements of the financial statement. From the perspective of the internal auditor, the responsibility of the external auditor is to identify any fraud in the financial transactions and financial statement (chapter 5, page 7). This indicates the gap in financial statement fraud detection and control responsibility inasmuch as both case study companies believe that the present practices of internal control, internal and external auditing are able to control and detect financial statement fraud while the research findings indicate the diverse perceptions of detection and control responsibilities between the internal and external auditors of the companies.

e. Present system of financial statement fraud control

The research further discusses the present system of financial statement fraud control in the context of the financial statement preparation process and other relevant controls in the companies. The results of the case studies and interview findings indicate that effective prevention strategies for financial statement fraud should involve the two parts of prevention control, namely, (1) financial accounting process control and (2) financial statement fraud preventive control. The research classifies the financial statement process controls as the main control that is involved in the transactional financial accounting process and throughout the financial statement preparation until the issuance of the financial statement. In addition, the financial statement fraud preventive control involves the support controls throughout the company’s system. Support controls in this context refer to the controls other than the
financial accounting process controls that can be used to control fraud in the financial statement. The following sections discuss the two identified strategies, particularly, the design of the control in the financial accounting process and preventive controls that the research perceives as an effective prevention strategy to control financial statement fraud in commercial companies.

i. Control in the financial accounting process

The research findings indicate that the main control of financial statement fraud should be derived from the financial accounting process. The controls for the financial accounting process involve the control of financial statement preparation from the beginning of transactional financial accounting, control at every financial accounting process, the auditing process and the issuance and publication of the financial statement. The controls aim to ensure that the correct financial statement is prepared by the companies through compliance with the financial reporting requirements. The financial accounting process involves the various levels of the accounting process before the consolidated financial statement is prepared at the group level. For the purpose of this research, the researcher focuses upon the controls that have been designed at the group level to produce the consolidated financial statements for both case study companies.

In relation to the control of the financial accounting process, the chief financial officer (CFO) of the respective company is responsible for ensuring adequate control of the transactional financial accounting process until the financial statement is completed and submitted for auditing. The transactional financial accounting process controls encompass the entire financial statement process. Adequate controls in the transactional financial statement process are to ensure that the correct financial statement is prepared and that the financial information gives a true and fair view of financial presentation. The true and fair view in financial statements should be free from any material misstatement and must be produced in a timely manner.
The research findings indicate that the design of the controls in the process of transactional financial accounting are explained in the accounting and finance policy. The accounting and finance policy are approved at the board level and reviewed by the companies’ audit committee. In addition to the accounting and finance policy, company A has designed a Financial Control Framework, which is an additional control in relation to the financial statement process. The case study findings indicate that the financial accounting process comprises three controls before the financial statement is published to the public. The following diagram (Figure 8) shows the three phases of the controls discussed:

**Figure 8: Financial accounting process control in case study companies**

Control one in figure 7 above refers to the financial accounting process control and the research identifies it as at the transactional accounting level, which is aimed at preparing the full set of accounts. In this case, the chief financial officer is responsible for implementation of the controls and ensuring that adequate controls are designed for each accounting process. The controls by the chief financial officer are to ensure compliance with (1)
accounting and finance policies and procedures, (2) accounting standards, and (3) regulatory requirements. The controls that appear in the company's policies and procedures describe the job responsibilities of the financial statement process, job descriptions at each level, the limit of authority, the competency of the finance and accounting team and the timeline of the financial statement reporting at each level of the organization. Therefore, the staffs throughout the entire organisation have a clear direction of each financial statement process and their respective role and responsibility. While the internal auditors of the companies are responsible to review the quality of the control designed and the completeness of the control implementation.

Control two in figure 7 above appears when the financial statement is completed. In this phase, the group chief financial officer is responsible for reviewing the completed financial statement by giving assurance of the completeness and the accuracy of the financial statement before it is submitted to the external auditors. Subsequently, control three appears when the completed and reviewed financial statement is submitted to the external auditor for the auditing process. The external auditor contributes control through their external auditing work. The completed financial statement is audited by the external auditor before the audit opinion is given for the audited financial statement. In the course of the external audit work, the external auditor will query any raised issues or material misstatement found. Thus, the chief financial officer is responsible for ensuring that ‘clearances’ are made to the relevant accounts. The term ‘clearances’ is used in both case companies to refer to an action by the chief financial officer to resolve the issues raised by the external auditors during the external auditing work, for example, queries raised in relation to stock valuation and impairment of asset management. The ‘clearances’ made of the audited financial statement will be reviewed by the internal auditor before the board audit committee meeting. Another two controls that have been identified at this phase are derived from the roles of the internal auditor and audit committee. The internal auditor plays their role to ensure the amendments have been made to clear the issues raised by the external auditors. In the meantime, the
audit committee is responsible to oversee the completeness and the accuracy of the audited financial statement. In the case of any new raised issues and suggestions made by the audit committee, it will be brought forward to the board of directors of the companies. In the case of a ‘clearance’ from any issue arising, the audited financial statement will be submitted for board approval. Finally, the control is derived from the board of directors, in which the approved audited financial statement and the completeness and the accuracy is agreed between the board of directors and the external auditors, and the financial statement is signed off by the external auditor as being a true and fair view. For public companies, the approved audited financial statement is presented during the Annual General Meeting for shareholders’ approval and published in the company’s website to reflect the good governance and the transparency of the financial statement. However, the public listed companies will further submit to Bursa Malaysia for the purpose of Bursa Malaysia’s listing requirements.

The research findings of the financial accounting process control indicate the three controls that emerge before the public issuance the responsibilities for which can be summarised as being primarily that of the chief financial officer and company board of directors. In this context, the chief financial officer is responsible for ensuring the completeness and accuracy of the financial statement prepared by the group accounting and finance departments and the board of directors is responsible for ensuring that the financial statement published by the company reflects a true and fair view of the financial position and financial performance

ii. **Financial statement fraud preventive and support controls**

In addition to the control of the financial accounting process, as discussed in (a) above, the research findings indicate the importance of the integrated controls of the financial accounting process and the six preventive controls due to the associated risk of financial statement fraud. The research differentiates the control of the financial accounting process to that reflected in the control of the preparation of the financial statement. In addition,
preventive control is non-accounting practice control that is regarded as a support control that is used to mitigate financial statement fraud in commercial companies. The preventive controls that have been identified include (1) methods and practice, (2) hiring and nomination process, (3) evaluation of performance and compensation, (4) company’s relation with stakeholders, (5) governance, and (6) culture (figure 9).

Figure 9: The financial statement fraud risk preventive and support controls

The financial statement fraud preventive controls, as shown in figure 8 above, are associated with the risk of financial statement fraud in the many departments and business functions. The preventive control of financial statement fraud requires proper methods and practice of a control system. The research findings indicate the importance of the company management in evaluating the effectiveness of the accounting policy and procedures designed that should be able to mitigate financial statement fraud. The research suggests that the anti-fraud programme in relation to financial statement fraud is designed and adopted as recommended by the professional bodies. The guidelines of the adopted anti-fraud programme is discussed in chapter four of this thesis, however, it has to be amended in accordance with the practice of financial statement fraud control. Other findings that have been highlighted from the respondents include the security of information technology
embedded in the computerised accounting system. In this context, unauthorised access to the accounting system requires a tighter monitoring process by every head of the accounting process to prevent any fictitious recording and amendment to accounting transactions. The researcher considers access authorisation as a potential risk of financial statement fraud and possibly one of the major issues that should be considered in financial statement fraud control. In addition, the accounting software adopted by the companies should be periodically maintained and updated due to the rapid changes in information systems. However, in addition to the security of information technology system, the factor of human competency in the related field of accounting and finance is significant for the production of an accurate financial statement.

The research findings indicate the importance of the effective hiring and nomination process as a preventive financial statement fraud control. This is possibly related to the risk of financial statement fraud if the company hires a dishonest person or perpetrators of fraud from other companies. The nomination of directors is explicitly linked to nominate the integrity and the honesty of directors due to their responsibility to ensure that an accurate financial statement is published by the companies. The importance of scrutinising the nomination process is in accordance with the research findings by Brennan (2007), which indicate that 71% of the financial statement fraud cases studied involved the company directors. The preventive strategies of financial statement fraud also include the evaluation performance and compensation given to the board of directors and senior management. The research findings indicate that the evaluation and the compensation methods are closely linked to the risk of financial statement fraud motives that might be used to achieve the bonuses and compensation.

The research findings indicate the importance of the company management to establish legal relationships with the company’s stakeholders. This is consistent with the causes of previous financial statement fraud cases that include fictitious suppliers and customers in order to achieve fraud objectives (Fifth, 2005). In this context, the auditing plan of the
internal and external auditor should be more concerned with checking the real existence of credit customers and creditors and the legal relationship. Given that the responsibility to ensure that an accurate financial statement is published by the companies is the burden of the company directors, the research indicates the importance of corporate governance practice in commercial companies. The preventive control governed by corporate governance includes the setting of the company’s strategies and objectives, policies and procedures, organizational structure, and compliance with the code on corporate governance; thus, shaping the right direction of the companies through the practice of good corporate governance at the top level and throughout the organization. In addition to all the preventive controls that have been discussed above, the research findings indicate the importance of good culture in commercial companies. The context of culture implies the ethical manner of business conduct that governs all the business transactions.

8.1.2 The detection strategies

The research findings indicate that detection strategies are important for financial statement fraud control. The strategies are occasionally relevant to the prevention strategies. To be specific, IIA et al. (2007) define fraud detection as a principle in managing the business risk of fraud and providing evidence of fraud. The findings from the case studies indicate that both companies use similar strategies to prevent and detect fraud in financial statements. Presently, the companies rely upon internal and external auditing, and whistle blowing and hotline procedures for the detection of financial statement fraud. The company management perceives the present internal and external auditing as being able to prevent and detect any fraud or irregularities in the financial statement. In the meantime, whistle blowing and hotline procedures are a fraud detection tool that is used as a reporting channel to report fraud in the companies. The research indicates that the company management highly perceives that the detection of financial statement fraud can be achieved through the internal and external audit functions. However the diverse perception of the detection responsibility emerges in the present roles of the internal and external auditors.
8.1.3 The response strategies

In addition to the prevention and detection strategies in relation to financial statement fraud, the research discusses the response strategy to complement the prevention and detection strategies of financial statement fraud control. The response strategy has been identified as an important strategy for financial statement fraud control to ensure the company has taken appropriate action concerning the reported financial statement fraud cases, appropriate punishment has been imposed on the fraudster, and the corrective action has been reserved by the company in relation to the previous fraud cases. However, the research findings indicate that the issue of financial statement fraud has not been recognized as a main risk in the companies risk management programme. Therefore, the research has not recognized any specific response provided by the companies as a strategy of response and corrective action in relation to financial statement fraud. However, the research findings indicate that any reported misconduct or fraud in the case study companies are managed by the respective legal department and the human resources department according to the company's policies and procedures. Given the high impact of financial statement fraud cases, the research suggests that the companies design specific response strategies. Therefore, the reported financial statement fraud cases should be properly responded to and corrected by the company. In addition, the proper response strategy possibly assists the company in remedying the harm caused by the fraud and enables the company to evaluate and tighten the company controls. Finally, the companies have a proper channel to report fraud in the context of the regulators enforcement.

8.2 What are the current best practices of PDR strategies?

The research aims to provide improvement for financial statement fraud controls, and, thus, examine the present practices in both case study companies. Therefore, the second research question attempts to identify any best practices of financial statement fraud control, particularly, to evaluate any practice strategy of prevention, detection and response in
relation to financial statement fraud. The research findings indicate that the present practices at both case study companies do not have any specific control or unusual practices and developed strategies of prevention, detection and response in relation to financial statement fraud control. However, the research has acquired the facts concerning the present practices that have been perceived as being able to achieve the control of financial statement fraud in both companies. Based on the case study findings, the research integrates all the controls and strategies adopted from both case study companies. The following figure (10) explains the present controls adopted and practised in both case study companies.

**Figure 10: Present financial statement fraud controls from both case study companies**

The research findings indicate that similar controls are commonly used by the case study companies, namely, internal controls that include standard policies and procedures, business ethics and corporate governance. However, the different controls that have been identified from both companies are the Financial Control Framework and Risk Management Framework. The management of these companies perceive that the present controls are used to mitigate the risk of fraud, and, particularly, financial statement fraud. The research integrates the different control practices at the different companies to reflect that the two different controls are possibly complementary for effective financial statement fraud control and possibly cover both aspects of the financial statement process and non-accounting
controls (discussed in section 8.1.1 (e) (i)) and preventive controls (discussed in section 8.1.1 (e) (ii)).

The research findings indicate that the Financial Control Framework is designed as an additional control in the financial statement process. It is designed in company A by replicating the Sarbanes Oxley Act 2002 from the United States. The framework mainly aims to provide control assurance in the financial accounting process even though the companies in Malaysia are not subject to the SOX 2002. The controls designed in the Financial Control Framework include the controls for each financial statement process encompassing the entire company from the division to the group level. The most important control adaption is the management certification of the internal controls designed over the financial statement. However, the attestation of the controls designed has not been evaluated or reviewed by the internal and external auditor and the management letter has not been published to the stakeholders. The control appears in the framework's aim to give assurance of the controls taken over the financial statement at every level of the company, which therefore improves the accuracy and the reliability of the group financial statement. The Financial Control Framework is an effort of the company to provide assurance of the company's transparency in respect of the financial statement. In contrast to the public companies' practice in the United States, the signing officers of the United States public companies' are required to establish, maintain and evaluate the internal control over the financial reporting process and the accuracy of the financial statement presented. Section 404 of the Sarbanes Oxley Act 2002 requires that the external auditor attests the management assessment of the designed internal control over financial reporting. Thus, the internal control over financial reporting will be audited and reported by the independent auditor. In this case, the company’s shareholders and the public would have the two different reports on the internal control over financial reporting and they would be able to evaluate the transparency of the financial statement.
The research findings indicate the different approaches that have been taken by case study B. Even though the present control has not included any specific control in relation to financial statement fraud control, company B highlights the risk management programme as the strategy to protect the company from any type of business fraud including financial statement fraud. The company perceives that the present controls and practice are able to protect the company from financial statement fraud. The designed Risk Management Framework includes adequate financial controls, internal controls and company’s governance. The framework, which was designed and adapted from Ernst and Young’s risk management model, reflects the aim for adequate control over the company’s internal controls including financial controls. The research found that what makes the framework useful for the preventive control of financial statement fraud is due to the four areas that have been emphasized in the framework, which comprise the three main areas of governance, people, and methods and practice. Apart from the above controls, the research findings indicate that the financial statement fraud controls involve the company’s business ethics, which are used to support the good conduct of the company’s stakeholders. The research findings indicate that the case study companies perceive the effectiveness of the present controls to mitigate financial statement fraud as neither case study company has experienced any incidence of reported financial statement fraud. Furthermore, no financial statement fraud cases have been reported through the whistle blowing and hotline procedures.

8.3 What are people doing and why are they doing it?

In examining the present practices of financial statement fraud control in both case study companies, research question three aims to understand the design of the present controls and the underlying reasons for their implementation. The research classifies five groups of different controls that appear in both companies practices to control financial statement fraud. These are (1) internal control system, (2) whistle blowing, hotlines and business
ethics, (3) Financial Control Framework and (4) prevention and detection mechanism. The following subsections discuss the controls and the underlying reasons behind them.

### 8.3.1 Internal control system

As large public companies, the resources of both case companies are well directed, monitored and measured. The research findings indicate that both case study companies have designed well-structured internal control systems that aim to meet the common objective of internal control management. Presently, both companies provide a uniformity of accounting process across the organizations and the complexities of business transactions are well guided by the companies’ policies and procedures. The research found that the policies designed describe the roles, job responsibilities, and flow of authority for each of the accounting functions. In addition, the procedure, which is an approved standard, describes each process requirement and provides the reporting line framework, particularly in respect of the financial statement process. Both case study companies publish a statement of internal control in the company’s annual report to provide assurance concerning the design of such controls. The statement aims to provide confidence in the effectiveness of the internal control and risk management practices in the organization. The research findings also indicate that the required improvements to the present system of internal control are possibly effective for financial statement fraud control. The results of the present practices indicate the importance of specifying assessment of the financial statement fraud risk. However, the research findings indicate that neither case company has assessed the risk of financial statement fraud in their risk management programme. The research found that it is significant to identify the risk of financial statement fraud as it possibly appears in business transactions. Furthermore, the identified risk needs to be evaluated by the company’s management. In this case the audit committee and board of directors should consider ways to evaluate the role of the company’s accountant and internal auditor in relation to financial statement fraud control.
8.3.2 Whistle blowing, hot line procedures and business ethics

The research findings indicate that whistle blowing, hotline procedures and business ethics training are three mechanisms that are commonly used to govern good practices in business. The controls are embedded in the companies’ internal control systems, which are found to be an effort to govern values for every individual and to encourage them, behave ethically. Any reported of improper conducts and fraud will be investigated by the whistle blowing committee. A meeting is held at least once a month to discuss the investigation of the reported cases and further action. The case companies also protect the confidentiality of whistle blowers provided that the report is made in good faith.

In any case of fraud, the whistle blowing and hotlines are found to be effective as reporting channels to report fraud in the companies, in particular, financial statement fraud. The present practices of both case study companies indicate that these three mechanisms are presently used to prevent and detect financial statement fraud, and that both companies are concerned with the confidentiality and safety of informers. From a practice perspective, business ethics procedures are in place to guide each and every individual in the company concerning how to conduct business professionally and ethically. In addition, the whistle blowing and hotline procedures are two mechanisms that are used to report the misconduct and unethical manner of respective individuals. Apart from the whistle blowing and hotline procedures provided in the companies, the capital market regulators also provide these channels to report any type of fraud including financial statement fraud. This indicates the adequacy of the reporting channel within the companies and capital market, as well as the high level of confidentiality to ensure the informers are well protected.

8.3.3 Corporate governance

The previous financial statement fraud cases have raised public concern concerning the corporate governance practice in organizations. The board of directors is expected to ensure the transparency of the reported financial performance. In this case the reported financial
information should reflect the factual financial condition and the financial statement should provide a ‘true and fair view’. The research findings indicate that throughout the history of both case study companies, they fully adhered to the highest standards of corporate governance. The statement of corporate governance is issued annually to inform the company’s stakeholders of the commitment of the board of directors in directing the business ethically and performing within the high standards of corporate governance. In respect of the financial statement fraud control associated with the board of directors, the research suggests the high involvement of the independent directors of the audit committee to oversee the conduct of the company directors in relation to financial statement matters. Given the high risk associated with financial statement fraud, the research also proposes that the standard setter or regulators review the fines imposed on company directors for any cases of financial statement fraud. From a review of the regulations of the three countries, the research found that Malaysia imposes the lowest fines on company directors in relation to financial statement fraud.

8.3.4 Financial control Framework and the Risk Management Framework

In addition to the above controls, there are two different controls designed in both case study companies, namely, the Financial Control Framework in company A and the Risk Management Framework in company B. The research findings indicate that the design of the Financial Control Framework reflects an additional control to enhance the reliability of the financial statement. The framework requires every accounting owner to document each required control for each accounting process, with the further requirement to test the effectiveness of the control. The research indicates that the underlying reason for this framework is to provide assurance of the responsibility taken for each accounting process. Therefore, the financial information provided for each accounting process is the responsibility of the key accounting owner, for example, the key accounting owner or head of department of accounting payable, receivable and expenses. The assurance concerning the control compliance is shown in the submission of a Letter of Assurance. The practice of the
Financial Control Framework is published in the company’s statement of internal control together with other practices of internal control to inform the stakeholders of the company’s effort to enhance the integrity of the financial information it provides.

The research findings indicate that the design of the Risk Management Framework in company B is the integration of the three elements – people, governance, and methods and practice – which aims to ensure that there is sufficient coverage of risk management throughout the whole organisation. Interestingly, the framework focuses on the responsibilities for the key risk and controls across the functional activities and business processes with the aim of aligning and coordinating the activities across the organization. However, although the framework does not include the specific risk of financial statement fraud, the company considers the risk of accounting activities in general.

8.4 What are the weaknesses that have not been addressed?

Research question four aims to highlight any weaknesses in the present practices of financial statement fraud control in both case study companies. Therefore, the research could offer improvements to the present practices of financial statement fraud control in commercial companies. The research findings indicate one issue in relation to the financial accounting process control in case company A and four issues in both case study companies that indicate gaps in the scope of internal auditing. The following subsections provide a discussion on these issues, and the research provides ameliorations in section 8.5 of this chapter. The subsections of the discussion comprise the issues of (1) internal control system and financial statement fraud control, (2) financial statement fraud control responsibilities, (3) internal auditing expectation gap, and (4) role of internal and external auditing in relation to financial statement fraud control.
8.4.1 Financial accounting process control

The research examines and discusses the financial accounting process control in section 7.1.1, subsection (a). Case company A appears to have an additional control for the financial statement process, namely, the Financial Control Framework. The framework aims to ensure the adequacy of each accounting process and test of the control. The research found one key control that should be improved in phase one of control. The chief financial officer designs the Financial Control Framework, and, at the same time, he is responsible for ensuring the correctness of the financial statement preparation. At this point, the design of the control in the Financial Control Framework is not reviewed by the audit-committee. The research suggests that the Financial Control Framework should be reviewed by the audit committee for a number of reasons. Firstly, the chief financial officer is the person who is fully involved in the entire financial statement process and is fully responsible for designing the internal control over the financial accounting process. Therefore, the controls designed by the chief financial officer of the company should be reviewed and approved by the independent directors who are totally independent from the operational side. Secondly, the reviewed and approved Financial Control Framework by the audit committee would reflect the transparency of the designed control. Therefore, company A would prevent any possibility of the chief financial officer hiding any accounting process to be audited. In addition, the research findings indicate that the scope of the internal audit work of case company A does not include the auditing of the Financial Control Framework. In this case, the internal auditor of company A has not given any assurance of compliance in their review of the Financial Control Framework.

8.4.2 Internal control system and financial statement fraud control

Generally, internal control is considered as the most important practice mechanism used to guide and regulate system business activities and functions, in particular, the design of the company’s policies, procedures, standards and regulations. In relation to financial statement
process control, the adherence to internal controls is assumed to protect the companies from any misconduct or wrongdoings, in general, or financial statement fraud, in particular. In addition, the adherence to internal control would assist the companies in achieving efficient and effective business operations and a true and fair view of financial reporting.

The research findings indicate that the present financial statement fraud control in both case study companies is mainly reliant on the company’s internal control system. The findings of the present control, as discussed in section 8.1 above, are related to the discussion of the internal control system and the role of the internal auditors in relation to financial statement fraud control. The research findings also reveal an interesting link between the internal auditor’s role and financial statement fraud control. This is due to the perceived control of financial statement fraud based on the internal control system. In this case, the research examines the current practices of internal auditing in relation to the financial statement process. The research findings also indicate that the internal auditor’s main role in both case study companies is presently perceived as ensuring adherence to the internal controls, and, thus, the company management perceives that the internal auditing work would detect any non-compliance, misconduct, and, specifically, financial statement fraud.

The research findings clearly indicate that the scope of internal auditing focuses on operational compliance concerning the design of the control and the relevant regulations for the financial statement. The findings from the research indicate that commercial companies should be concerned with two main auditing controls, firstly, the auditing of the operating compliance of the control designed for each accounting function, and, secondly, auditing the financial transactions, accounts balances, accounting procedures and financial statement.

The purpose of auditing the internal control in relation to the financial statement process is to ensure the compliance of control, such as segregation of duties, limit of authority, and meeting the reporting timeline and regulations compliance. It is also to ensure the adequacy and the independency of the officer designing the control of the financial statement process. In addition, the purpose of financial statement auditing varies accordingly. For example,
auditing financial transactions and account balances aims to ensure the validity and the accuracy of the posted financial transactions. While, auditing procedures aim to ensure that the financial statement process has adhered to the accounting procedures standards and regulations, and auditing the financial statement aims to ensure that the whole financial statement process is followed and that a true and fair view of the financial statement is published by the company.

In respect of the two main auditing financial statement processes, the internal auditors of both case study companies presently focus on auditing the operating compliance, which includes segregation of duties, limit of authority, and meeting the reporting timeline and regulations compliance. However, neither company audits the financial transactions, accounts balances, accounting procedures and financial statement. In addition, the research also indicates that the financial control framework designed in company A, as discussed in section 8.1 (1) (a) above, does not involve the internal auditor commitment. The effectiveness of the adequacy of control in the designed framework is not under the scope of internal auditing. The overall findings clearly indicate that the scope of internal auditing in both case study companies is mainly related to operational auditing based on the accounting and finance policy and regulation compliance and review of the completed financial statement. The scope of internal auditing of the case study companies, however, does not give any assurance that the company’s transactions, accounts balances and accounting procedures are in accordance with the accounting standards.

8.4.3 Financial statement fraud control responsibilities

Clearly, the management of the company is responsible (1) for ensuring that sufficient controls have been placed in the organization and (2) for ensuring that any error – misconduct and financial statement fraud in particular – have been measured and detected. Therefore, sufficient measurement controls would protect the companies from any misconduct and financial statement fraud in particular. In addition to the companies’
management responsibilities, the board of directors have a duty to ensure the ‘true and fair view’ of the financial statement. Therefore, the oversight controls on behalf of the board of directors is achieved through the board’s audit committee. The committee comprises independent directors who have a particular role to ensure the reliability and integrity of the financial information produced by the management of the company. In this respect, the board’s audit committee is responsible for monitoring the related control and the company’s internal control system in particular, to control the financial statement process. The board’s audit committee works independently with the companies’ internal and external auditor in the context of financial statement assurance.

In accordance with the control responsibilities from the companies’ management and oversight control from the board audit committee the research indicates that a related role of the internal auditor is to give assurance and review the controls made by the company management and ensure they are adequate in relation to financial statement fraud control. However, the research findings, as discussed in section 8.4.2 (Internal control system and financial statement fraud control), indicate that the internal controls over the financial accounting process are not relevant to the scope of the company’s internal auditing.

In relation to financial statement fraud detection and control responsibility, the external auditor appears to be under the impression that the internal auditors are responsible or have responsibility to detect and control fraud in the financial statement, while, conversely, the internal auditors do not appear to believe that financial statement fraud detection and control is their responsibility. In addition, the company management presume that detection of financial statement fraud can be done by the external auditors and that the prevention and control have been done by the internal auditor through the internal auditing work. Furthermore, the external auditor appears to expect the internal auditor to do something in relation to the financial statement. However, the detection of financial statement fraud does not appear to be within the scope of internal auditing. This indicates the expectation gap concerning internal auditing in both case study companies in relation to financial statement fraud control.
8.4.4 Internal auditing expectation gap

The research identified the presence of the internal auditing gap when company management fully relies on the internal control system to prevent financial statement fraud. However, the scope of internal auditing work is not relevant to the accuracy of the final published financial statement. In addition, the internal auditors of the case study companies perceive that the external auditor’s responsibilities include the detection of financial statement fraud. In contrast, the external auditors perceive that the responsibilities of the internal auditor include detecting financial statement fraud. The following diagram (figure 11) summarizes the internal auditing expectation gap.

Figure 11: Internal auditing expectation gap

The research identifies that the gap is positively related to the companies’ internal control system and the scope of internal auditing because the independent role of external auditing is outside of the scope of the companies’ business. To support the concept above, the
research further examines the scope of the internal auditor’s duties. The research uses the research findings, as discussed in section 8.4.2 where the research discussed the two main auditing controls in relation to financial statement. The gap found is in relation to duties in practice and the unmet expectations of the internal auditors’ duties in both case study companies. Clearly, the scope of internal auditing of the case study companies literally focuses on the audit operating procedures, and compliance with the standards and regulations. In addition, they also review the completed financial statements. Therefore, the unmet expectations of the internal auditor’s duties in respect of the control of financial statement fraud is non-auditing of the financial transactions and detailed checking of the account balances. Furthermore, presently, the internal auditing activities at both case study companies do not directly involve financial statement fraud control and deterrence.

The research further discusses the internal auditing expectation gap by examining the scope of internal audit testing in both case study companies. In this context the research specifies the two main audit tests as (1) test control and (2) substantive test on the financial statement process. The research refers the test control to the duties of the internal auditor to test the compliance of the company’s accounting policies and procedures designed by the company management, accounting standards and the relevant regulations imposed by the Malaysian regulators in relation to financial statements. In addition, the substantive test refers to the internal auditors’ duty to test the detail of the transactions, which includes the test of account balances and also analytical review. In this context, analytical review involves the use of accounting ratios, variances, and vertical and horizontal analysis of the completed financial statement. The research found that the present duties of the internal auditors of both case study companies focus on control testing of compliance with operating procedures. A control test is intended to verify that the present control of the financial statement process is operated and complied with. However, a control test is not relevant in providing assurance of financial statement accuracy and the audit testing does not cover the test of detailed financial transactions and account balances. Therefore, the research found that the
substantive internal auditing test in relation to financial information is an unmet expectation of the internal auditor's present duties.

8.4.5 Role of internal auditor in relation to financial statement fraud control

In relation to the internal auditing expectation gap that was discussed in sections 8.4.3 and 8.4.4 above, the research findings indicate that the role of the internal auditor is found to be significant to control financial statement fraud in companies. Thus, enhancement in the scope of internal audit activities, particularly internal audit testing, is required in order to reduce the internal auditing expectation gap. Aligned with the International Standards of Internal Auditing, the reliability and integrity of the financial results would be best achieved by the internal auditing process. Even though the role of the internal auditor is not primarily to detect any fraud in the financial statement, it involves ensuring the reliability and the integrity of the financial statement. Another assurance of financial statement fraud control was reviewed by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). The COSO defined the internal control as ‘a process, affected by an entity’s board of directors, management and other personnel, designed to provide reasonable assurance regarding achievement of effectiveness and efficiency of operations, reliable financial reporting and compliance with the applicable laws and regulations’. The phrase of providing the “reasonable assurance of reliable financial reporting and compliance with the applicable laws and regulations” is highly pertinent to this research. Two issues of concern were found, namely, reliable financial reporting, and, secondly, compliance with the laws and regulations. The assurance of reliable financial reporting might not be achieved without comprehensive audit testing of the internal financial statement auditing. The internal auditor of the case study companies should be the first filterer or gate keeper of financial statement fraud in the companies before it has been audited by the external auditors. However, the findings of the case study companies have shown that a lack of accounting expertise among the internal auditors is the main reason for their not auditing the financial statement. Therefore, the required enhancement and the development of internal audit duties would minimize the gap
in internal auditing and thus increase the control of financial statement fraud. The role of the internal auditor is presumably significant in ensuring that the company has been equipped with financial statement fraud mitigation controls.

8.4.6 Role of external auditor in relation to financial statement fraud control

The research also discusses the role of the external auditor in relation to the internal auditing expectation gap and different perceived responsibilities towards financial statement fraud detection and control. The research findings indicate the perception that external auditors’ duties do not include having a primary responsibility to detect financial statement fraud. However, the respondents presume that audit procedures and the designed audit plan should be able to detect any fraud in the financial statement. In reality financial statement fraud is the one type of fraud in which external auditors do have a duty to detect in particular, any misstatement in the financial statement that caused by fraud. Section 316 of the International Standard of Auditing requires the external auditor to consider fraud in a financial statement audit. The financial statement audit should consider the fraud description and characteristic, exercising the professional scepticism in considering the presence of fraud due to the material misstatements. Basically, the audit of financial statements does not guarantee the accuracy of the audited financial statements. In relation to the role of the external auditor, section 110 of the International Standard of Auditing also states that the responsibilities and functions of the external auditor are to express an opinion on the audited financial statement. The opinion on the true and fair view of the financial statement is in respect of all the material respects, financial position, results of operations and its cash flow in accordance with the accounting standards and generally accepted accounting principles. The external auditor has responsibility for designing the audit procedures that are able to obtain a reasonable assurance on any material misstatements arising from error or fraud. However, the financial statement is solely under the responsibility of the management. The external auditor is only responsible to express their opinion on the completed financial statement that has been prepared by the company. Therefore, sound controls of financial statement procedures should be established by the company management to ensure that
the prepared financial statement is free from any material misstatement and financial statement fraud in particular. The research identifies the role of the external auditor as being in accordance with the requirements of the Companies Act to audit the financial statement and ensure the transparency and integrity of the financial statement information. It could be the second defence of the financial statement fraud control after submission of the completed financial statement to the independent party. This indicates the responsibility of the companies to determine sufficient control of the financial statement process before it is audited and the reliability, integrity and transparency of the financial statement is confirmed.

8.5 What methods can be used to ameliorate the current weaknesses?

The research considers research question five as key to the research aims and objectives. The research aims to provide improvements to the financial statement fraud control based on the present practices at the two case study companies. The discussion of the research questions one to four of this research are relevant to the suggested ameliorations and indicate the following improvements in financial statement fraud control. The research addresses the two main ameliorations: (1) improvement in present practices of financial statement fraud controls in the commercial companies, and (2) financial statement fraud control at the top management level and highlight the value of honesty and integrity in the organizations.

8.5.1 Improvements to the present practices of financial statement fraud control in commercial companies

The enrichment of the present control has been identified to enhance the financial statement fraud control framework of the commercial companies. The research offers six ameliorations in relation to (a) financial statement control environment, (b) improvement of Financial Control Framework (internal control over financial accounting process), (c) financial transactions auditing by internal auditors, (d) determination of financial statement fraud
indicators, (e) determination of financial statement fraud detection tools, and (f) response of financial statement fraud cases.

(a) Audit Committee Control in relation to the Financial Control Framework

As discussed in section 8.1.1 (a) (figure 7) of research question one, the additional control has been designed in Company A, which is the Financial Control Framework. The Financial Control Framework has been designed by the chief financial officer, who is also on the board of company directors. However, the design of the control has not been reviewed and approved by the audit committee. Therefore, the research suggests that the audit committee control should exist in the first phase of control to ensure the independence of the internal control designed by the chief financial officer. The engagement of the audit committee in relation to the design of the control is aimed to ensure transparency. The review of the design of the control by the independent audit committee would enhance the reliability of the control and give assurance concerning non-conflict of interest of the chief financial officer.

The following diagram (figure 12) is similar to diagram (7), as shown in section 7.1.1. However, the small red box in control one is the additional control suggested. The additional control in control number 1 suggests that the role of the audit committee should include reviewing and approving the Financial Control Framework
b. Management Letter in relation to the design of the Financial Control Framework.

The research discusses the Financial Control Framework in section 8.1.1 as an additional internal control in relation to the financial accounting process in case company A. The framework design has been adapted from the Sarbanes Act 2002 (SOX 2002) in relation to internal control over financial statements. However, the current adaptations of section 302 and 404 of the SOX 2002 have not been fully complied with by the case company. Section 302 of the SOX 2002 requires the company management to assess the validity of the design of the control and notify any weaknesses concerning the internal control designed to the board of directors and external auditors. In addition, section 404 further requires the external auditor to assess and annually report on the adequacy of the design of the control. The section also requires external auditors to assess the management assessment on internal control over financial statements.

The implementation of the Financial Control Framework in company A is published in the Statement of the Internal Control embedded in the company’s annual report. Company A reports to the public concerning the implementation of the Financial Control Framework as a
key initiative adopted in relation to the quality of the company’s financial report, and constitutes one of the other elements of the company’s internal control. The report also indicates the requirement of every accounting process owner to submit a Letter of Assurance to confirm compliance with the control for each accounting process. However, company A does not publish any management letter in the company’s report in relation to the effectiveness of the Financial Control Framework. As a matter of good practice, the research suggests that company A should issue and publish a management letter in relation to the design of the Financial Control Framework. The management letter should include a statement of management responsibility for ensuring sufficient control over the financial statement and reporting the effectiveness of the control designed. The management letter issued in relation to the Financial Control Framework Practice will also delegate more responsibility to the whole organization in ensuring the integrity and reliability of the information published for the company’s stakeholder.

c. **Reviewing the scope of internal auditing function**

The research provides a suggestion to review the scope of the internal auditing activities in relation to financial statement control as a focus area for the present research. In this context, the role of the internal auditor is a key deterrent factor that is recognized as minimizing the gap in internal auditing. The research suggests the enhancement and the development of the scope of internal auditing functions in order to reduce the internal auditing expectation gap, as discussed in section 8.4.4 of this chapter. From the case study findings, the research complements prior research concerning internal audit and financial statements (Grass-Gill, 2012; Schneider and Wilner 1990) that provide evidence of the greater involvement of internal auditors required to control financial statement fraud, thus contributing to the quality of the financial statement. A new focus of internal auditing should include financial statement fraud control in the scope of internal audit activities. Particularly, the risk of financial statement fraud in each accounting and business function should be analysed and evaluated in addition to reviewing the related compliance with the company’s
procedures and regulations. Although the internal audit has a degree of focus on the financial aspects, the internal audit function is described as an independent advisor with the objective of ensuring that the company is achieving its strategic objectives, including the reliability of the financial statements that represent the true performance of the company.

Firstly, the research suggests that the enhancement and the development of internal auditing activities in relation to financial statement fraud control can be achieved with the following suggested approach (figure 12) to the Internal auditing approach to financial statement fraud control.

![Figure 13: Internal auditing approach to financial statement fraud control](image)

The concept of internal auditing of financial statement is embedded in the above approach to increase the mitigation level of financial statement fraud in companies. The internal auditor is viewed as part of the company, albeit independent of management as they give assurance concerning the companies’ internal control and report to the audit committee. Therefore, this approach would be the internal filterer to the risk of financial statement fraud.

Secondly, the research suggests the extension of the internal audit plan to enable the internal auditors to understand and consider the risk of a possible financial statement fraud in any business and accounting function. The risk of financial statement fraud possibly exists in various departments, for instance, finance, sales, purchases and human resources department. Therefore, the internal auditors should understand the entire business process and they should be accounting literate in order to review and provide recommendations.
concerning the sufficiency of the current controls of financial statement fraud. In addition, the research also suggests the importance of the internal auditor to identify the indicators and the possible schemes of financial statement fraud. The indicators of financial statement fraud are also known as red flags of financial statement fraud. Consequently, understanding the financial statement fraud schemes is important to obtain the fraud evidence and fraud detection. The International Standards of Professional Practice of Internal Auditing also recommend the Standard of Auditing Statement No. 99, which provides the indicator of financial statement fraud for effective financial audits. This possibly assists the internal auditors to control financial statement fraud in their internal auditing process. However, the research by Gullkvist and Jokipii (2013) found that the present practice of internal auditing does not focus on financial statement fraud red flags but concerns the red flags of misappropriation of assets. The understanding of financial statement fraud red flags possibly provides control for the internal auditor concerning which area and scenario they should examine in respect of those business and accounting functions for which there is the greatest incentive to commit financial statement fraud.

Thirdly, the research suggests control of financial statement fraud through in-depth checking of financial transactions and account balances. This will result in the improvement of internal audit testing that possibly increases the audit evidence. The research also indicates that the achievement of this control can be achieved through a substantive audit test by the internal auditors. Additional audit testing is essential to reduce the internal audit expectation gap, and, therefore, possibly increases the mitigation efforts of financial statement fraud in commercial companies. This finding is in accordance with the research finding by the previous research by Budescu et al. (2012); Bedard et al. (1999) and Chen et al. (2011) who provide evidence that an increase in audit testing results in a decrease in audit risk, and, thus, provides more audit evidence. In this case, the research suggests the possibility that the error and fraud detection by the internal auditors would increase the mitigation level before it has been audited by the external auditors. The researcher found that accounting
competency among the internal auditors is required to enhance the role of the internal auditors towards financial statement fraud control. In particular, to understand the indicators of financial statement fraud and in-depth checking on financial transactions and account balances. These findings will possibly encourage companies to review the scope of internal auditing in minimizing the gap in the scope of internal auditing.

8.5.2 Financial statement fraud control at top management level

The research findings on financial statement fraud control indicate that the most effective control should be derived from the top management of the companies. In this context, the top level control comprises the board of directors, senior management of the company, internal auditor, audit committee and external auditor. However, the research findings of Tillman (2009) indicate that previous financial statement fraud cases involve the collusion of the companies' board of directors, auditors and senior management. Given the high risks associated with cases of financial statement fraud, the research suggests the following financial statement fraud control among the top management of the company.

Financial statement fraud has been classified as management fraud in which the manipulation is done purposely to achieve the purposes of the corporate level. In addition to the corporate governance practices that govern the good conduct of company's directors, the role of the audit committee is found to be significant for financial statement fraud control at the top level of management. The research findings indicate that the prevention and detection of financial statement fraud are found to be difficult as the perpetrators of financial statement fraud are commonly from the top management of the companies. Consequently, the roles of the internal auditor and external auditor of the companies become ineffective and require greater involvement of the audit committee. However, based on the present practices, the research has discussed the present gap in internal control that is relevant to the role of the internal auditors (section 8.5.1 (c)). The results indicate the requirement for
internal auditors to review the scope of internal audit functions that significantly increase the mitigation of financial statement fraud.

Firstly, the research discusses the role of audit committee in relation to the internal audit expectation gap. The research findings indicate that greater control is required from the board audit committee to minimize the gap and reduce the ineffective roles of the internal and external auditor that has been claimed due to the involvement of top management. In relation to minimizing the gap in the internal audit functions the research suggests that the audit committee review the scope of the internal audit plan before the annual audit plan is reviewed and approved. In this context, the audit committee should consider that control of financial statement fraud is planned in the annual audit plan and thus provide a monitoring role as the company's audit committee to provide sufficient control, particularly in respect of financial statement fraud.

Secondly, in order to effectively review and monitor the financial statement fraud control, the research findings indicate the need of the audit committee to be financially literate to understand the entire accounting process and financial statement fraud indicators. The audit committee also needs to understand the current adaptation of accounting standards and be conversant with the nature of the company's business. Such understanding and knowledge might possibly assist the audit committee in identifying the financial statement fraud indicators or red flags. Furthermore, the research findings indicate the need of an experienced audit committee to assist the company management to control financial statement fraud and to take advantage of the vast experience of the audit committee. In addition, it is suggested that the audit committee be more independent in reviewing the financial statement and challenge the company management with any issues raised by the external auditors. Furthermore, the audit committee should be able to query the company management, internal auditors and external auditors in relation to the financial statement issues and the present control.
Thirdly, the role of the audit committee is found to be important in monitoring the accuracy of financial information published and possibly provides a financial statement fraud control of top level management. Accurate financial information is considered to be the most important control at the top level. Once the internal control and internal control over the financial accounting process have been fully monitored, the companies should ensure that the financial information fully reflects the final audited financial statements. In this context, the audit committee is responsible for monitoring the accuracy of the information in the financial statement after the audit opinion is given by the external auditors. However, the research findings indicate that the perception of the audit committee is that control of financial statement fraud can be achieved through the present duties of the audit committee, internal auditors and external auditors without interference by top management of the company. In relation to this, the research suggests a collaborative monitoring process be undertaken by the audit committee, internal auditor and external auditor with the aim of ensuring that the audit report fully represents the real performance of the company. The unchanged financial information based on the audited financial statement should be monitored until it is published to the stakeholders and public.

Finally, the research findings indicate the significance of the quality of the board’s audit committee members. This is associated with the number of directorships of the audit committee members in other companies given the high responsibilities that they are supposed to deliver. The research findings indicate the possibility of the ineffective roles of the audit committee in discharging their monitoring roles in public companies. The research modestly suggests that greater attention should be given by the audit committee members to fully understand the companies’ control and provide improvements to the present control. This is in accordance with the research findings by George (2012) who indicates the negative relationship between the audit committee performance and the number of directorships by audit committee members in other companies.
8.5.3 Inculcating the values of honesty and integrity

In addition to the improvements that have been suggested in relation to the present practices, the research considers honesty and integrity as two important values to control financial statement fraud. The research findings indicate the significance of the value of honesty and integrity as a financial statement fraud control, particularly, in respect of the top level management. The findings also indicate that financial statement fraud controls are found to be difficult as the fraud has been committed by the top management of the company, and, given the present controls, are ineffective, as the direction is derived from the top level of management and operational level. The research found that this situation is complicated as financial statement fraud might be planned comprehensively. Consequently, inculcation of honesty and integrity in the top management level should be considered the best solution to financial statement fraud control at the top level. However, honesty and integrity cannot be legislated and regulated except in cases of proven misconduct that can be punished accordingly. The research findings indicate the need of the company management to inculcate the values of honesty and integrity among the top management and company individuals. This can be achieved by continuously reinforcing the elements of integrity through the independent nomination and hiring process of top management and new staff of the companies. The company management should also conduct a regular basis of integrity training throughout the whole organization.
CHAPTER NINE

CONCLUSION

9.1 Introduction

This chapter aims to provide a conclusion to the research findings gained from the case studies, interviews and review of the regulations. The research aims to provide improvements to the present control of financial statement fraud in the context of strategic controls at the group level. To provide the improvements, the research examined and analysed what had been designed in the present practices, understood the reasoning and identified the loop holes of the designed controls. The research also asserts that the findings based on the case studies and interviews reflect the actual practices and experience in the context of present practices in Malaysian commercial companies.

Earlier research discusses the issue of financial statement fraud and the respective controls; however, the researchers do not study in the context of real practices and what controls are presently adopted among the commercial companies by way of financial statement fraud mitigation (George, 2012; Beasley et al., 2010; Tillman, 2009; Brennan & McGrath, 2007; Razaee, 2002; Beasley, 1996). In addition, a number of researchers discuss financial statement fraud detection methods, thus offering detection methods for the companies (Ravisankar et al., 2011; Dillon, 2009; Skousen et al., 2008; Spathis et al., 2007; Kirkos et al., 2005; Kwok, 2005). Furthermore, statistical information concerning financial statement fraud is offered by professional reports (KMPG, 2009, 2007, 2006 & 2005; PWC, 2011, 2007 & 2005; ACFE, 2012, 2008, 2004, 2002, 1996; NCFR, 1987). Therefore, the research provides a major contribution to the methodology and the knowledge concerning financial statement fraud control.

The two case study companies provide sufficient indication of the actual practices of financial statement control as the two companies are the two largest public companies in
Malaysia. The reliability and the trustworthiness of the present strategic controls are gained from the top level of management for both companies. In addition, the research uses the information from the interviews to determine the external controls from the group of regulators (chapter 7, page 165-172), as well as the independent and professional bodies in Malaysia (chapter 7, page 172-175).

The following sections conclude the research findings concerning the research questions and financial statement fraud control gained from the case study companies (sections 9.2 to 9.6), external controls gained from the regulators and professional bodies (section 9.7), and the implications from the review of the relevant regulations from three countries, namely, Malaysia, the UK and the US (section 9.8). In the following sections of this chapter, the research further emphasises on the contributions (section 9.9), recommendations and limitations of the research (section 9.10).

9.2 Research question one: Conclusion concerning present practices of prevention, detection and response strategies in relation to financial statement fraud

The case study findings demonstrate that neither case study company is highly concerned about the issue of financial statement fraud control (chapter 8, page 187-198). This provides an indication that no evidence was gained concerning specific controls embedded in the present internal control system and typifies the actual practice, in particular, the prevention, detection and response strategies to mitigate financial statement fraud. However, the implementation of the Financial Control Framework in company B is useful to increase the control of the financial statement process. This research supports the exploratory study by Alleyne and Howard (2005), who conclude that the financial statement fraud issue has not been considered as a major issue in Barbados. One possible reason is the lack of experience concerning financial statement fraud cases in both case companies. This is in accordance with the research findings of Yusof (2009) in the case study of insurance fraud in Nigeria, which indicates little awareness of fraud prevention in the case study companies.
The prevention strategies are significant for financial statement fraud mitigation. Despite the non-specific strategies concerning financial statement fraud control, the research finds that case study companies are highly reliant on the present internal control as financial statement fraud mitigation. The results indicate that the control of financial statement fraud risk is inconsequential in the context of internal auditing of both case study companies (page 8, page 190-192). The results indicate that a different perception emerges between the internal and external auditors concerning the responsibility of financial statement fraud detection. The research examines the prevention of financial statement fraud in respect of the financial statement process. The analysis of internal control in respect of the financial statement process includes the control embedded in the financial accounting process (chapter 8, page 193), as well as the financial statement fraud preventive and support control (chapter 8, page 196). The understanding of the controls designed for the whole process of the financial statement is achieved and the research highlights the best practices (research question two) as well as provides ameliorations for the identified weaknesses (research question five) in the following sections (section 9.3 and section 9.4). In respect to the detection strategies, the findings indicate that both case study companies are adopting similar strategies to prevent and detect financial statement fraud (chapter 8, page 199). These findings indicate that internal audit and external audit functions, whistle blowing and hotlines are presently used to detect any material misstatement and fraud in the financial statements. In related to the response strategies, the results indicate that non-specific strategies are designed in response to financial statement fraud; however, any reported fraud will be managed by the legal and human resource department (chapter 8, page 199).

9.3 Research question two: Conclusion concerning the current best practices in financial statement fraud mitigation

In respect to the findings gained from research question 1 (chapter 8, page 188-199), the research indicates that the lack of evidence represents a research limitation in identifying any best practices for financial statement fraud mitigation in the context of commercial
companies in Malaysia (chapter 8, page 200). In addition to the standard control of the financial statement process, different approaches were adopted as additional control to mitigate the risk of financial statement fraud. The Financial Control Framework is designed in company A (chapter 8, page 201) to stimulate the reliability of the financial statements as the framework requires more control and tests of the effectiveness of each accounting process. In addition, the Risk Management Framework designed in company B aims to heighten the risk control from people (stakeholders), governance and methods throughout the whole organisation. The research finds that the integration of these two different practices might enrich the present practices of financial statement fraud control as far as control in the financial accounting process and risk management are concerned.

9.4 Research question three: Conclusion concerning the understanding of what and why people are doing it

Research question three provides the underlying reasons for the present controls that represent the present control gained from the findings of research question 1 (chapter 8, page 188-199). The results indicate that the present controls of (1) internal control system (chapter 8, page 203), (2) whistle blowing, hotlines and business ethics (chapter 8, page 204), (3) corporate governance, and (4) the Financial Control Framework and Risk Management Framework (chapter 8, page 205) are presently assumed to provide adequate control against financial statement fraud. However, a number of weaknesses are highlighted in section 9.5 below that require improvement, as suggested in section 9.6.

9.5 Research question four: Conclusion concerning the weaknesses in the present system of financial statement fraud mitigation

Research question four aims to highlight the weaknesses that have not been addressed before in the present system of financial statement fraud mitigation. The results from research questions one to three above indicate the identified loopholes of the present controls in both case study companies. The results highlight two main weaknesses in
relation to the (1) financial statement process control and internal control system and financial statement fraud control. In relation to the financial statement process control, the research finds that lack of a review on the Financial Control Framework by the audit committee and non-declaration of the designed FCF in the annual report indicate the lack of transparency in the designed control (chapter 8, page 207).

In relation to the internal control system and financial statement fraud control, the combined results of the perceived control by the company management, the present audit functions, and the detection and control responsibilities of the internal and external auditors leaves scope for an expectation gap to arise in the present internal audit functions and the association of internal audit and risk towards financial statement fraud (chapter 8, page 208-214). The case study companies are highly reliant on their respective internal control for the prevention of financial statement fraud and detection strategies (chapter 8, page 208), and the present internal audit functions only focus on the operational audit and concern pertaining to corporate risk. This provides an indication that the scope of the internal auditing work is not primarily concerned with the accuracy of the financial statement information, but rather with the risk of losses to the respective companies (chapter 8, page 208). The particular aspects concerning the detection of fraud in financial statements and financial statement fraud control have been perceived diversely among the company’s internal and external auditors (chapter 8, page 210). In relation to this, the following section provides the ameliorations to improve the identified current weakness. Figure 14 below depicted the presence of internal audit expectation gap and the key contributory factors to internal audit expectation gap in relation to financial statement fraud detection and control responsibility.
Figure 14: Key contributory factors to internal audit expectation gap

Gap in relation to financial statement fraud detection and control responsibility

The board of directors has a duty to ensure the true and fair view of the financial statement.

The management of the company is responsible for ensuring that sufficient controls have been placed in the organization and any error – misconduct and financial statement fraud in particular – have been measured and detected.

In accordance with the control responsibilities from the companies’ management and oversight control from the board audit committee, the research indicates that a related role of the internal auditor is to give assurance and review the controls made by the company management and ensure they are adequate in relation to financial statement fraud control.

The gap is positively related to the companies’ internal control system and the scope of internal auditing because the independent role of external auditing is outside the scope of the companies’ business.

GAP IN RELATION TO FINANCIAL STATEMENT FRAUD DETECTION AND CONTROL RESPONSIBILITY

Different perception of external, internal and company management

The company management presumes that detection of financial statement fraud can be done by the external auditors and that the prevention and control have been done by the internal auditor through the internal auditing work.

The external auditor appears to be under the impression that the internal auditors are responsible or have responsibility to detect and control fraud in the financial statement.

While, conversely, the internal auditors do not appear to believe that financial statement fraud detection and control is their responsibility. The internal auditors of the case study companies perceive that the external auditor’s responsibilities include the detection of financial statement fraud.

Findings and evidence of internal audit expectation gap

Findings - company management fully relies on the internal control system (policies and procedures) to prevent financial statement fraud. However:

1. The scope of internal auditing work is not relevant to the accuracy of the final published financial statement
2. The detection of financial statement fraud does not appear to be within the scope of internal auditing
3. The internal controls over the financial accounting process are not relevant to the scope of the company’s internal auditing

What internal auditors do?

1. The scope of internal auditing focuses on operational compliance concerning the design of the control and the relevant regulations for the financial statement.
2. The scope of internal audit testing in both case studies - focuses on control testing of compliance with operating procedures. A control test is intended to verify that the present control of the financial statement process is operated and complied with. However, a control test is not relevant in providing assurance of financial statement accuracy and the audit testing does not cover the test of detailed financial transactions and account balances.
9.6 Research question five: Conclusion concerning what approaches can be used to ameliorate the current weaknesses

Research question five provides improvement in the present financial statement fraud controls based on the findings gained from research question one to research question four, as discussed above. The research highlights amelioration concerning the present practices of financial statement fraud control (chapter 8, page 215) and recommends (2) financial statement fraud control at the top level and stresses the value of honesty and integrity (chapter 8, page 220).

In respect of improvement in the present practices, the required role of the audit committee is found to be significant in overseeing the designed control (FCF) (chapter 8, page 215). In addition, for the good practice of FCF, the company is advised to issue and publish a management letter in relation to the designed FCF (chapter 8, page 216). As an area of focus for the present research findings, the results indicate the need to review the scope of the internal audit functions in relation to financial statement fraud control. The role of the internal auditor is a key deterrent that is acknowledged to minimize the gap in internal auditing.

The research provides the internal auditing approach to financial statement fraud control (chapter 8, page 218). The concept of internal auditing of the financial statement is embedded in the internal auditing approach as an internal filter to the risk of financial statement fraud to increase the level of mitigation in commercial companies (chapter 8, page 219). The research addresses the internal audit functions as supposedly constituting the first filter before the second filter comes from the external audit functions.

The research suggests auditing by the internal auditor of the financial transactions. This will be achieved through increasing the audit testing of substantive test and in-depth information checking of financial transactions. The concept of internal auditing is seen to be relevant and significant to be embedded to give assurance of the financial accounting process in addition
to external auditing of the financial statement. Therefore, adequate controls are embedded in the company’s system and a true and fair view of the financial statement is achieved. The research finding indicating that the role of the internal auditors should involve financial transaction auditing is significant for increasing the adequacy of control, the independency of the control designed and the transparency of financial statements.

The research provides important insights into the role of the internal auditors in respect of the accuracy and validity of the recorded financial information, and therefore, offers a deterrent for financial statement fraud (chapter 8, page 217-220). The findings of this research are consistent with the Institute of Internal Auditors Standard 1210.A2 which requires internal auditors to recognize indicators of fraud. In this context, the research refers to financial statement fraud. One possible explanation that could indicate the involvement of internal auditors in financial statement fraud control is evidence concerning the requirement of internal auditors to participate in the risk assessment and evaluate the adequacy and the effectiveness of the present internal control system (chapter 8, page 220). These findings are consistent with the role of internal auditors as the research describes – an independent advisor to the company management and able to achieve the objective of producing a reliable financial statement that represents the true status of the company’s performance.

To enhance the financial statement fraud control at the top management level, the research includes the interview results. The results indicate that a greater role of the board audit committee is required to minimize the gap and reduce the ineffective roles of the internal and external auditors that have been claimed as being due to the involvement of top management in the past financial statement fraud cases.

The results indicate that the quality of the audit committee includes them as financially literate, conversant with the nature of businesses, experienced, independent and robust in monitoring functions in overseeing the financial statement fraud control (chapter 8, page 221-223). Furthermore, the results indicate that a collaborative monitoring process should be
undertaken by the audit committee, and the internal and external auditors, to ensure that the unchanged financial information is published to the stakeholders and public. Other results that demonstrate the quality of the audit committee include the number holding directorships in other companies given the high level of responsibility that they are required to deliver. Therefore, this issue should be considered in the appointment of the audit committee.

Based on the interview results, the research recommends the inculcation of honesty and integrity values in the organisation, specifically among the top company management. Previous financial statement fraud cases indicate that financial statement fraud control is found to be complicated as the fraud might be comprehensively planned. Therefore, the interviews results indicate the best solution to financial statement fraud control can be achieved through the design of effective controls and the honesty and integrity of top management. The research further suggests that continuous integrity training should be conducted throughout the year as one type of mitigation plan.

The overall case study findings indicate evidence of an internal audit expectation gap, which constitutes a serious flaw in the internal control systems adopted by the companies. However, the recommendation of top management control supports the preeminent ameliorations for financial statement fraud control. The contribution of this research might improve the present internal control system and provide a more holistic solution for financial statement fraud control.

9.7 Summary on external controls gained from regulators and professional bodies

The research provides the regulatory control framework of the five responsible regulators (figure 15) that would collaborate in financial statement fraud mitigation. The identified roles and controls that have been discussed in chapter 7 (page 165-172) are considered as prevention mechanisms from the regulatory body from the external environment of the companies.
The framework also demonstrates the five bodies in respect to external controls which are derived from capital markets, public domain, company management, auditors, and the stock exchange. The findings of the research emphasise the greater role of regulators to establish, review and ensure that there are sufficient financial statement fraud regulations, and thus, increase the public confidence in the capital market.

9.8 Summary on the review of financial statement and financial statement fraud regulations

In respect to the financial statement and financial statement fraud regulations, the results of the review indicate that the conviction of financial statement fraud is often referred to as false representation, false accounting, and breach of trust and cheating (chapter 5, page 96-97). Most previous financial statement fraud cases indicate that the conviction of financial statement fraud is the responsibility of the company directors when companies make misleading statements. The findings pertaining to the Malaysian regulations indicate that the Capital Market and Services Act 2007 are considered the main financial statement fraud regulations. In addition, the Companies Act 1965, the Financial Reporting Act 1997, the Penal Code 574 and the Accountants Act 1967 are the supporting regulations that allow enforcement in different jurisdictions. A review of the findings indicates that Malaysia gives
the lowest penalties and exercises the most lenient enforcement in relation to financial statement fraud cases as compared to the UK and the US (chapter 5, page 101).

9.9 Contributions and Recommendations

The research has made contributions to research methodology; contributions to knowledge about the present practices in the form of practical recommendations to improve practice; contributions to academic theory in relation to the theoretical concept of financial statement fraud control and internal auditing of financial statement and, finally, contributions to the regulators and standard setters.

9.9.1 Contributions to methodology

This dissertation has demonstrated the value of a mixed method approach to financial research. The research gathered data from the actual and present practices in commercial companies. This differs from previous academic and professional research which was based on the statistical reports of financial statement fraud cases. The previous research indicated the results of the causes of financial statement fraud, perpetrators of financial statement fraud and suggested detection software for financial statement fraud. This study, based on the actual practices at the strategic level of financial statement fraud control, supports some of the existing findings, increases knowledge about financial statement fraud and is also able to recommend ameliorations. However, in addition, this study has uniquely identified that the internal audit expectation gap as a major issue of concern that needs to be addressed in order to enhance the present internal control design. This demonstrates that, while case study research is a valuable tool in the investigation of financial fraud issues, additional value can be obtained from direct observation of current practices.
9.9.2 Contributions to knowledge in the form of practical recommendations to improve practice.

This thesis has been able to make specific and practical recommendations in relation to the gap found in the internal audit system. The research results highlight the need for a review of the scope of internal auditing functions, mainly to minimize the internal audit expectation gap. Minimizing the internal audit expectation gap requires enhancement and development in the internal audit functions and the role of the internal auditor. These are related to the accuracy of financial information checking, particularly to the issue of internal audit risk that concerns fraud in financial statement, and the methods of internal audit testing. The recommended role of the internal auditor will augment financial statement fraud control as the improvement in audit testing increases the audit evidence, and, subsequently, decreases the financial statement fraud audit risk.

The research also addresses the two main areas that should be improved and the research identifies them as weaknesses in the present practices of financial statement fraud control. Firstly, the lack of a review of the Financial Control Framework by the board audit committee inasmuch as the framework is designed by the Chief Financial Officer. As a matter of transparency, the designed framework should be reviewed by the board audit committee and audited by the company’s internal auditor. The research also suggests that the company issue and publish a management letter in relation to the designed framework as a matter of good practice and increase stakeholder confidence concerning the integrity and reliability of the published information. Secondly, because of the diverse perceptions of the responsibility for financial statement fraud control, which provide evidence of the existence of the internal audit expectation gap, it is essential that the respective responsibilities are determined and agreed by the company management and internal auditor to strengthen financial statement fraud control. The research results provide an indication that the enhancement and development of the internal audit functions will increase the control as the current control is only suitable for the first part of financial statement auditing. The research proposes that the
internal auditor includes a substantive test on financial transactions, detailed checking on significant account balances and analytical review analysis.

9.9.3 Contribution to academic theory in relation to theoretical concept of financial statement fraud control.

The theoretical concept of financial statement fraud control mainly supports the Agency theory that is concerned with the relationship between the principal and agent and requires firms to run with a view to achieving the firm’s objectives. In relation to this, stringent monitoring and action towards a true and fair view of financial statement from the company directors further involve monitoring cost to the company in order to establish an effective financial statement fraud control. The theoretical concept of financial statement fraud control additionally minimizes the conflict of interest between principal and agent in regards to inappropriate behaviour of the agent. The Agency theory also supports the theoretical concept of financial statement fraud control due to the importance of commercial companies to issue reliable financial statements, responsibility of company directors towards reliable financial statements, and the rights of company’s stakeholders of getting a true and fair view of financial reporting.

The research explores the two parts of preventive control that effectively cover the financial accounting process control and non-accounting process control. Financial accounting process control is considered as the main control for financial statement fraud. Another aspect of control requires a greater and more robust monitoring role from the board audit committees. The findings from this research emphasize the greater responsibilities of company management and the internal auditor in minimizing the internal auditing expectation gap. The research indicates that the most effective non-accounting process control is through a collaborative monitoring system by the audit committee, and internal and external auditors to ensure the unchanged financial information is published to the companies’ stakeholders. The greater controls from the board audit committee will possibly
assist in minimizing the gap and reducing the ineffective roles of the internal and external auditor that have been claimed due to the involvement of top management.

Other recommendations for the non-accounting process of control concerns the value of honesty and integrity. The research found that the complex and extensive issues surrounding financial statement fraud can be solved with these values. However, although the value of honesty and integrity cannot be legislated or regulated among the company individuals, specifically among the top management, it can be inculcated and cultured at every level of the organization. The research highlights the importance of tightening the hiring and nomination process of the board of directors, which can be achieved by constant reminders through continuous training promulgating integrity.

9.9.4 Contribution to academic theory in relation to the theoretical concept of internal auditing of financial statement.

This research contributes the theoretical concept of internal auditing of financial statement which is supportive to increase the mitigation level of financial statement fraud. A greater involvement from internal auditors in financial statement auditing perhaps minimize the internal audit expectation gap. It will complement the external auditing of the financial statement as internal and external auditors will be collaborating to control fraud in the financial statement. The recommended concept includes the two main parts of internal auditing financial statements that focus on rules and regulations compliance and the accuracy of financial information. This recommendation is intended to fill the gap found in the role of the internal auditor towards financial statement fraud detection and control; however its effectiveness would need to be tested in practice.

9.9.5 Contribution to policy.

The research findings indicate that the regulated rules of each of financial statement fraud regulatory authorities are well established to ensure that the market is efficiently and fairly
operated. However, the findings from this research add to policy by suggesting that collaborative control from the body of regulators in Malaysia is also necessary for effective financial statement fraud mitigation.

This research adds to policy in Malaysian financial regulation by recommending that the regulators increase the penalties and charges imposed on company directors. It suggests that financial statement fraud regulations are tightened in order to increase the mitigation level of financial statement fraud in the capital market: specifically increasing the responsibility of the company directors concerning the transparency of the financial statement. Malaysia imposes the lowest penalties against defrauders compared to the UK and the US and the recommendations suggest that these should be increased to be sufficiently stringent to deter potential fraudsters. The research also suggests that the Malaysian standard setters introduce provision pertaining to the scope of the external auditor’s practice that prohibits company auditors from providing non audit services while simultaneously providing audit services to their client company. The provision is significant to avoid any conflict of interest arising from the auditors providing both services to the client company.

The review of the financial statement and financial statement fraud regulations indicates that legislation has been put in place in an attempt to prevent financial statement fraud in Malaysia. However, the key finding from this research and one which has the greatest impact on policy is that further improvements could be made in the internal control systems. In relation to this, the policy recommendation is that the role of the regulators should be increased to mitigate financial statement fraud supported by significant deterrents in terms of penalties imposed for breach of the requirements of the legislation.
9.10 Recommendations for an anti-fraud programme: the strategies of prevention, detection and response in relation to financial statement fraud

The research offers insights into the importance of having an anti-fraud programme, in particular the prevention, detection and response strategies of financial statement fraud in response to a review of the guidelines for Managing the Business Risk of Fraud (IIA, et al., 2007). The research suggests that the design of the anti-fraud programme should focus on three main elements: 1) financial statement fraud risk mechanism, (2) financial statement fraud risk evaluation, and (3) financial statement fraud risk responsiveness. The focus on these three elements is significant to ensure that sufficient control for financial statement fraud is incorporated in the designed anti-fraud programme.

9.10.1 Financial statement fraud risk mechanism

The financial statement fraud risk mechanism aims to provide details of the programme designed to ensure the adaptability and compliance of the programme. In relation to this, the research includes three strategies of prevention, detection and response in relation to financial statement fraud that are supposed to be matched with the nature of the business, organizational structure and the whole system of the organization. To achieve this, the research integrates all the research findings in recommending the anti-fraud programme, in particularly the prevention, detection and response strategies in relation to financial statement fraud. To be an effective anti-fraud programme, the three strategies designed should be well distributed across the company to ensure every individual in the organization comprehends the process of the strategies and their own roles and responsibilities. Once a clear explanation is provided in the programme, the company has to focus more on financial statement fraud evaluation and responsiveness. The research further elaborates the recommended three strategies of prevention, detection and response in relation to financial statement fraud as financial statement fraud control in commercial companies.
a. Prevention strategies

Prevention strategies should be supported from both the internal and external environments. The prevention from the internal environment is gained from the prevention strategies designed by the company management and the prevention from the external environment is achieved from the regulators and the relevant independent bodies. The following seven prevention strategies are found to be effective in financial statement fraud prevention in an organization:

i. Values of honesty and integrity

The first prevention strategy concerns the values of honesty and integrity, particularly among the top management. Even though these values cannot be legislated or measured by the company, these could be cultured in the organization beginning with the process of recruitment and on-going training across the company. The values of integrity and honesty are important to build a strong tone at the top. The strong tone at the top could be achieved through the independent selection of company directors. Therefore, the nomination committee plays an important role in ensuring that the company directors are appointed accordingly. Once the tone at the top has been established in the organisation, the company will perhaps be able to culture the values throughout the organisation.

ii. Specific internal control over financial statement

The second financial statement fraud prevention strategy identified is specifically through internal control over the financial statement. The control designed should be considered in each accounting process and identification of any potential financial statement fraud risk should be made. In this case, the company needs to identify the indicator or red flag that might exist in each accounting process. The control should be designed by the chief financial officer and approved by the audit committee.
iii. **Assessment of internal control over financial statement**

The third prevention strategy relates to the second strategy. It is suggested that the company hire an external auditor to assess the effectiveness of the internal control design for the financial statement process. Although the process might incur additional cost, the company has to measure this against the huge impact of financial statement fraud.

iv. **Participation of internal auditor in financial statement auditing**

The fourth strategy is the involvement of the internal auditor in financial statement auditing, as discussed in the above paragraphs. Internal auditing of the financial statement in public companies would not incur additional cost. However, the company has to ensure the competency of the internal auditors in accounting and auditing of financial statements.

v. **Greater role of board audit committee**

The sixth prevention strategy of financial statement fraud has been found in the role of the audit committee. The role of the audit committee is important in financial statement fraud control. The committee acts as the independent body of the company to oversee the integrity of the financial statements and the internal control designed. The proactive role of the audit committee in overseeing the financial matters is highly significant in financial statement fraud control. The experience and the competency of the audit committee contribute to effective overseeing of the reported financial statement. Therefore, they have to pick up and deal with any issue raised by the external auditors.

vi. **Financial statement fraud risk management**

The seventh prevention strategy pertains to financial statement fraud risk management. Every company needs to design a specific risk management programme to control financial statement fraud. As the internal control over the financial statement has been designed in relation to the financial statement process, the financial statement fraud risk management programme is supposed to cover the four elements of governance, people, methods and
practice. The internal control over the financial statement and the financial statement fraud risk management programme supposedly covers the accounting system and the non-accounting system.

vii. **Effective corporate governance**

The eighth prevention strategy of financial statement fraud complements all the other prevention strategies with effective corporate governance among the board of directors. The practice of corporate governance, specifically in Malaysia, is not compulsory for public companies unless the public company has been listed on the stock exchange.

Listed public companies are required by Bursa Malaysia to report their corporate governance practice which gives assurance to the company's stakeholders. The effective practice of corporate governance would be achieved through the combination of good structure of company's board of directors and a strong tone at the top. The independent conduct of company directors that create the strong tone at the top would prevent financial statement fraud from the top management.

b. **Detection strategies**

The research findings indicate that conventional detection methods are commonly found from whistle blowing and hotlines. In addition to these detection procedures, the internal auditing and external auditing are expected to detect fraud in financial statements. In relation to this, the research suggests that the companies consider the detection tools and software, as initiated by previous research through data mining techniques (Bose & Mahapatra, 2001), Multiple Discriminant Analysis (Altman, 1968), Financial Statement Fraud Ontology (Dillon & Hadzic, 2009) and Benford's Law (Durtschi et al., 2004)). The research also enables the companies to clearly describe what constitutes financial statement fraud to assist the individual in reporting the misconduct. In addition, the informers should be highly protected. The research also suggests the availability of whistle blowing and hotline channels to directly
report to the Securities Commission. Therefore, any perpetration by high level company management would be controlled and mitigated.

c. Response strategies

The research findings indicate that neither case study company has designed any response strategy. As such, the research suggests that the companies design and document the response strategy and corrective actions to remedy the harm caused by financial statement fraud. The research suggests four actions that should be taken by the companies in their response strategies. Firstly, the board of directors have to give priority to the issue of financial statement fraud in board meetings. To implement the antifraud programme, the board needs to establish the fraud committee that consists of independent directors and dependent directors. The role of independent directors is found to be important in the case of the involvement of company directors in financial statement fraud.

Secondly, the fraud committee should plan the response procedures in any case of financial statement fraud. The fraud committee is accountable for providing the fraud reporting channel until the prosecution process, through which the perpetrators of financial statement fraud will be dealt in accordance to the company’s fraud policy and the necessary disciplinary action before legal action is taken. Thirdly, the research suggests that the board of directors establish a fraud investigation committee. The committee would be responsible in investigating the reported cases, examining the causes of fraud, identifying the breach of financial statement process control, and suggesting the improvement of the identified control. Fourthly, the research promotes the appointment of forensic accountants to deal with the financial statement fraud investigation. Forensic accountants are expert in auditing, accounting and investigative skills pertaining to accounting fraud, particularly, and financial statement fraud.

The research found that the anti-fraud programme is significant in controlling financial statement fraud cases in public companies. The strategies designed reflect the non-
tolerance of any financial statement fraud case in the company and show that the companies have responded to financial statement fraud appropriately and in a timely manner.

9.10.2 Financial statement fraud evaluation

The research considers financial statement fraud risk evaluation as an important system to evaluate the potential risk of financial statement fraud. The company management has to identify the exposure of financial statement fraud risk for each financial statement process. The identified exposure should be evaluated periodically through which the financial statement fraud schemes would be identified. The schemes for prevention of financial statement fraud might exist in a variety of departments, places and groups of population in the company. In relation to this, each company has to focus on the identification of financial statement fraud perpetrators and how they exploit the system and hide the fraud.

9.10.3 Financial statement fraud responsiveness

In addition to the financial statement fraud risk mechanism and evaluation, the research considers that the responsiveness of financial statement fraud risk is significant to ensure that the entire management is adhering to the programme designed. Therefore, the commitment from the company individuals should be done through the affirmation process. The affirmation process should be signed by the employees to affirm their understanding concerning the controls designed. In another effort to show the responsiveness, the conflict of interest disclosure should be signed by the company management. The responsiveness of this anti-fraud programme can be achieved through the monitoring process by the company management together with the internal and external auditors. The monitoring process should also focus on the reporting procedures and risk management programme.

9.11 Summary

The research contributes methodology to the study of financial statement fraud. The case studies and interviews undertaken by this research fulfil the present gap of research where
actual experiences of the present practices are gained from two case study companies. The research also contributes new knowledge to the practical control of financial statement fraud, which requires that a greater role be played by the internal auditor and company management. The greater role of internal auditor in the scope of internal audit functions and company management possibly reduces the internal audit expectation gap that has been identified in this research analysis.

The concept of internal auditing of financial statements provides the extension of financial statement auditing by the company’s internal auditors. Thus, it increases the control and the transparency of financial statements published by commercial companies. The concept of internal auditing of financial statements provides the extension of financial statement auditing by the company’s internal auditors. Thus, it increases the control and the transparency of financial statements published by commercial companies. This concept has been reconfirmed by further interviews with accounting professionals. The researcher gained a positive response towards this new concept of internal audit expectation gap. It concurs with the findings that require a greater role by internal audit functions to reduce the gap found in the internal control system. However, this proposal might not be appropriate towards private limited companies as they have no expertise and do not require an internal audit department. All companies are threatened by fraud; therefore, an effective internal control system is a significant tool to mitigate the risk of fraud.

The research also offers anti-fraud programmes, particularly in respect of the prevention, detection and response strategies as part of a company’s efforts to mitigate financial statement fraud. External controls are gained from the participation of regulators to increase the imposed penalties and charges of financial statement fraud. The findings of this research are consistent with those of Ayala and Ibarguen (2006) who suggested that new government regulations and severe penalties for the fraud perpetrators are one approach to generate reliable financial information and to rebuild trust in the capital market institutions.
9.12 Limitations

The research is based on case study analysis, interviews with group respondents and a review of the regulations and guidelines to provide improvement to the financial statement fraud control in commercial companies. The strategic controls of financial statement fraud at the group level are the focus of research in providing recommendations for the improvement of financial statement fraud control in commercial companies. However, the research does not examine the operational control of financial statement fraud, and therefore, does not aim to resolve a specific financial statement fraud but rather examines what is being practised at the group level to mitigate financial statement fraud.

9.13 Further research

The research provides recommendations for improvement concerning financial statement fraud control based on the actual practices in the two case study companies and the perceived roles and responsibilities of the selected respondents. The research shows that greater involvement from internal auditors and company management is required to minimize the internal audit expectation gap, thus necessitating the greater participation of internal auditors in financial statement auditing. Additional studies could be further performed by employing statistical questionnaire analysis concerning the perceptions and beliefs of the issue of internal audit expectation gap among internal auditors, external auditors and company management. The research focuses on the strategic control of financial statement fraud by investigating the group level controls. Further research could be performed by focusing on the operational controls of the specific schemes of financial statement fraud in the accounting process.
References


American Institute of Certified Public Accountant (AICPA) (2012), About the ACPA
Available at: http://www.aicpa.org/About/Pages/About.aspx
(Accessed 13 December 2012)

Argyris, C. (1990) Overcoming organizational defenses: Facilitating organizational learning,
Allyn and Bacon, Boston, MA

Association of Fraud Examiners (1995), Fraud examiner’s manual, 2nd revision, ed. SCFE,
Austin, TX.

A Guide to Sarbanes Oxley Act 2002. Available at:
http://www.soxlaw/index.htm
(Accessed: 11 January 2010)

for public companies, Journal of Management of Value. Available at:
http://www.webcitation.org/5tZ0THjI8
(Accessed: 13 May 2011)

perspective of the Sarbanes-Oxley Act. Managerial Auditing Journal, 21 (1), 23-33

Baker, C.R and Bettner, M.S (1997) Interpretive and critical research in accounting: A
commentary on its absence from mainstream accounting research, Critical Perspective on
Accounting, 8 (4), 293-310

Baker N. (2011), Gear up for faster auditing, Magazine of the Chartered Institute of Internal
Auditing (IIA), 35(7), August 2011. Available at:
wnload.cfm%3Fdocid%3D97771B76-C1D0-4935-
8A8355DB593A714A+Baker+(2011)+internal+auditing+standard&cd=1&hl=en&ct=clnk&gl=uk
(Accessed: 5 February 2012)

and the Adelphia scandal, managerial Auditing Journal, 24 (2), 183-203

Bell, T.B. and Carcello, J.V (2000) A decision aid for assessing the likelihood of fraudulent
financial reporting, Journal of Practice &Theory, 19(1), 169-184

Baxter, P and Jack, S (2008) Qualitative case study methodology: Study design and
implementation for novice researchers, The Qualitative Report, 13 (4), 544-559

Benston, G.J. (1973) Required disclosure and the stock market: An evaluation of the

Beasley, M. S. (1996) An empirical analysis of the relation between the board of director

the Committee of Sponsoring Organizations of the Treadway Commission. Available at:
(Accessed: 18 December 2011)
Becker, H.S (1968), Social observations and social studies, International Encyclopedia of Social Sciences 11


(Accessed: 3 March 2010)


(Accessed 18 October 2012)

(Accessed 18 January 2010)

(Accessed: 9 February 2010)

(Accessed: 8 November 2010)

(Accessed: 10 October 2013)


(Accessed: 6 May 2010)
(Accessed: 13 December 2010)

(Accessed: 8 December 2009)


Crown Prosecution Service. Available at: http://www.cps.gov.uk/legal/d_to_g/fraud_act/#a07
(Accessed: 28 March 2010)


Cherrington, H.V. (1942) The investor and the Securities Act, 1st edn, American Council on Public Affairs, Washington, DC


(Accessed: 7 March 2010)


Dillon D. and Hadzic M.(2009), A Framework for detecting financial statement fraud through multiple data sources, 3rd IEEE International Conference Digital Ecosystem and Technologies


Dodd, E.M.Jr (1932) For whom are corporate managers trustees? Harvard Law Review, 45, 1145-1163


Financial Conduct Authority (2013) Available at: http://www.fca.org.uk/


Flesher, D.L (1996), Internal Auditing: Standards and Practices, Altamonte Springs, FL: The Institute of Internal Auditors


Hillison, W., Pacini C. and Sinason D.(1999), The internal Auditor as fraud- buster, Managerial Auditing Journal, 14 (7), 351-362


KPMG International (2006a) *Financial Statement Fraud and Fraud Risk Management*, KPMG Forensic Malaysia


282


Leung, P., Cooper, B.J and Perere, L. (2011) Accountability structures and management relationships of internal audit: An Australian study, Managerial Auditing Journal, 26(9), 794-816


Mahrer, A.R (1988) Discovery oriented psychotherapy research, American psychologist, 43(9), 694-702


O’Malley, S.F (1993) Legal liability is having a chilling effect on the auditor’s role, Accounting Horizons, 7, 82-87


Rae, K. and Subramaniam, N. (2008) Quality of internal control procedures: Antecedents and moderating effect on organizational justice and employee fraud, Managerial Auditing Journal, 23 (2), 104-124


Accessed: 2 March 2010


Shaw, K.E. (1978), Understanding the curriculum: the approach through case studies, Journal of Curriculum Studies, 10(1), 1-17


Soh, D.S.B and Bennie, N.M (2011), The internal audit function: Perceptions of internal audit roles, effectiveness and evaluation, Managerial Auditing Journal, 26(7), 605-622


(Accessed 18 January 2011)


Summers.B (2008), The Fraud Act 2006; has it had any impact?, Amicus Curiae, (75). Available at: http://sas-space.sas.ac.uk/dspace/bitstream/10065/1783/1/amicus75_summers.pdf
(Accessed: 8 November 2010)


Available at: http://www.klgates.com/files/Publication/5ca1eda3-acd7-47e1-9431-6f0511d1e7e4/Presentation/PublicationAttachment/ee2da30a-9843-4264-b182-f06d9d381051/Corp_Gov.pdf

Thief Act 1968 (UK)
http://www.opsi.gov.uk/RevisedStatutes/Acts/ukpga/1968/ukpga_19680060_en_1
(Accessed: 8 October 2010)

(Accessed: 6 October 2010)


