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Inclination towards fraud among the participants in financial reporting process

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Abstract

Fraud is a significant ethical dilemma for businesses and harmful to the capital market participants. Financial reporting fraud is an intentional misstatement of financial information to mislead the financial statement users. It causes huge losses to the organizations, threatens the investors' confidence on the published financial statements and erodes the image of accounting profession. This descriptive paper attempts to explore the inclination level towards financial reporting fraud among the participants in the financial reporting process and to determine the effect of their personal background on such inclination level. Using a sample of 121 Muslim participants in the financial reporting process at Malaysian banking institutions, the findings indicate that the inclination level is low. The inclination level is only affected by the working experience at the present bank and the bank type. The findings provide insights to the banks' stakeholders on the inclination level of fraud among the participants in financial reporting process and are particularly useful to the top management of banking institutions for a better understanding on personal background items influencing fraud in financial reporting intention. Limitations and suggestions for future research conclude the paper.

Keywords: Inclination, financial reporting fraud, Muslim, bank type, personal background

1. INTRODUCTION

Fraud is a significant ethical dilemma for businesses and is on an increasing trend (KPMG, 2009). It is believed to be the most serious corporate problem in the present business environment (Palshikar, 2002; Smith, Normah, Syed Iskandar Zulkarnain, & Ithnahaini, 2005). By its very nature, fraud is not accurately observable or measureable as it is commonly hidden. Fraud commonly committed through collusion between employee and third party, or, between employee and management (KPMG, 2009). It takes a median time lag of 18 months before the reported frauds are detected (ACFE, 2012, 2014). Fraud causes huge losses to the organizations including intangible costs of a damaged reputation (Button, Lewis, Blackbourn, & Shepherd, 2015).

Occupational fraud encompasses many forms of misconducts such as corruption, asset misappropriation or financial statement fraud. Financial statement fraud is defined as "the intentional material misstatement of financial statements or financial disclosures or the perpetration of an illegal act that has a material direct effect on the financial statements or financial disclosures," (Beasley, Carcello, & Hermanson, 1999: 11). Although low in percentage of about 8% from total occupational fraud, financial statement fraud caused the greatest median loss at $1 million (ACFE, 2012, 2014). Most common activities leading to financial statement fraud include concealment of liabilities and expenses; improper revenue recognition; and, inadequate disclosures (Beasley et

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al., 1999; KPMG, 2009; Weld, Bergevin, & Magrath, 2004). In this study the term financial statement fraud is used interchangeably with "fraud in financial reporting" or "financial reporting fraud".

Although financial reporting fraud is not a new phenomenon, it becomes more prominent among the financial regulators, corporate audit committee, accounting professional, fraud investigators, academia and the public due to high profile scandals such as Enron, WorldCom, Adelphia, Tyco, and Global Crossings. Those scandals led to the question of the financial report reliability and the decision usefulness of financial data. Thus, this descriptive paper attempts to determine the level of inclination towards financial reporting fraud among Muslim participants in the financial reporting process at Malaysian banking institutions. This study also examines the influence of personal background on the level of inclination among those participants. The term inclination is used in this study to describe the level of intention for financial reporting fraud among those participants.

This study selected the participants in the financial reporting process because the people who are entrusted with company's sensitive information and controls, especially those dealing with finance functions or finance-related role are those who are more frequently implicated in fraud (KPMG, 2011; Rezaee, 2005). Malaysian banking industry is chosen due to the magnitude impact of fraud occurrences to the industry as compared to other industries. The nature of business with abundant cash resources under the banks' control attract various frauds and embezzlements activities (Steinkamp & Solis, 2010). Although the issue of fraud in banking institutions is not widely documented in public domain either locally or abroad due to sensitivity of such information to the nature of the industry, one of the causes of financial distress and banking crisis was due to fraud and corruption (Latter, 1997 in Nathie, 2010). The failure of Islamic banks including Bank Taqwa, Faisal Islamic Bank, Kuwait Finance House, International Islamic Bank of Denmark was due to bad management, improper accounting and management system (Rajhi & Hassairi, 2011).

2. LITERATURE REVIEW

2.1 Inclination for Fraud in Financial Reporting

This study examines the inclination or intention rather than actual financial reporting fraud as the actual fraud decisions are aggregated into financial statements and not easily detectable (Carpenter & Reimers, 2005). As the actual fraud is commonly hidden, the intention to perpetrate fraud is taken as a proxy to the actual fraudulent behaviour (Buchan, 2005; Gibson & Frakes, 1997). Identifying such intention is relevant in accounting and auditing practices, due to the difficulties and costs associated with its deterrence (Rezaee, 2005). Limited research conducted measuring the actual ethical (unethical) behaviour due to the sensitivity and difficulties associated with observing the occurrence of such behaviour (Ahmed, 2010; Haines & Leonard, 2007; Sweeney & Costello, 2009; Trevino, 1992).

Only few published studies specifically examined the intention for fraudulent financial reporting. Results indicated that the CFOs of large companies are more likely to report fraudulent financial statements (Gillett & Uddin, 2005); the theory of planned behaviour is relevant in predicting whether managers' reporting decisions are ethical or unethical (Carpenter & Reimers, 2005); and, the theory of reasoned action explains behavioural intentions of non-normal financial reporting among managers and employees involved in accounting discipline (Siti Noor Hayati, Kamaruzaman, Rashidah, & Kamil, 2009; Siti Noor Hayati, Kamil, Rashidah, & Wah, 2011). Researches in other fields on the intention towards cheating behaviour that has similar characteristics with fraudulent financial reporting were also conducted (e.g. Flannery & May, 2000; Randall & Gibson, 1991; Stone, Jawahar, & Kisamore, 2009). Both behaviours performed for personal gain or reward that led to ethical implications which may impact various parties and requires considerable attention.

2.2 Personal Background as determinants for Intention

The rising trend of fraud in financial reporting urges for preventive action and need to be combated (Albrecht & Albrecht, 2002; Siti Noor Hayati et al., 2011). As fraud in financial reporting is initiated by people, the human factors need to be investigated to identify the root causes of the fraud in financial reporting incidences. In the review of ethical decision making literatures for a period from 2004 to 2011 (Craft, 2013) and the earlier period between 1996 to 2003 (O'Fallon & Butterfield, 2005), various individual and organizational factors were examined for their relationships with ethical intention. Some examples on the findings highlighted in both reviews include no significant relationships with ethical intention and ethical decision making - firstly, for age (Shafer, Morris, & Ketchand, 2001); secondly, for gender (Elango, Paul, Kundu, & Paudel, 2010; Jones & Kavanagh, 1996; Shafer et al., 2001); thirdly, for job position (Shafer et al., 2001); and, fourthly, for education level (Shafer et al., 2001). Apart from the two reviews, other studies also found the insignificant relationship with ethical intention on the personal background including gender (Foon & Fah, 2011; Sweeney & Costello, 2009); gender and age (Barnett & Valentine, 2004); age, gender, level of education, and experience (Nill & Schibrowsky, 2005); and, monthly income and experience (Cengiz, Ferman, & Akyuz, 2012; Kurland, 1996).

In contrast, both reviews (Craft, 2013; O'Fallon & Butterfield, 2005) included studies with significant results on the relationships with ethical intention and ethical decision making for gender (Beekun, Stedham, Westerman, & Yamamura, 2010; J. R. Cohen, Pant, & Sharp, 2001; Singhapakdi, 1999; Sweeney, Arnold, & Pierce, 2010; Valentine & Rittenburg, 2007); job level or position (Shapeero, Koh, & Killough, 2003); and, for work experience (Jones & Kavanagh, 1996; Valentine & Rittenburg, 2007). Other empirical research has also concluded on the significant impact on ethical intention for gender (Haines & Leonard, 2007; Stedham, Yamamura, & Lai, 2008; Stylianou, Winter, Niu, Giacalone, & Campbell, 2013); gender and age (Leonard, Cronan, & Kreie, 2004); gender, age, level of education and working experience (Pierce & Sweeney, 2010); and, for years of experience (O'Leary & Stewart, 2007).

3. MATERIALS AND METHOD

3.1 Sampling

The unit of analysis in this study is the Muslim participants that had a minimum of five years' experience in financial reporting process at Malaysian banking institutions. As the list of all the elements of the population could not be obtained, this study used a non-probability purposive sampling targeting only Muslim participants that involved in the financial reporting process for a minimum of five years, in both Islamic and conventional banks, either locally-owned or foreign-owned banking institutions.

3.2 Data collection

A total of 206 self-administered questionnaires were distributed to forty four banks. The questionnaires were personally hand-delivered to the respective bank's contact in thirty six banks, while for the remaining eight banks, the questionnaires were sent via secured postage (courier service) as the bank's contact could not be established. The distribution and collection process took over a two months' period. Ultimately, 127 questionnaires were returned (61.7%) but only 121 questionnaires (58.7%) were valid for further analysis due to the incomplete responses, irrelevant respondents and outliers.

3.3 Measures

A scenario on an ethical dilemma related to the deferring of office supplies expense into the following year to meet the current year's net income target was presented in the questionnaire to gauge the inclination towards fraud in financial reporting. The expense was not recorded upon use, which is an intentional violation of generally accepted accounting principle and resulted in financial statement fraud (Public Oversight Board, 2000 in Carpenter & Reimers, 2005). The inclination level is measured based on a single statement worded as -There is a _____ *(please specify)* % chance that I will delay the recording of this office supply into the following year- as described in Ajzen and Fishbein (1980). The respondents gave their response by estimating the percentage of likelihood or level of inclination to engage with the decision described in the ethical dilemma.

4. RESULTS AND DISCUSSION

4.1 Respondents' Profile

Table 1 summarizes the respondents' profile based on 121 valid and usable responses. This comprised of 58 (47.9%) male respondents and 55 (45.5%) female respondents. The greatest group of respondents is within the age group of 40 years and above (35 or 28.9%). Most of the respondents (62%) possessed Bachelor degree, while the concentrated income is within the range of RM5000 and below (36.4%). The respondents mainly are at middle management position (50.4%), while 38.8% are at executive level. The executive level are those designated as executives in the accounting or finance department; and, the middle management level are those designated as Assistant Vice President/Manager/Head of accounting or, Vice President/Senior Manager in accounting or finance department of the related banking institutions. For the working experience in banking sector, 69.4% of the respondents had five to fifteen years and 44.6% had less than five years working experience at their present bank. With respect to financial reporting experience in banking institution, most respondents (60.3%) fall within the range of five to less than ten years. 61 respondents (50.4%) worked in Islamic banks, while 60 respondents (49.6%) worked with conventional banks, with most of the respondents serve locally-owned banks (78.5%). Hence, the respondents' profile indicates the credibility of the respondents for this study purpose as they represent both male and female groups working in Islamic and conventional banks, with reasonable length of working experience in financial reporting and in banking.

Table 1: Respondents' Profile

Item	**Category**	**Frequency**	**%**	**Category**	**Frequency**	**%**
Gender	Male	58	47.9	No information provided	8	6.6
	Female	55	45.5			
Age	< 30 years	25	20.7	≥ 40 years	35	28.9
	30- < 35 years	28	23.1	No information provided	12	9.9
	35- < 40 years	21	17.4			
Qualification	Bachelor	75	62.0	Diploma and below	9	7.4
	Master	15	12.4	No information provided	1	.8
	Professional	21	17.4			
Income	≤ RM5000	44	36.4	> RM10000	12	9.9
	RM5001-RM7000	31	25.6	No information provided	7	5.8
	RM7001-RM10000	27	22.3			
Job Level (Position)	Executive	47	38.8	No information provided	13	10.7
	Middle management	61	50.4			
Working experience in banking sector	5- < 10 years	60	49.6	≥15 years	36	29.8
	10- < 15 years	24	19.8	No information provided	1	.8
Working experience in financial reporting in banking	5- < 10 years	73	60.3	≥15 years	19	15.7
	10- < 15 years	26	21.5	No information provided	3	2.5
Working experience at present bank	< 5 years	54	44.6	10- < 15 years	15	12.4
	5- < 10 years	32	26.4	≥15 years	20	16.5
Bank type	Islamic banks	61	50.4	Conventional banks	60	49.6
Bank ownership	Local-owned bank	95	78.5	Foreign-owned bank	26	21.5

4.2 Level of Inclination for Fraud in Financial Reporting

For comparison purpose, the individual percentages as specified by each respondent indicating their inclination level are summarized into six different ranges as shown in Table 2 below.

Table 2: Percentages of Inclination towards Fraud in Financial Reporting

Inclination (%)	**Frequency**	**Percent**
0	30	24.8
1 – 25	29	24.0
26 – 50	22	18.1
Sub-total	**81**	**66.9**
51 – 75	21	17.4
76 – 99	17	14.0
100	2	1.7
Sub-total	**40**	**33.1**
Total	**121**	**100**

From the table, 81 respondents (66.9%) indicated 50% and lower inclination towards fraud in financial reporting, with 30 respondents (24.8%) showed no inclination at all. In contrast, 40 respondents (33.1%) indicated more than 50% inclination towards fraud in financial reporting, with only two respondents (1.7%) specified 100% inclination for such intention. Thus, there is a low inclination level towards fraud in financial reporting among Muslim participants in the financial reporting process in Malaysian banking industry.

4.3 Personal Background as Determinants of Inclination Level

Further analysis was done to determine the significant difference between the respondents' personal background with their level of inclination, using Chi-square test for independence. This test is useful for examining the relationship between two categorical variables where each of these variables can have two or more categories (Pallant, 2010). For this purpose, the percentages of inclination were split into two groups to indicate low inclination (i.e. 50% and lower); and high inclination level (i.e. more than 50%), respectively. The association of each personal background item with the percentages of inclination groups is measured in turn.

From the Chi-Square tests results (Table 3) the Asymp. Sig. values of eight personal background items are larger than the alpha value of .05, while two values are lesser than 0.05. Thus, there is no significant different for the percentage of inclination towards fraud in financial reporting when comparing the respondents' personal background except for the bank type between Islamic and Conventional banks; and, the working experience at the present bank. The insignificant findings on gender, age, level of education (qualification), monthly income, job position, working experience (in banking and in financial reporting) and bank ownership are supported by several past studies. For example, no significant conclusion derived in prior studies on the relationships with ethical intention or ethical decision making for firstly, gender (Barnett & Valentine, 2004; Cengiz et al., 2012; Chan & Leung, 2006; Foon & Fah, 2011; Jones & Kavanagh, 1996; Nill & Schibrowsky, 2005; Shafer et al., 2001; Street & Street, 2006; Sweeney & Costello, 2009; Zgheib, 2005); secondly, age (Barnett & Valentine, 2004; Cagle & Baucus, 2006; Eweje & Brunton, 2010; Nill & Schibrowsky, 2005; Shafer et al., 2001); thirdly, education level (Cagle & Baucus, 2006; Foon & Fah, 2011; Nill & Schibrowsky, 2005; Shafer et al., 2001); fourthly, monthly income (Cengiz et al., 2012; Kurland, 1996); fifthly, job position (Cengiz et al., 2012; Pierce & Sweeney, 2010; Shafer et al., 2001); and, lastly, working experience (Kurland, 1996; Nill & Schibrowsky, 2005).

Table 3: Chi-Square Tests and Symmetric Measures

	Chi-Square Tests			**Symmetric Measures**
	Value	Df	Asymp. Sig. (2-sided)	
Continuity Correction [a]				**Phi coefficient value [a]**
Gender * Inclination	0.165	1	0.685	0.057
Job Position* Inclination	0.005	1	0.945	0.026
Bank type * Inclination	**4.795**	**1**	**0.029**	**0.217**
Bank ownership * Inclination	2.121	1	0.145	-0.154
Pearson Chi-Square				**Cramer's V value**
Age * Inclination	3.167	3	0.367	0.170
Qualification* Inclination	3.217	3	0.359	0.164
Income * Inclination	1.915	3	0.590	0.130
WE banking * Inclination	0.200	2	0.905	0.041
WE financial reporting * Inclination	1.202	2	0.548	0.101
WE present bank * Inclination	**8.321**	**3**	**0.040**	**0.262**

[a] *Computed only for a 2x2 table; WE indicates working experience*

In contrast, the significant difference for the bank type (which is similar to firm type) is supported by prior studies, namely Cengiz et al., (2012) that conclude on the significant difference in attitude towards business ethics among employees in different firm types of finance sub-sector – banks, participation banks and insurance companies. Similarly, the significant difference between Big Eight firms and local CPA firms for fraud variable (i.e. no material effects of fraud financial statements) and GAAP variable (i.e. financial statements are materially in accordance with generally accepted accounting principles) was found by McKinley, Pany and Reckers (1985). In a study examining the analyst forecast and recommendation optimism across four firm types, it was found that the analysts of retail brokerage firms are more optimistic than those serving only institutional investors (Cowen, Groysberg, & Healy, 2006), and, the auditors employed by international CPA firms were less likely to express an intention to engage in ethically questionable actions auditors employed by local CPA firms (Shafer, 2008). Specific to this study, the significant difference of bank type on the inclination towards fraud in financial reporting may reflect the different in the identity of Islamic banks and conventional banks. The principle underlying the operation and activities of Islamic banks is *Shari'ah* law, whereas conventional banks are operating solely for business purpose with no religious aspect (Sudin & Wan Nursofiza, 2009).Those who manage and govern Islamic banks are not only expected to make economic decisions on behalf of the shareholders and fund depositors in enforcing the rules of God, but to be believers imbued with piety and righteousness (Haniffa & Hudaib, 2007). Firms with strong religious social norms found to experience lower incidences of financial reporting irregularities (Dyreng, Mayew, & Williams, 2012; McGuire, Omer, & Sharp, 2012). As for the significant result of working experience at the present bank, it is consistent with the studies that had concluded on the significant relationship between work experience and ethical intention (Eweje & Brunton, 2010; Jones & Kavanagh, 1996; O'Leary & Stewart, 2007; Pierce & Sweeney, 2010; Valentine & Rittenburg, 2007).

Further examination on the difference in each of the personal background item against the differences in percentages of inclination was done using crosstabulation test. From Table 4, the respondents that had low inclination level with 50% and less inclination towards fraud in financial reporting are mainly characterized by the male respondents (34.5%); within the age group of 40 years and above (21.1%); possessed bachelor qualification (40.8%); with monthly income of RM5000 and below (25.4%); Their job position are at middle management level (37%); had five to less than ten years working experience in banking industry (34.2%) and in financial reporting process of the banking institution (42.4%). They served the present banking institution for not more than five years (34.7%); worked in Islamic banks (38.8%); and, locally owned banks (49.6%). These characteristics gave overview on the specific personal background that differentiates the inclination level towards fraud in financial reporting among the respondents.

Table 4: Crosstabulation

		Inclination (%)				Total	
		50% and less		More than 50%			
		Count	% of Total	Count	% of Total	Count	% of Total
Gender	**Male**	39	**34.5**	19	16.8	58	51.3
	Female	34	30.1	21	18.6	55	48.7
Age	< 30 years	20	18.3	5	4.6	25	22.9
	30-<35	16	14.7	12	11.0	28	25.7
	35-<40	14	12.8	7	6.4	21	19.3
	40 and above	23	**21.1**	12	11.0	35	32.1
Qualification	**Bachelor**	49	**40.8**	26	21.7	75	62.5
	Master	11	9.2	4	3.3	15	12.5
	Professional	16	13.3	5	4.2	21	17.5
	Diploma and below	4	3.3	5	4.2	9	7.5
Income	**RM5000 and below**	29	**25.4**	15	13.2	44	38.6
	RM5001-RM7000	19	16.7	12	10.5	31	27.2
	RM7001-RM10000	18	15.8	9	7.9	27	23.7
	Above RM10000	10	8.8	2	1.8	12	10.5
Job Position	**Middle management**	40	**37.0**	21	19.4	61	56.5
	Executive	32	29.6	15	13.9	47	43.5
Working Experience in Banking Industry	**5-<10 years**	41	**34.2**	19	15.8	60	50.0
	10-<15	16	13.3	8	6.7	24	20.0
	≥15 years	23	19.2	13	10.8	36	30.0
Working Experience in Financial Reporting	**5-<10 years**	50	**42.4**	23	19.5	73	61.9
	10-<15	19	16.1	7	5.9	26	22.0
	≥15 years	11	9.3	8	6.8	19	16.1
Working Experience at the Present Bank	**<5 years**	42	**34.7**	12	9.9	54	44.6
	5-<10	19	15.7	13	10.7	32	26.4
	10-<15	11	9.1	4	3.3	15	12.4
	≥15 years	9	7.4	11	9.1	20	16.5
Bank Type	**Islamic banks**	47	**38.8**	14	11.6	61	50.4
	Conventional banks	34	28.1	26	21.5	60	49.6
Bank Ownership	**Local-owned**	60	**49.6**	35	28.9	95	78.5
	Foreign-owned	21	17.4	5	4.1	26	21.5

For assessing the effect size of each personal background item on the percentage of inclination towards fraud in financial reporting, the correlation coefficient value (*phi* coefficient or Cramer's V) was examined (Table 3). This value can range from 0 to 1, with higher values indicating a stronger association between the two variables. Specifically, the value of 0.10 indicates small effect, 0.3 reflects medium effect and 0.50 shows large effect (J. Cohen, 1988). From Table 3, although the values for bank type (0.217); and, for working experience at the present bank (0.262) are higher compared to other personal background items, these values are still below the medium effect size threshold of 0.3 (J. Cohen, 1988). Thus, all personal background items gave small effect on the inclination towards fraud in financial reporting, with the bank type and working experience at the present bank show stronger effect on the inclination towards fraud in financial reporting among the respondents.

In short, the Chi-square test for independence indicated no significant association between all personal background items and inclination towards fraud in financial reporting except for the bank type (χ^2 = 4.795, ρ=0.029, *phi*= 0.217) and the working experience at the present banking institution (χ^2 = 8.321, ρ=0.040, Cramer's V= 0.262). Overall results also indicated small effect size of all personal background items on the inclination towards fraud in financial reporting

5. CONCLUSION

The overall inclination level indicates that the Muslim participants in financial reporting process had low intention of committing fraud in financial reporting. This gives a positive signal on the reliability of the financial reports prepared within the banking institutions. This may also indicate the trustworthiness of Muslim participants in financial reporting process in performing their professional duties. It was also found that the difference in bank type between Islamic banks and conventional banks; and, working experience at the present bank were significant towards the inclination for fraud in financial reporting. This may reflect that the respondents are safeguarding the ethical identity of Islamic banks.

The findings provide insights to the banks' stakeholders on the inclination level of fraud among the participants in financial reporting process, and are particularly useful to the top management in banking institutions towards a better understanding on the influence of personal background towards financial reporting fraud. However, the findings of this study need to be interpreted with caution because the findings were derived from descriptive results focusing purely on the personal background of the respondents. Future research should explore other personal and organizational variables reported in prior research that potentially affecting the inclination towards fraud in financial reporting or unethical behavioural intention such as the influence of attitude, subjective norm, religiosity, and professional code of ethics.

Another limitation is the use of scenario to reflect the ethical dilemma in financial reporting process. Although the scenarios are widely used in business ethics research (e.g. Ampofo, Mujtaba, Cavico, & Tindall, 2011; Carpenter & Reimers, 2005; Chun-Chang, 2007; Flannery & May, 2000; Randall & Gibson, 1991; Uddin & Gillett, 2002), the scenarios are artificial and only examine hypothetical situations (Brief, Dukerich, Brown, & Brett, 1996). Scenario is presented with a limited information thus the respondents' decision may not reflect their true judgment in a more realistic and complex setting (Barnett & Valentine, 2004). Thus, the responses received represent, at best, the tendencies for financial reporting fraud among the Muslim participants in financial reporting process. However, steps were taken to minimize the potential of social desirability bias in using scenarios, through the presentation of measurement items in a non-offensive and neutral manner to the respondents; and, the use of self-administered questionnaire with the covering letter assuring anonymity and confidentiality of the responses received (Flannery & May, 2000; Fritzsche, 2000; Nederhof, 1985). Thus, future research using survey method incorporating different scenarios representing various ethical dilemmas relating to the participants in financial reporting process may be undertaken for comparison in the research outcome.

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