RISK ATTITUDE AND FRAUD DETECTION: A MALAYSIAN CASE

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Abstract

Fraud is an important issue in many countries such as in the United States, United Kingdom, including of Malaysia. Malaysian Approved Auditing Standards, AI 240 "Fraud and Error" was established to provide guidance on the auditor's responsibility to consider fraud and error during the audit of financial statements. The auditors are required to appropriately assess fraud risk during the planning of the audit work so that they can provide reasonable assurance that any material misstatement in the financial statements has been detected. If the external auditors are not able to detect fraud, this may expose them to litigation. The present study aims to examine whether risk attitude has an effect on the external auditors' ability to detect the likelihood of fraud. An experimental approach is adopted by sending case materials to audit partners and audit managers attached to auditing firms operating in Malaysia. The result shows that means difference exists on the ability to detect the likelihood of fraud between the external auditors who are risk averse and those who are risk taker.

Key words: External auditors, fraud, fraud detection ability, risk attitude.

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1. Introduction

For the last twenty to twenty five years, Malaysia has not been spared of the occurrence of cases of fraudulent activities in its public companies. Examples of these include the Bank Rakyat, Bumiputra Malaysia Finance (BMF), Pan Electric Group of Companies, Perwira Habib Bank, Deposit Taking Cooperatives (DTCs) and Cooperative Central Bank (CCB) cases (Ali, 1994). KPMG Malaysia (2003) in their Fraud Survey 2002 Report stated that from 168 responses from chief executives of public listed and top private companies in Malaysia, 50% of them had experienced fraud in their organization. Forty percent of the companies claimed that they had suffered losses between RM10,001 and RM100,000 over the past years (i.e. a period from January 2001 to December 2002) due to fraud, 33% above RM1 million, while 12% reported incurring losses of RM10,000 and below[1].

In the United States, Mitchell (1997) in his article stated that the "Report to the Nation on Occupational Fraud and Abuse" showed that losses from fraud caused by managers and executives were 16 times greater than those caused by non-managerial employees. KPMG Malaysia (2003) reports that in the Malaysian scenario, non-management employees caused 56% of financial losses due to fraud, while employees in the management category caused 18% of financial losses due to fraud.

Vanasco (1998) contends that fraudulent financial statements are of great concern not only to the corporate world, but also to the accounting profession. He adds that such events will undermine the credibility of auditors in their reporting function and erode public confidence in the accounting and auditing profession. Public accountants undoubtedly contributed to the recent corporate frauds by certifying financial statements that ultimately proved to be fraudulent or at least defective (Ribstein, 2002). Zeune (1997) states that independent auditors detect only 5% of fraud. As a result, the public may question why auditors are unable to detect fraud during the conduct of the annual audit. The recent collapse of Enron shed some news and somewhat threw unfavourable light on the role that external auditors play in the detection of fraud (Thomas & Clements, 2002). Although fraud may not be well documented in Malaysia, this issue could not be taken for granted because what happened in other countries, for instance in the US, could happen elsewhere.

[1] KPMG Malaysia Fraud Survey Report 2009 stated that financial losses due to fraud ithin the range of RM10,001 and RM100,000 accounted for 20% of the fraud incidents reported. This, however, is still considered as low.

Furthermore, the country should be concerned about the response to KPMG Malaysia's (2003) survey that showed the occurrence of fraudulent activities in Malaysia. The issue is made more important based on the findings by KPMG Malaysia's (2003) survey that external auditors only detected 4% of the fraud incidences[2].

Many researchers suggest that personality may affect job performance. Very few studies in the ability to detect fraud (Pincus, 1984; Bernardi, 1994 and Zimbelman & Waller, 1999) had examined the effect of personality factor on the ability to detect the likelihood of fraud. Nevertheless, those studies present inconclusive results. Selto and Cooper (1990) state that risk attitude may affect decision making. It is ironically to note the former Arthur Andersen case, in which a $7 million fine levied against Arthur Andersen because of its mishandling of Waste Management a few months before the Enron scandal broke did not provoke Arthur Andersen to significantly change its ways (Ribstein, 2002). Risk attitude, being a personality trait itself, had never been specifically investigated in the fraud detection literature. Hence, the present study takes the first attempt to examine the possibility that the external auditors' risk attitude might have affected their ability to detect the likelihood of fraud.

2. Literature Review and Hypothesis Development

2.1 Detection of Fraud

Review of the literature shows that factors examined by studies on the ability to detect the likelihood of fraud can be categorized into several dimensions: audit task, personality, cognitive factors, auditor's ethical status, auditor's characteristics, audit firm's characteristics, audit firm's roles, auditor's roles and fraud risk indicators.

Analysis of the literature shows that very limited studies on ability to detect fraud (Pincus, 1984; Bernardi, 1994; and Zimbelman & Waller, 1999) had investigated the effect of the external auditor's personality on his/her ability to detect the likelihood of fraud. Nonetheless, no study investigates the risk attitude of the external auditors. Hence, the present study takes the first attempt to examine the effect of the external auditors' risk attitude on their job performance, particularly in detecting fraud. The present study will contribute to the literature through providing evidences on the fraud detection ability of the external auditors in Malaysia. Notwithstanding the importance of the other eight dimensions which were investigated before, personality, in particular risk attitude, is the focus of the present study because it is a fundamental aspect of the external auditors and might influencing the external auditors in performing their task. Thus, the present study suggests that personality factor, i.e. risk attitude, may affect the external auditors' ability to detect the likelihood of fraud.

2.2 Studies on personality factors in accounting literatures

Accounting literature offers some studies on the impact of personality traits on various issues such as auditors' behaviour (DeCoster, Rhode, Gaines and Murphy, 1971; Choo, 1986; Rasch & Harrell, 1990; Tsui & Gul, 1996; Donnelly, Quirin & O'Bryan, 2003), auditors' judgment (Lehmann, 2001), job exhaustion (Law, 2003) and managers' opinion (Hartmann, 2005). These studies offer mixed results concerning the effect of the personality traits on the dependant variables concerned. In terms of a specific personality trait which is risk attitude, many studies in business literature had examined risk attitude within the context of capital market issues (e.g. Ross, 2004; Frutos & Manzano, 2002) and tax judgment (e.g. Kaplan & Reckers, 1985). In accounting literature, Helliar, Lonie, Power and Sinclair (2002) have examined the attitude to risk by Scottish chartered accountants and considers whether their risk-taking attitudes are similar to or different from those of other business managers in the United Kingdom.

As mentioned earlier, in fraud detection literature only Pincus (1984), Bernardi (1994) and Zimbelman and Waller (1999) examined personality factors. The present study analyzes the effect of specific personality of the external auditors which is risk attitude on their ability to detect the likelihood of fraud. The attempt taken by the present study is essential because only Pincus (1984) finds that personality factors (that are field independent, narrow category width and ambiguity tolerant) have direct effects on ability to detect fraud. Hence, the present study may offer empirical evidence concerning the possible influence of personality, specifically risk attitude, on the external auditors' ability to detect the likelihood of fraud within the context of developing country.

2.3 Expected Utility theory

Expected Utility theory by Savage (1954) provides a methodological framework for the evaluation of alternative choices made by individuals, firms and organizations. Utility refers to the satisfaction that each choice provides to the decision maker. Thus, utility theory assumes that any decision is made on the basis of the utility maximization principle, according to which the best choice is the one that

[2] KPMG Malaysia (2009) fraud survey for the period of 2007-2008 reported that external auditors detected 8% of the fraud incidences in Malaysian companies.

provides the highest utility (satisfaction) to the decision maker.

Within the context of the present study, it is expected that the continuation in providing services to the existing audit client or retention of existing client would be the utility of the external auditors. Hence it is perceived that the external auditor would try to produce unqualified audit report to satisfy the audit client and subsequently may prolong (retain) the engagement with the same audit client. Thus, the external auditor who is risk taker will carry out less extensive audit tests eventhough various fraud risk indicators exist and thus will be not able to detect the likelihood of fraud. On the other hand, the external auditors who are risk averters would do extensive audit tests given high fraud risk indicators exist and thus able to detect the likelihood of fraud. The present study proposes that risk averters are more able to detect the likelihood of fraud compared to risk takers. Hence, the present study hypothesizes that:

H: External auditors who are risk averters are more able to detect the likelihood of fraud compared to those who are risk takers.

3. Research Method

3.1 Research design

An experimental approach is utilized in the present study. There is one independent variable that is risk attitude, which is manipulated as risk-aversion and risk taking.

3.2 Research instrument

3.2.1 Case material

The present study uses case material which is developed by modifying those of Zimbelman (1996), Brief, Dukerich, Brown and Brett (1996), and Moet (1997). A case study of high fraud risk scenario is developed for XYZ Manufacturing Bhd. and the subjects are required to assume that they are involved in the audit this hypothetical company.

3.2.2 Sample

Practicing independent auditor registered in Malaysia, designated as audit partner or audit manager who are attached to the auditing firms operating in Malaysia is the sample group of the present study. There is no database, however, available regarding the numbers of audit partners and audit manager in Malaysia. Database of auditing firms operating in Malaysia was obtained from the Malaysian Institute of Accountants (MIA) website. As at May 2006, the MIA website indicates that there are 1370 firms registered with MIA. The present study distributes the research materials to all these auditing firms. Since the actual total population of audit partners and audit managers attached to the auditing firms operating in Malaysia is unknown, therefore the present study used all auditing firms operating in Malaysia as perceived population.

3.2.3 Administration of the research instrument

The research instruments were mailed directly to the auditing firms. The cover letter stated clearly that the research materials must be attempted by audit partner or audit manager of the firms. A pilot test was conducted with 30 audit managers drawn from the sample firms in the study. The feedback from the pilot testing required no amendment of the research material. Hence, the instruments are validated since the results of the pilot test show that the case is realistic.

3.3 Variables of the study

3.3.1 Dependent variable

The dependent variable is the external auditors' ability to detect the likelihood of fraud. This variable is measured on a 7-point Likert scaling ranging from extremely unlikely to extremely likely, by asking the subject: "Based on your judgment, what is the likelihood that the management of XYZ Manufacturing Bhd. would fraudulently misrepresent the financial statements?. An answer "likely" and above indicates that the management fraud is considered to have been detected.

3.3.2 Independent variable

The independent variable is the risk attitude. It is measured by following the methodology adopted by Helliar et al. (2002). The subjects are given with a scenario concerning financial decision and they are required to choose one option (i.e. Option A or Option B). The subject is considered as a risk averter if he/she choose option A and a risk taker if he/she choose option B.

4. Results and Discussion

4.1 Response rate

The response rate of the present study is approximately 6%. Although this rate is low and may not be representative of the population, the sample size is considered adequate for research that is experimental in nature[3]. Roscoe (1975) states

[3] Early-versus-late tests have been conducted and the results shows that the responses of the late response subjects are not statistically different from the responses of the early response subjects. Thus, should the response rate be greater than 6%, as per obtained by the present study, the results of the present study would not be significantly different, since a non-response bias does not exist.

that a sample size larger than 30 and less than 500 is appropriate for most research. The final reporting sample is shown in Table 1.

Table 1. Response rate

	N	*%*
Research instruments distributed	1370	100
Less: Non-replied research instruments	1277	93
Research instruments received	**93**	**7**
Less: Research instruments rejected	13	1
Usable research instruments	**80**	**6**

4.2 Hypothesis testing

Since there is only one independent variable which is nonmetric and one dependent variable which is metric, thus t-test is used to test the hypothesis (Sharma, 1996). An independent sample t-test was conducted and the results are presented in Table 2. The independent sample t test evaluates the difference between the means of two independent groups, i.e. risk aversion group and risk taking group. Since the variances of the two groups are different and the sample sizes are uneaqual (i.e. risk aversion group = 68; risk taking group = 12) thus, data on equal variances not assumed is used. The result shows that there is a significant different, p = 0.089, in the means of the external auditors who are risk averters and those who are risk takers. Thus, it can be concluded that risk attitude does have a positive effect on the external auditors' ability to detect the likelihood of fraud. Hence, the hypothesis of the present study is accepted.

Table 2. Tests of risk attitude effect on the ability to detect the likelihood of fraud

Group statistics

	Risk attitude	N	Mean	Std. Deviation	Std. Error Mean
Ability to detect fraud	Risk aversion	68	5.5441	.96867	.11747
	Risk taking	12	5.0000	.95346	.27524

Independent Samples Test

		Levene's Test for Equality of Variances		t-test for Equality of Means						
									95% Confidence Interval of the Difference	
		F	Sig.	t	df	Sig. (2-tailed)	Mean Difference	Std. Error Difference	Lower	Upper
Ability to detect fraud	Equal variances assumed	.250	.618	1.798	78	.076	.54412	.30264	-.05838	1.14662
	Equal variances not assumed			1.818	15.289	.089*	.54412	.29926	-.09269	1.18093

- Significance level = 10%

4.3 Discussion

Risk attitude has an effect on the external auditors' ability to detect the likelihood of fraud. The findings corroborate with the Expected Utility Theory in that the decision/judgment made by the external auditors is on the basis of the utility maximization principle, according to which the best choice is the one that provides the highest utility (satisfaction) to the decision maker, that is the external auditors, that is the ability to retain the audit client by issuing an unqualified audit report. The findings also support Pincus (1984) that personality has an effect on the ability to detect the likelihood of fraud. The present study concludes that the continuation in providing services to the existing audit client or retention of existing client would be the utility of the external auditors. Thus, the external auditors who are risk takers would carry out less extensive audit tests eventhough various fraud risk indicators exist and thus will be not able to detect the likelihood of fraud. This is because their aim is to retain the engagement with the same audit client by producing unqualified audit report to satisfy the audit client. On the other hand, those who are risk averters would be very careful and highly consider the fraud risk indicators that exist and perform extensive audit tests and thus able to detect the likelihood of fraud.

5. Conclusion

The results of the present study has conformed to the literature that personality, that is specifically risk attitude, affects job performance, specifically to the present study in terms of fraud detection. Future research may be conducted to investigate the effect of risk attitude on the performance, i.e. ability to detect the likelihood of fraud, of another group of auditors, i.e. internal auditors..

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