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Factors Influencing Fraudulent in Financial Reporting Using Fraud Triangle Theory in Malaysia: A Conceptual Paper

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Abstract
Through the years, many highly publicised financial reporting frauds have occurred around the world. In each case, misrepresented financial reporting led to huge financial losses and a number of bankruptcies. Therefore, auditors and management are more concerned with fraud in financial reporting as it is more likely to occur, and the amounts involved are huge. This can lead to disturbing effects on the current global economy. Somehow, fraud in financial reporting can be prevented by knowing the factors that can contribute to it. Hence, with the objective of enhancing the understanding of the primary factor that caused fraudulent financial reporting, this conceptual paper aims to discuss the fraud triangle theory. In relation to this, there are three conditions that exist when fraud occurs, which are: (i) pressure, (ii) opportunity, and (iii) rationalisation. In addition, this paper also aims to propose a recommendation for eliminating or minimising the fraud triangle elements in theory.
Keywords: Fraud Triangle Theory, Fraudulent Financial Reporting, Pressure, Opportunity, Rationalisation

Introduction

These days, scandals involving the financial accounting of businesses have ceased to be surprising pieces of daily news. There are various interesting cases that involve in fraudulent activities. For instance, the cases of Enron, WorldCom, Lehman Brothers, Bernie Madoff, Olympus, and others are a few of the most notable ones that have been negatively affected by the debilitating effects of fraud. These cases have significantly escalated global concerns about fraud, resulting in the loss of billions of dollars of shareholders' value and contributing to a decline in investors and public confidence in the world's financial markets (Abdullahi & Mansor, 2015). Accounting fraud can be defined as the practice of manipulating a company's financial reporting on purpose in order to give the appearance that the business is in better financial shape than it actually is. This issue involves employees, accountants, or could potentially be the business itself manipulating the trust of shareholders and investors. It is certainly possible for a business to counterfeit its financial reporting by exaggerating its revenues, concealing its expenses, and making misleading representations regarding its assets and liabilities (Nickolas, 2022).

The Enron scandal is one of the most well-known issues of manipulating financial reporting. Enron utilised its off-balance-sheet businesses in order to conceal the company's liabilities from the shareholders and creditors. Thus, this proves that Enron had committed accounting fraud because it failed to disclose the relevant facts of its business activities (Nickolas, 2022).

The broad view is that the primary priority should be preventing fraud, which has been the subject of numerous research studies. Detecting fraud after it has happened is more costly and ineffective than avoiding it from happening in the first place. When the fraud is found, the asset is frequently lost forever, or the likelihood of recovering the entire loss is extremely limited. Additionally, looking into scams, particularly those involving huge multinational businesses, is expensive and time-consuming. Nevertheless, when the emphasis is placed on preventing fraud, all financial losses, time, and effort spent on reconstructing fraudulent transactions, finding offenders, and recovering missing monies may potentially be avoided (Abdullahi & Mansor, 2015).

In a nutshell, finding fraudulent activities is not a simple task, and it is necessary to have an in-depth knowledge of the characteristics of fraud and the methods used to conceal it. Thus, the fraud triangle plays a vital role as this model will help analyze the variables that can lead someone to commit occupational fraud (Cressey, 1953). Besides that, it is made up of three parts that, when combined, result in fraudulent behavior: the perception of pressure, the perception of an opportunity, and the rationalization of the behavior. The fraud theory developed by Cressey helped regulators, professionals, and academics better understand why trust violators perpetrate fraud (Mohottige et al., 2018).

Fraudulent Financial Reporting

Fraudulent financial reporting is defined as the deliberate overstating or understating of balances in financial reporting (ICAEW, 2020). It is often difficult to identify this form of fraud because accounting treatments are frequently judgmental, resulting in a fine line between optimistic but acceptable financial reporting and fraud. Financial reporting fraud is the least common type of fraud, but when it happens, businesses loss the most on average (ACFE, 2019).

Financial reporting fraud is a bit different from asset misappropriation and might be more difficult to identify. The latter is more likely to occur but usually involves smaller amounts of money. For example, someone might lie to steal inventory or commit billing fraud for personal benefit. In contrast, the former may not include any direct monetary benefit. Individuals are generally driven by internal or external organisational pressures to meet performance objectives and associated indirect rewards, such as avoiding the loss of a bonus payment or an increase in share price (ICAEW, 2020).

A study by Beasley et al (2000) has found that fraudulent financial reporting generally involves:

1) Falsifying, altering, or manipulating accounting records or supporting documentation used to create financial reporting.

2) Intentionally misrepresenting events, transactions, or other material information in financial reporting.
3) Incorrect application of accounting standards pertaining to amounts, classification, presentation, or disclosure.

Determining if the reviewed financial reporting is in good order or contains materially misstated information is vital. Thus, financial reporting analysis can be used to determine the possibility of fraud in financial reporting. Several tools have been developed to assist users in analyzing financial reporting. According to the Association of Certified Fraud Examiners (ACFE, 2019), one of the methods is percentage analysis, including vertical and horizontal analysis.

Vertical analysis is a method for examining the connections between the components in financial reporting for a single reporting period. The analysis yields percentage values for component relationships, which can be compared over time. This technique is also referred to as "common sizing" in financial reporting. In the vertical analysis of an income statement, net sales are assigned 100%; in a balance sheet, total assets are assigned 100% on the asset side, and total liabilities and equity are expressed as 100% on the other side. Every item in each section is expressed as a percentage of these numbers (ACFE, 2019).

The horizontal analysis examines the percentage difference in each financial reporting item from one year to another. The first period in the analysis is regarded as the baseline, and changes in the following periods are calculated as a percentage of the baseline. If more than two periods are shown, the changes in each period are calculated as a percentage of the prior period. The generated percentages are then thoroughly examined. In horizontal comparisons, evaluating the amount of change and the percentage is critical. A 5% change in an account with a large ringgit amount may be far more significant than a 50% change in an account with little activity. In comparison to vertical analysis, the analysis fails to detect minor or insignificant frauds. However, both methods turn changes into percentages, which can then be compared to show the most important areas that can help detect fraud in financial reporting (ACFE, 2019).

Fraud Triangle Theory

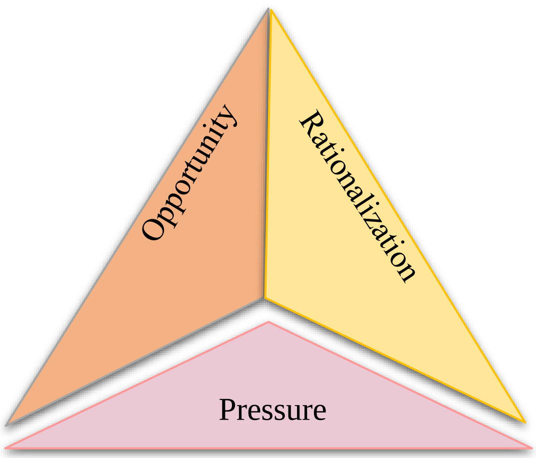

Figure 1: *Fraud Triangle*

Donald Cressey, a criminologist, began studying the reasons that encourage people to engage in fraudulent and unethical behaviour in 1950 (Dorminey et al., 2010). He began his investigation into fraud by claiming that whatever humans do must have a reason. Questions like, "Why do individuals commit fraud?" prompted him to focus his research on what

motivates people to violate trust. During a 5-month period, he interviewed 250 criminals whose behaviour fit two criteria: (i) persons initially assume obligations of trust in good faith, and (ii) circumstances cause them to break the trust. He states that three elements (pressure, opportunity, and justification) must coexist for a crime to occur. Cressey further states the following: "*Trust violators are those who conceive of themselves as having a financial problem that is non-shareable and have knowledge or awareness that this problem can be secretly resolved by a violation of the position of financial trust. They can also apply verbalisations to their own behaviour in that situation that allow them to adjust their conceptions of themselves as trusted persons with their conceptions of themselves as users of the entrusted funds or property"* (Cressey, 1953).
The three components of fraud, as outlined by Cressey (1953), are typically presented in the form of a diagram, such as shown in **Figure 1**. The diagram's top element represents the opportunity and rationalisation, while the bottom element represents the pressure or motive to do the fraudulent act (Rasha & Andrew, 2012). The fraud proposition has become well-known as the Fraud Triangle throughout the years.

Background of Study

In this study, the focus is on fraud that occurs in financial reporting. Financial reporting fraud had escalated, and it was found that 77% of the financial reporting fraud is committed by individuals in the company's senior management, executives, and accounting officers through sales and buy operations or during the consolidation of company accounts (Norziaton, 2022). Moreover, a company manipulates financial reporting because it wants to show that its performance looks better than the actual outcome and ensure that they maintain a favourable position in the future. Financial reporting is frequently performed by numerous people with different motives within the company to make the company's position appear stronger on paper even though the company faces financial conflict (Aghghalaleh et al., 2014).
One of the companies with the biggest financial reporting fraud scandal was 1Malaysia Development Berhad (1MDB) in 2015. This complex and far-reaching case involved the alleged misappropriation of billions of dollars from the state investment fund. The funds were purportedly embezzled for personal gain and used for extravagant purchases, including luxury real estate, artworks, and a Hollywood film production. The scandal shook Malaysia's political landscape and sparked investigations and legal actions across multiple jurisdictions. Recently, Serba Dinamik Holdings Berhad Scandal, an engineering services company, faced allegations of financial irregularities in 2021. The company was accused of overstating its revenue and engaging in questionable related-party transactions. The scandal led to the suspension of the company's shares, investigations by regulatory authorities, and ongoing efforts to address the allegations and restore investor confidence. FGV Holdings Berhad, a major palm oil producer in 2017, was highlighted regarding the company's mismanagement, governance issues, and financial irregularities. These included accusations of inflated land purchases and dubious transactions. The scandal led to investigations, changes in top management, and efforts to restore trust and transparency within the company. Getah Indus Holdings Berhad, a rubber product manufacturer, faced allegations of financial irregularities in 2019. The company was accused of overstating its sales figures and manipulating its financial statements. The scandal led to investigations by regulatory authorities and legal actions to address the fraudulent practices. Cuscapi Berhad, a technology solutions provider, faced allegations of inflating its revenue figures through fictitious sales transactions and engaging in irregular accounting

practices in 2018. The scandal led to regulatory investigations, changes in management, and efforts to improve corporate governance and financial transparency. There are many more previous cases not being highlighted here, and it raises a concern about the severity of the impact on the trust of the public towards Malaysian authorities and governance. The financial fraud cases involving publicly listed companies in Malaysia have significantly impacted investors, the economy, and the overall trust in the country's financial markets.

Problem Statement

A report published by ICAEW (2019) states that the listed companies' financial reporting has grown enormously over the last 50 years. In regard to this matter, cases of fraudulent financial reporting have also increased severely in recent years to establish and give a flawless picture of the company's performance, stability, and profitability. In this context, the current intense business environment where the market is highly challenging has sparked fierce competition in the worldwide market share. As a result, these matters have triggered many organizations to commit financial reporting fraud in order to succeed in the global commercial rivalry and strengthen their position in the marketplace. The misreporting of financial information can mislead the users of the financial information from making the right economic decisions. For instance, the high-quality financial information in the financial reporting prepared by public companies can significantly influence investors' and creditors' confidence.

Respondents state that there has been a rise from 36% in their company fraud over the last two years to 49% in 2018 (PwC, 2019). Apart from that, the 2018 Fraud Survey PWC from the Asia Pacific again produced strong outcomes, as in 2018, the fraud rate expanded from 30% to 46%. Romney et al (2021) also reported that a recent survey illustrates that 49% of companies have experienced fraud. Furthermore, the Association of Certified Fraud Examiners (ACFE) conducts periodic comprehensive fraud studies. It releases its findings that show the amount involved in fraudulent financial reporting is very high compared to other types of fraud, with a median loss of $975,000 (ACFE, 2019). Hence, all these findings demonstrate that fraud in financial reporting is a big problem nowadays and must be addressed carefully. In this instance, Enron and WorldCom are among the two dominant high-profile cases related to financial reporting fraud.

Regarding the above matter, Thanasak (2013) mentioned that it is vital for the organisation to determine the factors that can lead to and contribute to fraud in financial reporting instead of trying to construct a strategy to decrease fraud and its risks. This is because the organisation can try to prevent fraud from happening in the first place by knowing the factors behind the individual's decision to commit the fraud. In this case, various theories have attempted to justify the factors of fraud, and among them is the "Fraud Triangle Theory," which was developed by Dr Donald Cressey in 1950. This fraud triangle theory is the most broadly recognised and established model explaining why people commit fraud. Therefore, this conceptual paper is written to discuss the factors that lead to fraudulent behaviour related to financial reporting, as fraud can pose a significant threat to the organisation.

Gap of Research

A few research studies have been published related to the factor influencing financial reporting manipulation (Fazli et al., 2014). Abdullahi & Mansor (2015) have highlighted the fraud triangle theory and fraud diamond theory, which examine the fraud concept and discusses the convergence of the two classical theories. Mohottige et al (2018) also reported the new fraud triangle theory, where the purpose is to provide external auditors, forensic accountants, and other stakeholders with a more comprehensive understanding of employee fraud and the factors that contribute to its occurrence. Thus, this research will look and dig deeper at the factor that influences the manipulation of financial reporting, which is mainly about the fraud triangle theory, to see how the regulatory bodies should have behaved and responded to the growing current fraud issues in Malaysia.

Objectives of Study
The primary objectives of this study are:
1. To provide a greater understanding of fraudulent financial reporting.
2. To discuss the factors that influence the act of fraud in financial reporting.
3. To suggest solutions for reducing intentional fraud activities in financial reporting in the future.

Conceptual Framework

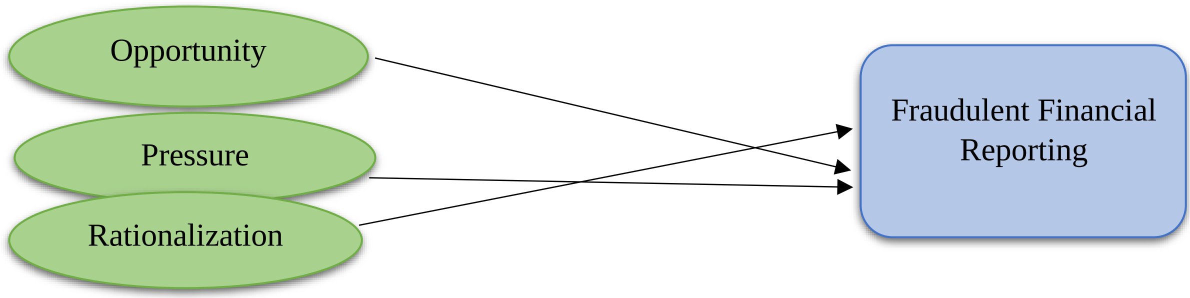

Figure 2: The proposed Conceptual Framework for Factors Influencing Fraudulent in Financial Reporting

Figure 2 depicts the factors that influence people to commit fraud in financial reporting. It is created to show a clearer picture and greater understanding of how opportunity, pressure, and rationalisation are closely related to fraud in financial reporting. This conceptual framework emphasises the elements that contribute to people conducting fraud, such as element opportunity, which describes the situation that opens the opportunities to enable fraud. It also emphasizes the need or pressure to commit fraud and the attitude or character that leads people to conduct fraud, allowing them to commit dishonest acts consciously and wilfully rationally. This shows that all these factors were directly related to the act of fraud and significantly led people to manipulate financial reporting.

Factors Influencing Fraudulent in Financial Reporting
Pressure
One of the elements in the fraud triangle theory is pressure. Pressure refers to a person's incentive or motivation to commit fraud, which can lead to unethical behaviours. Pressure must exist for every fraud perpetrator to act unethically (Abdullahi and Mansor, 2015). The pressure can motivate the perpetrator to misrepresent the financial reporting. In this instance, the pressure will drive the management to misappropriate toward achieving a certain degree of profit even if the method can violate the law. One of the huge factors that can lead to committing fraud is pressure (Lister, 2007). It is also said that the perpetrator felt that the pressure could not be shared and concluded that committing fraud is the best way to get out of a complicated situation (Yuniasih et al., 2020). Thus, these previous studies show

that the pressure the perpetrator faces leads them to behave wrongly by committing an illegal act to solve the underlying problem in the organisation.
Financial reporting pressure can exist in financial, industry conditions, or management characteristics (Romney et al., 2021). Financial pressure refers to meeting or beating the profits' expectations to prevent a stock price decline. This aim is to make the financial reporting look attractive in the stakeholder's eye, especially investors. Next, industry conditions such as new regulatory requirements impairing financial stability or profitability can also motivate fraud. Besides that, the organisation can also create massive pressure on their employees by setting up unrealistic performance standards that force individuals to falsify financial results to achieve the targets and get compensated or rewarded by the organisation. The company is more likely to engage in fraud when the return on assets (ROA) in the prior year is high because the financial targets in the current year will increase and the managers will face more tremendous pressure to achieve them (Summers & Sweeney, 1998). However, a few studies highlight that financial pressures are among the common type of pressure that lead to financial reporting fraud. According to research done by Persons in 2006, a company's great profitability will lessen the likelihood that the company will commit fraud. In addition to this, financial reporting fraud was found to be strongly and positively correlated with financial difficulties experienced by the organisation (Hasnan et al., 2013). This is because the company's financial stability is represented by its high profitability. Additionally, investors will not consider investing in companies with low profitability as they will encounter challenges in paying out a significant amount of dividends to their shareholders. Therefore, this tight situation encourages the management to manipulate the organisation's profits by committing fraud in financial reporting. For instance, WorldCom reported its expenses of $3.8 billion as an asset, which led to overstatements in its 2001 net profit for the purpose of maintaining its image as a successful company. Thus, to conclude, pressure can be considered the key motive in the manipulation of financial reporting for individuals to commit fraud.

Opportunity
The second essential component for the conduct of fraud is the perception of an opportunity. The perception of an opportunity can be defined as the condition that includes one's own abilities that enable a perpetrator to do three things: commit fraud, conceal fraud, and transform theft or misrepresentation into personal gain. Besides that, an ineffective control or governance structure that is ineffective and makes it possible for a person to perpetrate fraud against a company creates the perception of opportunity. This matter is brought up as "weaknesses in internal control" within the realm of accounting (Abdullahi & Mansor, 2015). The concept of perceiving opportunities argues that people will make the most of the opportunities presented (Kelly & Hartley, 2010). In addition to that, the rationale behind the decision to commit the crime is pressure, but the employees have also set in mind that there will be an opportunity for him to get away with it. Cressy believes that there are two components that make up the perceived chance of breaking trust, and those components are general knowledge and technical skill. The awareness that the employee's position of trust may be violated is referred to as general information. In contrast, the capabilities necessary to commit the violation might be referred to as technical skills. These are often the same abilities that one has to possess to be employed by a company and keep a position once they have it (Mohottige et al., 2018).
Besides that, an opportunity can also be broken down into two parts: the vulnerability of the organisation to manipulation on its own, as well as the conditions within the organisation that

can make it more likely for fraud to occur. For instance, the conditions will be favourable for the employee to engage in fraudulent activity in the event that there is insufficient job division, inadequate internal control, irregular auditing, and other problems of a similar nature. In most cases, the likelihood of fraud occurring increases proportionately with the decreased likelihood of being caught. Furthermore, the availability of a chance to engage in fraudulent activities in an organisation can be attributed to several contributing factors, such as the negligence of employees who violate company policies and the absence of disciplinary action.

A weak internal control structure leaves several opportunities available, including weak authorisation processes, poor task segregation, inadequate asset protection, and many more. Thus, having a strategy for what steps to take when a violation has been identified is extremely important. Maintaining standardised processes and rigorous oversight methods is the most important factor in making your business operations resistant to fraud. However, simply putting these mechanisms in place is not enough, as fraud is still possible if the security protocols are implemented but are not monitored, do not function properly, and are not enforced.

Rationalisation

The third factor influencing the manipulation of financial reporting is rationalisation in the fraud triangle. Murphy and Dacin (2011) reported that even though the opportunity and pressure elements have always been present, the people who committed fraud still need to justify their fraudulent actions. It shows that rationalisation is a key component of fraudulent behaviour. Moreover, rationalisation indicates that people who engage in fraud activity need to develop a certain morally acceptable belief to her/him before acting unethically. The rationalisation is the justification and excuse that immoral conduct differs from criminal activities. This is because if a person cannot justify the act of dishonesty, it is unlikely that they will commit fraud. For example, an organisation's employees justify that they have no other choice but to involve themselves in criminal acts. This is because rationalisation occurs when an individual’s capacity causes them to redefine their selfish and bad behaviour as morally acceptable.

Rationalisation is hard to detect since it is difficult to comprehend the mind of the fraudster. Fraudsters have a certain mentality that allows them to rationalise or justify their fraudulent actions (Hooper & Pornelli, 2010). This is due to the rationalisation of justification for fraudulent behaviour as the employees lack integrity (Rae & Subramanian, 2008). Kenyon and Tilton (2006) reported that the possibility of engaging in fraud depends on the individual's personal attitudes and ethical values. Moreover, based on the research, both people with high moral character and those who are related to an immoral person will justify their fraudulent behaviour before committing fraud activities.

Furthermore, the rationalisation factor greatly influences the manipulation of financial reporting (Kula et al., 2011). This is because a person with no experience in committing fraud and without prior criminal history has their own justification to support the action that they did. Thus, these fraud offenders are the person who finds themselves entangled in a challenging situation to make any decision. It demonstrates that first-timers justify their behaviour and do not see themselves as criminals, as this finding is supported by the outcome of a survey by KPMG in Singapore in 2011. Moreover, an individual who commits fraud rationalises fraud in various ways. When employees steal money from a company, they excuse or rationalise their dishonest behaviour by justifying that they are merely borrowing that money from the company. A worldwide economic crime survey stated that 12% of respondents believe that the biggest danger of fraud comes from people making up justifications for their behaviour (PwC, 2019). Therefore, when there is rationalisation among employees in a company, the possibility of manipulating financial reporting fraud will rise.

Conclusion

It can be concluded that fraudulent financial reporting occurs when there are factors of opportunity, pressure, and rationalisation. Financial reporting that presents a true and fair view is vital for the performance of the company. However, some companies manipulate financial reporting for their own benefit. This study's findings align with the fraud triangle theory because it shows that financial reporting fraud may occur when there are 3 theoretical elements: opportunity, pressure, and rationalisation. Moreover, the effect of the financial reporting being manipulated is that the company might provide incorrect information to the users and may lead them to make wrong decisions.

The first elements that influence fraudulent financial reporting are pressure, as financial pressure refers to a need to meet or beat the profits' expectations to prevent a decline in a stock price. It ensures that the financial reporting looks attractive in the eye of the stakeholder, especially investors. Besides, opportunity is the second essential element for fraud, as an ineffective governance structure makes it possible for a person to perpetrate fraud against a company. This is due to the weakness in internal control within the realm of accounting. Lastly, the third element is rationalisation, as it indicates that people who engage in fraud need to develop a certain morally acceptable belief to her/him before doing an unethical act. It is because when there is rationalisation among employees in a company, the possibility of manipulating financial reporting fraud will rise. Thus, an audit committee, including internal and external auditors and the board of directors, is responsible for preventing fraud in financial reporting. Per auditing standards, auditors must be reasonably assured that financial reporting is accurate and free from fraud or error. Additionally, the auditor's duties include identifying, assessing, and properly responding to fraud risks using numerous tools and procedures to ensure no fraudulent activity occurs.

Fraudulent reporting has exposed weaknesses in corporate governance, regulatory oversight, and accounting practices. As a response, it is crucial for authorities to enhance transparency, strengthen regulatory frameworks, and enforce stricter penalties for fraudulent activities. Taking these measures may restore investor confidence, foster a healthy business environment, and ensure the integrity of its financial system.

Companies should implement robust internal controls, foster an ethical culture, and educate employees on financial reporting standards and fraud awareness in order to prevent financial reporting fraud. Programmes for whistleblowers and routine internal audits can help identify and combat fraudulent activities. Accuracy and dependability can be improved through data analytics, AI tools, and external audit supervision. Important measures also include enhancing regulatory oversight, providing incentives for whistleblowers, and maintaining continuous monitoring and enhancement of financial reporting processes. Consulting professionals in the legal, financial, and compliance disciplines can guarantee a comprehensive approach tailored to the company's requirements.

Recommendation

To begin with, there must be a measure that can be taken by considering removing pressure elements in the fraud triangle to avoid fraud from happening. However, the financial reporting pressure is much more difficult to remove than opportunity elements as it is closely related to organisational culture, external conditions, and individuals' ethical framework. An example of overcoming the pressure that can cause manipulation in financial reporting is widening the criteria for measuring the performance of the management staff and other employees by incorporating more ethnically based matter and considering the organisation's sustainability. Hence, the individual will not be pressured to achieve certain financial targets by generating false transactions of financial reporting. This is supported by the statement from Saud et al (2021) that said a compensation system that is measured solely based on monetary terms could promote unethical behaviour in the organisation.

In terms of opportunity, increasing the perceived likelihood of detection and punishment is stressed in order to reduce the opportunity. Additionally, assessing and ensuring the efficiency of controls with regard to identifying and preventing occupational fraud is also crucial. To evaluate such effectiveness, numerous proxy metrics may be used. Some of the popular techniques are by comparing the median loss and detection period, or the employees' opinion of the efficiency of anti-fraud measures, between two organisations, one of which is adopting a certain measure, such as a whistleblowing programme, and another of which is not. Besides that, another necessary technique the company could use is conducting regular audits and making necessary modifications, particularly regarding fraud dependent on access to digital systems. This will ensure that security standards continue providing the desired protection level.

This study found that rationalisation is one of the factors influencing the manipulation of financial reporting. Rationalisation has made it possible for people to defend their wrong behaviour. This is due to the mindset of the people who commit fraud that justify their fraudulent acts as they might have their own beliefs. Therefore, the company can provide an integrity courses programme or give any good encouragement to the employees to have high integrity as one of the prevention mechanisms to ensure that the company has a good environment. The employees can increase their morality and integrity to prevent them from committing fraud or manipulating any information that can affect the company's financial reporting.

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