

## **FRAUDULENT FINANCIAL REPORTING AND COMPANIES' CHARACTERISTICS: EVIDENCE FROM TAX AUDIT**

Norsiah Ahmad  
Juahir Mohd-Nor  
Norman Mohd-Saleh

### ***Abstract***

*Fraudulent financial reporting has become an important issue in accounting profession. The implementation of self assessment system appears as incentives to companies to misstate their financial reports to reduce tax obligation. Fraudulent financial reporting may cause vast losses to government income, as well as losses to the users of financial reports. This study examines the relationship between fraudulent financial reporting and firms' characteristics that are size, types of ownership and types of auditor in companies audited by Inland Revenue Board of Malaysia (IRB). This study uses political cost theory to explain fraudulent financial reporting in companies. The study found that company size and audit quality have significant negative relationships with fraudulent financial reporting. Findings from this study may assist IRB in identifying possible cases for audit in the future.*

**Keywords:** *Fraudulent financial reporting, firm characteristics, tax audit, audit quality, ownership.*

### **INTRODUCTION**

Misstatements of financial reports have become an important issue within the accounting profession. According to Rezaee (2005), misstatement of accounting statements is an attempt by companies/organisation to deceive or mislead information in accounting statements that are being issued to investors and creditors.

The use of the Self Assessment System (SAS) that was first introduced in Malaysia in 2001, has indirectly given opportunities to tax-payers to commit misstatements in financial reports for the purpose of lessening the profit and subsequently, reduce tax. Through SAS, taxpayers have more freedom in reporting their income since this system allows Inland Revenue Board (IRB) to accept in good faith any report submitted to them. The objective of the introduction of SAS is to encourage

voluntary compliance by every category of tax-payers. Under this system, tax-payers are responsible for their own tax matters, starting from keeping accurate records to reporting the income according to guidelines under the tax laws and paying the taxes due within the stipulated timeframe. It is anticipated that SAS will create a situation whereby tax-payers will submit all their tax information honestly and voluntarily (Marshal et al., 1997).

However, to further ensure that the tax-payers comply with the guidelines and report their income accurately, the IRB will conduct a tax audit. Before the introduction of SAS, tax audits were performed only on certain cases where more information and clarification are needed. Therefore, audit was not one of the main activities of IRB before the introduction of SAS. Since the introduction of SAS, tax audit becomes one of the core activities of IRB (Enforcement Department Report, IRB, 2005). Results from audit findings show that some taxpayers are engaging in fraudulent financial reporting as a mean to reduce their tax liabilities. In 2002 alone, a total of 1,850 audit cases were solved, resulting in tax and penalty amounting to RM77.03 million as compared to the previous year of RM51.25 million. Therefore, Marshal et al. (1997)'s statement that SAS is able to motivate voluntary compliance may not be suitable to Malaysia's environment with a background of Asian culture particularly at the early stage of implementation.

Past studies on fraudulent financial reporting relate the fraudulent acts with earning management activities (Guenther 1994; Roubi & Richardson 1998; Northcut & Vines 1998), audit quality (De Angelo 1981; Seok Woo Jeong & Joonhwa Rho 2004) and director's composition in a company (Beasley 1996). Nearly all studies (except Beasley (1996)) used proxies to represent fraudulent acts rather than the actual fraudulent reporting done by the companies. This article discusses issues on fraudulent financial reporting using evidence from tax audit carried out by IRB on unlisted companies in Malaysia. With reference to the completed tax audit cases, this article discusses the relationship between companies' characteristics with the types and amount of fraudulent reporting that were submitted to IRB for tax purposes. This study uses real tax cases where the non-compliance with the Malaysian statutes and tax laws are used as the measurement of the fraudulent financial reporting. To our knowledge, there is no single published research on the issue of fraudulent reporting uses real data from tax audit findings.

This article is organized as follows. The next part discusses issues on fraudulent financial reporting for the tax purposes follows by discussion on conceptual framework and the development of research hypotheses. Next, the research method used will be explained in the fourth section, followed by the research's results and discussions. This paper will be summarized in the last segment.

## **FRAUDULENT FINANCIAL REPORTING AND TAX NONCOMPLIANCE**

Fraudulent financial reporting discovered during tax audit process is a form of tax noncompliance committed by the company.<sup>1</sup> Companies have the tendency to report lower profit to reduce tax. Therefore, the act of fraudulent financial reporting that can be found in a tax audit could be categorized as understatement of sales, overstatement of purchases, transfer-pricing, and, unallowable expenses, allowances, and stocks adjustment under the tax act.

The propensity to carry out fraudulent reporting to reduce tax burden exists through earning management activities in term of income shifting between assessment years. Guenther (1994) reveals that fraudulent financial reporting occurs surrounding the period of changes in income tax rate. It is performed through earning management techniques. According to Guenther (1994), in general, firms involve in earning management activities, would normally report lower discretionary current accruals in the year just before the tax rate is reduced, and report higher discretionary current accruals after the tax rate is reduced. The study shows that managers transfer or shift profit from a high tax rate period to a low tax rate period through options available in accounting. This is supported by Roubi and Richardson (1998). Their study provide evidence that discretionary current accruals are managed by non-manufacturing corporations in Canada, Malaysia and Singapore in response to changes in the statutory corporate income tax rates in these countries between 1985 to 1988.

In addition to the intention to reduce tax, companies which are scrutinized politically would choose appropriate accounting policies that can reduce profit to reduce

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<sup>1</sup> Tax non-compliance may be in the form of (1) misstatements or non-reporting of some income, (2) non submission of tax return form within stipulated time, and (3) non-payment of tax indicated in the return form. This study focuses on the first form of non-compliance.

its vulnerability to be scrutinized by the public such as the financial accounting users, the media, employees and others. These stakeholders may make various claims such as a rise in employee compensation scheme, various financial and non financial benefits to the workers and a price reduction if they recognize that the company is making excessive profit. This situation may also attract the tax authorities to carry out a tax examination on the company, which will bring about a significant amount of tax to be paid and will result in out flow of cash from the company to the government or make payments to the many claims made by employees and users (Watts & Zimmerman, 1986).

In the attempt to increase corporate tax through the Tax Reformation Act 1986, political groups in United States use effective tax rates in their claim that most companies pay a small amount of tax or totally neglect to pay any tax at all (Northcut and Vines, 1998). According to Northcut and Vines (1998), political examination by certain political groups influences companies to choose the accruals that will reduce income for tax.

In general, the management can choose accounting techniques and estimates which are permissible under the standards, and can use judgment in deciding when to write-off assets. These accruals tend to be less visible to the outside parties once manipulated compared to manage real transactions. In some circumstances however, managers may also use real transactions to defer revenue or accelerate expense recognition, or in transfer pricing particularly when such transactions result in a huge saving in tax. Therefore, control mechanisms and attempts to reduce such behavior should come from inside the companies and from those who have access to original transaction data such as the external auditor or tax auditor.

Good corporate governance practices may limit financial statement fraud. Beasley (1996) study on companies that were taken actions by public authority for fraud in financial statement shows that financial statement fraud appears to be influenced by the composition of outside and inside members on the board. The results indicate that control companies (companies without a fraud) have boards with significantly higher percentages of outside members than fraud companies. However, the presence of an audit committee does not significantly affect the likelihood of financial statement fraud. This implies that the board director's independence contribute to good quality financial reporting.

Apart from independent director, the presence of external auditors should also reduce fraud in financial reports. In studying the relationship between audit quality and company size, De Angelo (1981) suggests that larger audit firms provide better quality audit services as compared to smaller audit companies. Larger audit firms with a greater number of clients have ‘more to lose’ in terms of their reputation by failing to report a discovered breach in a particular client’s records. This collateral aspect increases audit quality supplied by larger audit firms. In protecting their valuable reputation, it is expected that larger audit firm will be more complied with accounting standards and audit procedures in preparing financial statements thus resulting in less misstatement of financial reporting that could be found in tax audit.

However, the difference in the quality of audit services between large and small audit firm may not occur in all countries. A study by Seok Woo Jeong and Joonhwa Rho (2004) on types of auditors and audit quality in Korea, reveals there is no significant difference in discretionary accruals between companies audited by ‘*Big 6*’ and ‘*Non Big 6*’ auditors. This is due to similar audit quality provided by both classes of audit firms. In Korean environment, auditors may not believe that they have a high likelihood of getting caught if they provide low-quality audits. Moreover, even when they are caught by the government agency, the penalties are not severe enough to cause auditors to provide high-quality audits.

In tax compliance studies, the possibility of being audited by tax authorities is a factor commonly used to test the level of firm’s compliance. A study by Bradley (1994) on 471 large-sized companies with regards to factors influencing tax compliances, concludes that the ‘audit by authorities’ factor partly contribute to tax compliances. According to Rice (1992), the decision regarding company’s taxes that needs to be reported to tax authorities is based on the tax liabilities, penalties for possibilities being traced due to under-reported of income, and probabilities of being audited. Using the Tax Compliance Program database in the United States, the result reveals that compliance by public companies is higher as compared to non-public companies. In addition, the group of companies under tight control of laws such as banks have higher compliance rate compared to companies that are not controlled by laws. This is because of public

companies and certain companies under law's tight control are always monitored and audited by authorities.

Therefore, it can be summarized that studies on fraudulent of financial statements are related to accruals management, and the likelihood that it can occur is dependent on the effectiveness of the board of directors and audit quality. Studies on tax compliance thus far, focus more on tax payer's attitude and factors influencing tax compliance at individual tax payer level. Therefore, there exists a gap in the studies which is to acknowledge the characteristics of companies that commit fraud in financial reporting through tax non-compliance discovered during tax audit. Most studies in the past focused on common misstatement of financial statement for the purpose to mislead users such as investors and creditors. In this research, we focus on the tax authorities as one category of user of financial statement.

## **CONCEPTUAL FRAMEWORK AND HYPOTHESES DEVELOPMENT**

The political cost theory introduces a political dimension that influence the choice of accounting policies during a high profitability period by companies within a financial year. The high level of profit would attract the public such as the employees and consumers, to make various claims such as an increase in salary, various benefits to the workers and a price reduction. This situation will also attract the tax authorities to carry out tax examination on the companies. In the end, companies are forced to pay a huge amount of tax (subsequently results in an outflow of cash from the company) to the government or make payments to the claims made by employees and consumers.

The political cost hypothesis suggests that there is a positive relationship between political cost and the possibility of a company adapting income reducing accounting procedures. Companies may use systematic understatements of reported profit to avoid potential political costs associated with high profitability and market dominance. According to Zimmerman (1983), the political cost relates to company size because the larger companies, the more likely they are more visible and therefore are more exposed to government examination and wealth transfer. In lieu with political cost theory, this research investigates whether company size affect accounting choices in a way that

would reduce profits to avoid attentions from the government besides to prevent cash outflow that will be borne by the companies.

Nonetheless, size is also associated to companies' level of internal control. Increase in size will also increase the level of internal control in a company ( Icerman & Hillison, 1990). If this assumption true, an increase in firm size will result in more income reducing misstatement of financial information. In other words, there should be a positive relation between misstatements and company size. Therefore, the first hypothesis is developed according to the political cost theory as follows:

**H<sub>1</sub>: There is a positive relationship between company size and fraudulent financial reporting.**

A company's form of control is also likely to be associated with the misstatement in financial reporting. Section 139 Income Tax Act 1967 (ITA 1967) defines "a controlled company" as a company that is controlled or managed by a capable individual who owns a large share in the company or has controlling voting power in a company. Most controlled companies are owned by families or have a sole ownership. In discussing the protection of outside investors, the issue of ownership concentration in company turns out to be crucial because expropriation of minority shareholders or investors by the controlling shareholders is extensive (La Porta et al., 2000). According to the entrenchment hypothesis (Morck et. al., 1988), when the equity block ownership (which can be the director's ownership) is so significant, more opportunities for them to make decisions that benefit themselves at the expense of other stakeholders. This concentrated block ownership is similar to the one described as "controlled companies" in Income Tax Act. Consistent with Claessens et al. (2000) that found ownership structure in Malaysian firms is highly concentrated, we expect that this effect could dominate if the block equity ownership is significant i.e in controlled companies. In this case, the controlling investors incline to use the profits of the company for their own benefits rather than to return the profit to the outside investors. Among the methods used to transfer profit are selling output, assets or securities in the company they control to another company they own at below market prices. The actions would, not only benefit them, but would reduce the

profit as well as the tax obligation. Past studies discover that this form of companies (controlled companies) have the tendency to involve in misstatements of financial statements compared to uncontrolled companies. Therefore, it is expected that controlled companies (whether through family ownership or sole ownership) will record more misstatements in financial reporting compared to uncontrolled companies.

In this study, all companies that fall under Section 139 ITA 1967 are considered as controlled companies such as because they are controlled by family members or sole proprietors. Therefore, the second hypothesis is developed as follows:

**H<sub>2</sub>: There is a positive relationship between control of the company and fraudulent financial reporting.**

Auditors play an important role in ensuring that financial statements released to users present the true and fair view of the company financial status. De Angelo (1981) suggests a good proxy to audit quality is the audit firm's size because big audit firms will lose more if it gives low quality services due to the firms' high reputation in the market. Result from this also study shows that auditors from *Big 6* audit firms give better quality services compared to smaller auditors or *Non-Big 6*.

In another study, Carcello and Nagy (2004) use auditor's specialization and auditor's firm size as proxies to audit quality in their study. Audit specialization may also reflect audit quality in a complex environment because auditors have more familiarities with the industry environment. The result shows a negative and significant relationship exists between auditor specialization with misstatement in the client financial statements, and therefore suggest that audit quality strongly depends on an auditor's specialization in a particular industry. However, since the sample firms used in this study are mostly unlisted companies and are relatively smaller in size compared to the sample of listed companies investigated by Carcello and Nagy (2004), the effect of auditor specialization is minimized due to less complex environment. Therefore, we envisaged that the effect of reputation is more important than the effect of familiarities with industry environment indicated by industry specialization.

In a study conducted by Heidi et al., (2003) on size of audit firm and earnings management in Belgium, an insignificant relationship is established between the size of audit firm and earnings management due to the institutional environment in Belgium. Nevertheless, a studies conducted in Malaysia by Norman et al., (2004) discover that earnings management is less practiced in companies audited by ‘*Big 6*’ firms compared to companies being audited by firms that are not in the ‘*Big 6*’ category, thus less fraudulent financial reporting is committed. Therefore, the third hypothesis is developed as follows:

**H3: There is a negative relationship between size of audit firm and fraudulent financial reporting.**

## **RESEARCH METHOD**

### **The sample**

The data used are the completed tax audit cases conducted on unlisted companies by IRB Kuala Lumpur branch in 2004.<sup>2</sup> We select only one year for completed tax audit cases because we want to exclude the effect of non-compliance due to changes in tax rules over time, and the time lag for the companies to adjust for these changes. However, there are some small variations in the starting time (one or two years before 2004) of the tax audit. To our knowledge, during these periods, there is no significant change in tax rules occurred that may have affected the results. Since most companies are audited for several years of assessments, only the latest assessment year is taken as a sample for this research to avoid overlapping of cases. Audit in the latest assessment year usually has already taken into account all adjustments from previous year assessments. From the 470 subjects that were audited, only 396 cases are completed and suitable for the research.

### **Measurement of independent variables**

The independent variables used for this research are the size of audit firm, the size of companies and the form of company’s control. The size of audit firm is divided into two

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<sup>2</sup>This year is selected because it was the latest year of assessment at the time the research was carried out.

categories; big-sized audit firms, and small and medium-sized auditors. Big-sized audit firms or famously known as *Big 4* in Malaysia are audit firms such as PriceWaterhouse Coopers, Deloitte Kassim Chan, KPMG and Ernst and Young. These audit firms are coded as 1. Small and medium-sized audit firms refer to audit firms other than those stated above and the companies using the service of these audit firms are coded as 0.

IRB uses total amount of sales to determine the size of the company. Table 1 shows classification of the size of company used by LHDN. Consistent with prior studies, in this study, the size of the company is represented by natural log of total sales (Norman et al., 2004; Kooyul Jung & Soo Young Kwon, 2002).

**Table 1: Size of the company based on sales**

Sales from (RM)	To (RM)	Size
0	500,000	1
500,001	1,000,000	2
1,000,001	10,000,000	3
10,000,001	100,000,000	4
100,000,001	And above	5

The last independent variable is the form of company control. We use an indicator to classify companies into a controlled or non-controlled company. In this study, the information on company control is gathered through audit reports produced by IRB's audit officers and also by examining financial statements that are sent to the IRB by tax payers to be audited. Code 1 is given to controlled company and code 0 is given to non-controlled company.

### **Measurement of dependent variable**

The dependent variable used is misstatements of financial reporting that is found during the tax audit. The non-compliances or misstatements in the financial report that are found are classified into seven categories: understatement of sales, overstatement of purchases, stock adjustments, unallowable expenses, allowances adjustments, transfer pricing and other adjustments. The total amount of all these misstatements is denoted as MISSTATE\_AMOUNT. To get total income without misstatement (TRUEINC), the total amount of misstatements (MISSTATE\_AMOUNT) were added back to the unaudited

income and considered as additional incomes. The measurement for this dependent variable MISSTATE\_RATIO is the MISSTATE\_AMOUNT divided by the TRUEINC.

Due to the sample comprises of small and medium-sized companies, there is no transfer pricing offence discovered during tax audit since there is no inter-company transaction within the company's group. Transfer pricing strategy is more likely to happen in multinational organizations and when there are inter-company transactions within a group. Therefore, transfer pricing is omitted in the next analysis.

### **Control variable**

Another factor that could influence misstatements in financial reporting is the type of industry. [Watson et al. \(2002\)](#) use the type of industry in his study on voluntary exposure of accounting ratios in the UK. The study shows that the type of industry is an important indicator in ratios disclosure. Less voluntary exposures were implemented by the media and utilities industries compared to other industries. In this research, the type of industry is utilized as the control variable for the reason that some industries are subjected to certain regulations and may have different incentives to use strategies to make fraudulent financial reporting compared to some other industries.

### **Research model**

The empirical model to test the hypotheses is as follows;

$$\text{MISSTATE\_RATIO}_i = \alpha_0 + \alpha_1 \text{AUDIT}_i + \alpha_2 \text{SIZE}_i + \alpha_3 \text{OWNER}_i + \alpha_4 \text{MANF}_i + \alpha_5 \text{COMC}_i + \alpha_6 \text{AGRI}_i + \alpha_7 \text{SERVICE}_i + \alpha_8 \text{CONTRUC}_i + \alpha_9 \text{ESTATE}_i + \varepsilon$$

where;

MISSTATE_RATIO <sub>i</sub>	=	MISSTATE_AMOUNT/TRUEINC
MISSTATE_AMOUNT	=	Total amount of misstatement
TRUEINC	=	Total income + MISSTATE_AMOUNT
AUDIT <sub>i</sub>	=	Type of auditor (Big-4=1, others=0),
SIZE <sub>i</sub>	=	Company size (natural logarithm of sales),
OWNER <sub>i</sub>	=	Form of company's control (controlled = 1; non-controlled=0),
MANF <sub>i</sub>	=	Manufacturing industry,
COMC <sub>i</sub>	=	Commercial industry,
AGRI <sub>i</sub>	=	Plantation / Agricultural industry,
SERVICE <sub>i</sub>	=	Services industry,
CONTRUC <sub>i</sub>	=	Construction industry,
ESTATE <sub>i</sub>	=	Real estate industry,

## RESEARCH FINDINGS AND DISCUSSION

### Company characteristics

We use natural log of total sales as the proxy to the company size in the regression analysis. For descriptive statistics, we arrange the samples and make divisions based on the median, to differentiate between smaller and larger-sized companies. Therefore, 198 companies, which are fifty percent (50%) from the sample i.e 396 companies, are small-sized companies and the rest of the 198 companies are large-sized companies.

Table 2 shows the type of industry, type of auditors and form of company's control for the sample. There are seven industries based on the IRB's business code. Majority (40.1%) of the companies are from commercial industry, followed by 26.8 percent of service industry, 13.6 percent of manufacturing industry, 12.6 percent of construction industry, and the rest are plantation and real estate industry and other industries represents a total of 4.3 percent. Although there appears to be an irregular distribution pattern across industries, the effect is controlled in the regression analysis.

**Table 2: The types of industry, auditors and company control**

	Quantity	Percentage (%)
<b>Industry</b>		
Manufacturing	54	13.6
Commercial	159	40.1
Service	106	26.8
Construction	50	12.6
Agricultural	5	1.3
Real Estate	5	1.3
Others	17	4.3
<b>Total</b>	<b>396</b>	<b>100.0</b>
<b>Type of Auditors</b>		
Big Auditors	50	12.6
Small Auditors	346	87.4
<b>Total</b>	<b>396</b>	<b>100.0</b>
<b>Type of Control</b>		
Controlled Companies	193	48.7

Non-controlled Companies	203	51.3
<b>Total</b>	<b>396</b>	<b>100.0</b>

There are 346 companies (87.4%) that use services from small-sized audit firms whereas 50 companies (12.6%) use big-sized audit firms or ‘*Big 4*’. This figures show that there is an inclination of the sample companies to use services from small-sized audit firms. This is because a majority of the companies are unlisted small companies which are small in size and they have the tendency to use smaller-sized audit firms to avoid paying a premium for bigger-sized audit firms. Taylor and Simon (1999) suggest that large audit firms are able to command a fee premium on a global basis.

It also appears from Table 2 that the sample is fairly divided between controlled and non-controlled company. There are a total of 193 companies (48.7%) classified as controlled, whereas the rest of the 203 companies (51.3%) are non-controlled companies. This is consistent with Claessens et al. (2000) that find a significant control by families in companies from East Asian economies.

### Descriptive Test

From Table 3, the negative min values show the amount of adjustments or misstatements found in tax audit of financial reports (scaled by total income without misstatement). The negative values of understatement of sales, unallowable expenses and other adjustments shows that the adjustments or misstatements result in a decrease in the amount of taxable income. Accordingly, the negative values of understatement of purchases, inventories adjustments and allowance adjustments show these adjustments result in an increase in the taxable income. Therefore, to obtain the taxable income without adjustments or misstatements, all these misstatements have to be added to (or subtracted from) reported taxable income.

**Table 3: Descriptive Statistics**

VARIABLES	Min	Max	Mean	Standard Deviation
Log of total sales	4.695	9.419	6.875	0.603
Income	0.000	2.632	0.317	0.377
Understated of sales	-0.845	4.359	0.801	0.320
Overstated of purchase	-0.116	2.907	0.086	0.265
Inventories adjustments	-0.133	1.075	0.005	0.059

Unallowable expenses	-0.032	11.342	0.208	0.709
Allowances adjustments	-0.392	0.319	0.004	0.034
Other adjustments	-0.171	1.932	0.025	0.149

### Misstatements of financial reporting and company's characteristics

The Chi-Square Test ( $\chi^2$ ) is executed to see whether the distribution frequency of the misstatements depends on the characteristics of the companies under study. Table 4 shows the result of the  $\chi^2$  test. The result shows the distribution of companies misstating unallowable expenses depends on the form of company control ( $p < 0.10$ ), type of audit firm ( $p < 0.05$ ) and company size ( $p < 0.10$ ). Other categories of misstatements are free from the influence of company's form of control. The results also show that the misstatement activities in the form of overstatement of purchases also depend on the type of audit firm and company size.

**Table 4:  $\chi^2$  Test on Company's Characteristics and Misstatements**

Type of Misstatements	Company's control $\chi^2$ (p)	Type of auditors $\chi^2$ (p)	Size $\chi^2$ (p)
Understatement of sales	0.245 (0.686)	1.831 (0.224)	1.164 (0.345)
Overstatement of purchases	0.180 (0.902)	4.149 (0.042)*	3.430 (0.084)**
Inventories adjustments	1.442 (0.339)	0.506 (0.367)	1.641 (0.337)
Unallowable expenses	3.488 (0.064)**	4.139 (0.045)*	3.443 (0.080)**
Allowances adjustments	0.539 (0.551)	0.912 (0.364)	1.948 (0.231)
Other adjustment	0.002 (1.000)	0.269 (0.154)	1.715 (0.261)

\* Significant at  $p < 0.05$

\*\* Significant at  $p < 0.10$

### Hypotheses testing

This research uses Tobit regression analysis to test the hypotheses. The OLS regression technique is not suitable in testing these hypotheses due to the possibility of obtaining a biased result, as the dependent variable data collected contained many empty figures (Burr, Choi, Mutchler and Caro, 2005). The three hypotheses in this research are tested simultaneously with the type of industry as the control variable. The result of the hypotheses testing is shown in Table 5.

**Table 5: Tobit Regression**

<b>Variables</b>	<b>Coefficient</b>	<b>Z Statistic</b>	<b>Probability (P)</b>
Constant ( $\alpha_0$ )	0.989	3.698	0.000
AUDIT ( $\alpha_1$ )	-0.176	-2.531	0.011*
SIZE ( $\alpha_2$ )	-0.120	-3.202	0.001**
OWNER ( $\alpha_3$ )	0.006	0.152	0.879
MANF ( $\alpha_4$ )	0.092	0.782	0.434
COMC ( $\alpha_5$ )	0.127	1.169	0.242
AGRI ( $\alpha_6$ )	-0.100	-0.424	0.671
SERVICE ( $\alpha_7$ )	0.058	0.529	0.596
ESTATE ( $\alpha_9$ )	0.233	1.096	0.273
CONTRUC ( $\alpha_8$ )	0.349	2.953	0.003**

R square 0.1028

Note: \*, \*\*, significant at 0.05 and 0.01, respectively

where;

$AUDIT_i$	=	Type of auditor (Big-4=1, others=0),
$SIZE_i$	=	Company size (natural logarithm of sales),
$OWNER_i$	=	Form of company's control (controlled = 1; non-controlled=0),
$MANF_i$	=	Manufacturing industry,
$COMC_i$	=	Commercial industry,
$AGRI_i$	=	Plantation / Agricultural industry,
$SERVICE_i$	=	Services industry,
$CONTRUC_i$	=	Construction industry,
$ESTATE_i$	=	Real estate industry,

The R square for this test using the Tobit regression is 0.1028. The result of this test shows that hypothesis 3 is supported, where there is a significant negative relation between the type of audit firm and fraudulent financial reporting. This result suggests that Big-4 audit firms (that is a proxy for audit quality) are able to constraint financial misstatements activities committed by companies. Table 5 also shows that hypothesis 1 is not supported. On contrary, this study found there is a significant negative relation between size of companies (represented by total sales) and misstatement in financial reports. However, this result is consistent with the opinion that a company's size has a positive relation with the level of internal control within a company (Icerman & Hillison, 1990) and therefore, would negatively related to misstatement in financial reports. For this reason, the study discovered that when there is better internal control levels within a company, then the chances of committing financial misstatements will decrease.

The test result for the second hypothesis is also not supported. There is no significant relation between the form of a company's control and misstatement of financial reports. The result shows no difference from the aspect of the misstatement in financial statements between controlled and uncontrolled companies.

Results of the analysis also show that most independent variables chosen are not able to illustrate the magnitude and possibilities of misstatements committed. This suggests many other factors that may explain the possibility and amount of financial statement misstatements in companies that are beyond the scope of this study.

## **CONCLUSION AND RECOMMENDATION**

The findings of this research conclude that the size of companies and the size of audit firms have significant effects on tax evasion activities through fraudulent financial reporting. However, a company's form of control, whether it is a controlled or non-controlled company by families or a sole proprietor, has no significant effect on misstatements of financial reports. However, the sample of companies used in this study is unlisted companies and the results are not generalizable to listed companies. Listed companies may have more stringent rules for listing and have better corporate governance mechanisms within the company as control.

The tax authority's audit focus should not be allocated differently in concentration and treatment to the two forms of company's control (controlled or non-controlled) given that these two forms of control do not necessarily lead companies to commit financial report's misstatement.

The research finding also shows that bigger size company is not an indication of non-compliance of tax through misstatements of financial report. Compared to Zimmerman (1983), this study shows that larger companies are likely to commit less misstatements due compared to smaller companies. This may be due to the existence of better internal control and proper accounting systems in small and medium unlisted companies. Furthermore, larger companies are subjected to more public and regulators scrutiny and enforcement of law and regulations and subsequently they develop better corporate governance monitoring system. Based on the findings, the tax audit policy

should pay more consideration to smaller and medium-sized companies as these companies are more incline to commit misstatements for the purpose of tax evasion. It is possible that smaller and medium size companies not to have proper accounting systems and probably have less effective internal control systems. With the absence of a good system, accounting manipulation to reduce income could happen.

Consistent to past studies such as De Angelo (1981), this study provide evidence that companies using services from bigger size audit firms are less likely to commit fraud as compared to companies using the services of smaller auditors. This result suggests that bigger size audit firms give better audit services to avoid risks associated with low quality services. As a conclusion, in selecting cases to be audited, the tax authorities should also place more focus on the type of auditors that audit, prepare and compute the tax liabilities for the companies. Attention should be given to companies engaging small sized audit firms for the possibility that the auditor would give lower quality audit services compared to those engaging big size audit firms.

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