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Cooking the Books: The Case of Malaysian Listed Companies

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Abstract

Cooking the books refers to fraudulent accounting activities undertaken by a business to falsify its financial statements. Thus, the objectives of this study are to investigate what the cooking-the-books activities carried out by businesses consist of, how they conduct them, and what the impact is on the business and its shareholders. The case study sample companies are two Malaysian companies that had received various awards from reputable third-party organizations. On the other hand, the activities undertaken in both companies have caused them to be labelled as Malaysian mini Enrons. We employ a qualitative research methodology as most prior research employs a quantitative methodology to investigate the determinant factors in businesses' cooking-the-book activities. The result of the study shows that the managers have used their positions, prior experience, and regulatory loopholes in their activities. Furthermore, the financial report restatement and higher reported earnings are the early warning signals of their activities. As a result of this, the Malaysian Securities Commission has revised the corporate governance code, and among others incorporated the Audit Oversight Board, known in the US as the Public Company Accounting Oversight Board.

Key words: Cooking the Books, Financial Statement Fraud, Earnings Management, Malaysia, Developing Countries

1. Introduction

Belkaoui defined accounting as "the process of identifying, measuring and communicating economic information to permit informed judgements and decisions by the users of the information" (Belkaoui, 2004). Since the output of accounting is financial statements, high quality is required for the state's security market efficiency and its economy. As stated by the Chairman of the Malaysian Securities Commission:

"Investors rely on financial statements as a key medium to evaluate their decisions and therefore we will always be concerned about the quality of information provided in these financial statements. If auditors fail to deliver a quality audit, investors, vulnerability to misstated financial statements and fraudulent financial reporting will continue to remain" (Zarinah Anuar, Chairman, Malaysia Securities Commission, 2007).

Furthermore, the issue has drawn a great deal of attention from shareholders, investors, analysts, and regulators, particularly after the largest accounting fraud, which happened in the earlier decades of the twenty-first century, resulted in losses amounting to billions of dollars in market capitalization and shareholders' funds (Rezaee, 2005). The management in those companies had performed cooking-the-books activities in their financial reports, in which they employed highly sophisticated accounting techniques to window dress their financial performance (e.g. Enron, WorldCom, Global Crossing, etc.) (Lomax, 2003). Cooking-the-books activities are fraudulent accounting activities performed by companies to falsify their financial statements (Lomax, 2003). Synonymous terms are fraudulent financial reporting and earnings management (Zack, 2012) .

The activities carried out by these businesses gave investors and regulators an awakening signal concerning the reality that companies are hiding the ugly truth between the lines of their financial data (Ficha & Shivdasani, 2007; Lomax, 2003).

In order to restore investor confidence, for example, the US Government introduced the Sarbanes–Oxley Act in 2002. The objective is to protect investors against future incidents related to accounting and or financial fraud. This is because it has serious implications for the country's economy, business, shareholders, investors, and society at large (Gordon, Henry, Louwers, & Reed, 2007). Cotton (2002) estimated $460 billion losses in market capitalization because of financial statement fraud in 5 companies, namely Enron, WorldCom, Quest, Tyco, and Global Crossing (Rezaee, 2005). Therefore, the objectives of the study are to investigate why businesses engage in cooking the books, how they do it, and what the impact is on the businesses and shareholders.

Based on our limited knowledge, we have synthesized at least two gaps in the literature. First is the research on financial statement fraud, particularly on cooking-the-books activities conducted by businesses, and second is the research on developing countries. The former found that most of the prior literature is empirical in nature and investigates business earnings management or earnings manipulation practices. Researchers have used various techniques, models, and proxy variables, such as discretionary accruals, board composition, CEO turnover, restatement revenue, etc., to explain and predict business earnings manipulation practices (Core, 2010; Feng, Ge, Luo, & Shevlin, 2011; Ficha & Shivdasani, 2007; Welc, 2011). However, a limited number of studies demonstrate financial statement fraud or "cooking the books" by the individual business and the parties involved (Firth, Rui, & Wuc, 2011; Rezaee, 2005). Second, most of the studies were based in Western and developed countries and few studies have been conducted in Asian and developing countries, which have a different market setting and institutional background (Firth et al., 2011).

We organize the remainder of the paper as follows. The next section briefly reviews the literature on cooking-the-books activities, earnings management, and earnings manipulation. Section 3 discusses the research design and the case study sample companies. The analysis and discussion is in Section 4. Finally, the conclusions are presented in the last section.

2. *Review Of The Literature*

Financial and accounting theorists argue that financial statement auditing is an important mechanism that helps to protect the interests of shareholders, investors, and other interested users. The audit process provides reasonable assurance that financial statements are free from material misstatements. However, in actual fact, this traditional check and balance fails to detect complicated accounting methods followed by managers, particularly when using normal audit procedures. This literature review presents the prior research on why managers become involved in cooking-the-books activities, how they perform them, and what the monetary impact is on the business and its shareholders.

2.1 The Corporate Kitchen

To begin the review, we enter the corporate kitchen with questions concerning why managers engage in cooking-the-books activities that will lead to financial statement fraud and what their incentives are to engage in these activities (Lomax, 2003; Richardson, IremTuna, & Wu, 2003). Who is the master chef? The master chef is normally among the top management, such as the Chairman, Chief Executive Officer (CEO), or Chief Financial Officer (CFO) (Feng et al., 2011). In this research, we refer to them as managers because they have significant influence over the business's financial and operational activities (Feng et al., 2011) as they have been appointed by the shareholders to run the business. In accounting theory and economic theory, the relationship and power to control the business are known as agency theory (Scott, 2011). The theory suggests that the relationship is shaped by individualistic and opportunistic interest by the agent (manager) and principal (shareholder) (Belkaoui, 2004). For example, the agent's opportunistic interest forces the principal to design appropriate incentives together with monitoring tools (auditing and governance) to minimize the damage as a result of the self-serving manager's actions.

The manager's personal gains, such as stock options, annual bonuses and increments, contractual agreements between shareholders and debt holders, raising additional capital or debt, meeting analyst targets, managerial labour market, regulatory weakness, and loopholes in accounting standards, are among the reasons why managers want to be involved in cooking the books (Efendi, Srivastava, & Swanson, 2007; Feng et al., 2011; Firth et al., 2011; Gordon et al., 2007; Lomax, 2003; Richardson et al., 2003; Scott, 2011). Other than that, the manager's inclination to show off to his associates as a symbol of his success in managing the business is another reason for engaging in the activities (Lomax, 2003). For example, the ex-CEO of Tyco Corp. had charged the business half of the cost ($2.1 million) of his wife's birthday party (Lomax, 2003).

The study by Firth et al. (2011) on Chinese public listed companies from 2000 to 2005 found that a high debt-to-equity ratio that businesses relate to the contractual agreement is among the factors that influence managers to falsify their financial statement. An empirical study by Welc (2011) of 1183 companies listed on the Warsaw Stock Exchange from 2000 to 2009 found another factor, analyst predictions and shareholder expectations, among the reasons why managers engage in "cooking their books" (Welc, 2011). Another study conducted by Efendi et al. (2007) on 193 US companies from January 2001 to October 2006 found that executive personal gains, such as stock options and debt covenants, are the factors that influence them to engage in the activity, particularly during a stock market boom period. Furthermore, in his PhD thesis, Babalyan (2004) studied 115 companies listed on the Swiss and Frankfurt stock exchanges from 1999 to 2001 and found that the businesses have taken advantage of the flexibility in accounting standards to meet analysts' expectations (Babalyan, 2004).

2.2 The Recipes

The second question regards how managers cook the books, or the recipes. Earnings restatement is one of the common methods used (Richardson et al., 2003). The literature suggests that managers will choose a certain accounting method to cover a business's poor performance during bad times (Callen, Livnat, & Segal, 2006). As posited by Richardson et al. (2003), "it is reasonable to assume that earnings restatement firms can be characterized as firms who knowingly and intentionally engaged in earnings manipulation". Their argument was based on their study of 440 US companies that had undertaken earnings restatement from 1991 to 2000. They found that the accounting accrual methods related to working capital (account receivable, inventory, and account payable) and non-current assets (property plant and equipment, intangibles, differing tax and post-retirement liabilities) were statistically significant for explanations of the accounting manipulation technique carried out by the sample companies. Callen et al. (2006) studied 695 accounting restatement activities performed by US companies from 1986 to 2001 and found direct evidence of managerial opportunistic behaviour as an explanation. The restatement methods involve changes in accounting policies affecting the firms' earnings. Those policies are changes in inventory method (46%), expenses (23%), and revenue (13%) recognition policy, and other changes in accounting method (18%).

A related-party transaction is another common recipe used by managers in fraudulent financial reports. Related-party transactions are defined as "transactions between a company and related entities (e.g., subsidiaries, affiliates, principal owners, officers, and directors)" (Gordon et al., 2007). American Institute Certified Public Accountants posit that the auditors face difficulties in identifying and tracing the transactions. They are entirely dependent on whether the manager wants to disclose them. Furthermore, many parties and different types of transactions are involved, despite the introduction of the Sarbanes–Oxley Act in 2002, to limit the activities (Gordon et al., 2007). Initially, the transactions are made for genuine purposes or are *bona fide* transactions, but they are sometimes employed by managers for fraudulent purposes. As a result, there will be less disclosure in the annual reports to cover up the activities. The renowned case is Enron Corporation, the largest bankruptcy case in US history in 2001 (a decrease in shareholder equity to USD 1.2 billion) before it was replaced by WorldCom in 2002 (Brickey, 2003; Gordon et al., 2007). In this case, Enron executives had established Special Purpose Entities to hide the business's debt and also to overstate its earnings.

Another recipe in cooking the books is income smoothing. This method is used by managers to accumulate earnings during good years and defer them to bad times (Scott, 2011). The objective is to reduce the variations in the reported earnings (Scott, 2011). The executives take advantage of flexibility in accrual-based accounting techniques, for example hedging the financial derivatives instrument, loan loss provision, particularly by banking institutions, or easing credit terms to increase sales. They do so to control the volatility in earnings as they receive pressure from the shareholders (requesting a stable dividend), investors and analysts (meeting the forecast), and creditors (avoiding violations in debt agreements). A recent study by Tsitinidis and Duru (2013) of twenty leading banks in Nordic countries from 2004 to 2012 found that managers use loan loss provisions in their income smoothing activities. In addition, the provisions follow the Accounting Standard issued by the International Financial Reporting Standards and respective countries' Generally Accepted Accounting Principles (Tsitinidis & Duru, 2013). However, in the earlier publication by Fonseca and Gonzalez (2008), the use of loan loss provisions as an income smoothing tool is dependent on the accounting standards, institutional background, and regulations in the respective countries (Fonseca & González, 2008).

Graham (2002) gives more details of cooking-the-books activities carried out by businesses. Those are overstating reported earnings, unrecorded sales transactions, temporary withholding receivables payments, setting up dummy suppliers, and falsifying purchase documentation and transactions (Graham, 2002). A study of US public companies from 1998 to 2007 found that there were 347 cases of financial statement fraud. The techniques used by the company managers were revenue recognition (61%), overstated assets (51%), understated liabilities or expenses (31%), misappropriation use of assets (14%), and others accounting techniques (20%) (Zack, 2012).

2.3 The Finished Dish

What is the economic impact on the business, or the finished dish? The economic impact from the actions leads to significant economic losses to the business, especially when it becomes insolvent, shareholders' and investors' investment has shrunk to zero, creditors cannot claim their money, and employees lose their job and pension money, and to a larger extent it affects the state economy (Lomax, 2003). For example, the cooking activity performed by the top executives in Enron Corporation, WorldCom, Quest, Tyco, and Global Crossing are estimated to have caused $470 billion losses in market capitalization (Cotton, 2002). A study by Karpoff et al. (2008) of 585 US firms from 1978 to 2002 revealed that on average the penalty imposed by the cooking-the-books activities on a single firm is $23.5 million, but the reputational loss incurred by the business is far greater than that (Karpoff, Lee, & Martin, 2008).

3. *Research Methodology*

In this research, we employ content analysis to answer the above research questions. Neuendorf (2002) defined content analysis as a research technique for making a valid inference from the data according to the content in the document. Document study is an indirect method or one that uses secondary source data. Document analysis is an integrated and conceptually informed method, procedure, and technique for identifying and analysing documents for their relevance, significance, and meaning related to the subject under study.

We gather research evidence from the businesses' available documents, such as annual reports, press releases, and announcements from the Malaysian Security Commission and Stock Exchange. We use qualitative data analysis software (Atlas.ti version 6) to sort and organize the data in such a way that it relates directly to cooking-the-books activities appearing in documents as per our research questions. The software helps us in the analysis but it cannot replace the interpretation that takes place throughout the research process (Pedersen, 2010). In this research, we chose two Malaysian listed companies, namely Transmile Group Bhd and Megan Media Bhd. Those two companies, due to their cooking-the-books activities, have been labelled as causing a Malaysian mini-Enron financial scandal because of the amount (the biggest amount so far in Malaysia) and the involvement of the company's top management (Zaimee, 2007).

4. *Result and Discussion*

4.1 Transmile Group Bhd

Enter the corporate kitchen. Transmile Group Bhd was incorporated in 1993 and subsequently listed on the Malaysia Stock Exchange in June 1997. The principal activity of the business is in express air cargo, for which it has obtained landing rights in many Asia-Pacific countries. The clients of the company consist of well-established forwarders, such as DHL Worldwide Express, United Parcel Service, Nippon Express, and the local Pos Malaysia Bhd. Other related business activities run by its subsidiary include flight maintenance. Since the company's largest shareholder is one of the well-known local billionaires and the second-largest state investment arm, its shares are under the radar of analysts and institutional investors. In 2006, the company was voted among Asia's top 200 small–midsize companies by one of the renowned business publications, *Forbes Magazine*.

The cooking recipes. The early warning signal for the business's cooking-the-books activity was perceived by the public after it failed to meet the submission deadline for the 2006 annual accounts to the stock exchange in April 2007. This is because the external auditor did not want to sign the accounts as he was unable to obtain the necessary evidence for the transactions related to trade receivables and the sale and purchase of property plants and equipment in the company and its subsidiary. Earlier on, in February 2007, the board had approved an unaudited result that had shown an 80% increase in revenue, doubled net profit, and trade receivables that had ballooned to RM381 million from RM111 million in 2005 (Fong, 2007b). A day earlier, the audit committee meeting highlighted several issues in the accounts; however, the issue was not brought up during the board meetings in the followings days, maybe because of the influence from members of the audit committee as they were the persons engaged in the activities.

In May 2007, the new Board appointed a forensic auditor to conduct a special audit of the company's account and its subsidiaries. The auditor found that the revenue was overstated by a total of RM622 million for three consecutive financial years from 2004 to 2006 (Fong, 2007b; Zaimee, 2007). In addition to that, another cash outflow of RM341 million was "purported property plant and equipment" because there was discovered to be little supporting documentation for that transaction (Zaimee, 2007). Furthermore, the company was said to have made payments totalling RM189 million without supporting payment vouchers (Zaimee, 2007). The special audit into its subsidiary accounts found items on related-party sales transactions in which the subsidiary owed to the business more than RM103 million.

The finished dish. The newly appointed director has lodged a police report regarding the false statement on revenue, property plant and equipment, and payment to third parties. As a result of that, the former CEO, i.e. the founder, and the ED were charged by the court for the submission of misleading financial statements. Furthermore, the two former independent directors as well as audit committee members were found guilty under the Securities Act for the authorized release of a misleading financial statement to the stock exchange (the first case in Malaysia to impose a charge on independent directors and give a signal to the market that independent directors cannot just endorse everything given to them). In July 2007, the company announced the winding up of its subsidiaries due to larger group liabilities and finally the shareholders suffered a loss of their investment from the massive drop in the company's share price, which was the highest on 3 January 2007 at RM14.40, to RM4.64 on 3 July 2007 and below RM0.50 since March 2010 (Oh, 2010). On 24 May 2011, the company was delisted from the exchange. Furthermore, the shareholder funds decreased from RM424 million in 2007 to a negative of RM289 million and loss in market capitalization of RM1.2 billion.

4.2 Megan Media Bhd

Enter the corporate kitchen. Megan Media Bhd was incorporated in 1994 and listed in August 2000 under the second board company. In 2002, it moved to the main board of the exchange. The principal activity of the company and its subsidiaries is the manufacturing and marketing of electronic data storage products, such as diskettes, video tapes, and recordable compact discs. The company was the first company to receive pioneer status from the state because it is the largest manufacturer of data storage products in Malaysia.

The cooking recipe. A year after the Transmile case was made public, the cooking-the-books activity of the company shocked the local securities market. The signal of accounting irregularities become public knowledge in April 2007, when two of its subsidiaries made a default payment to all of their maturing trade facilities obtained from the local bank amounting to RM893.97 million (the principal amount).

As a result of that, the company proposed a debt restructuring plan to regularize its financial position. As such, the bankers requested the company to appoint a forensic auditor to conduct the investigation into the company's books and its subsidiaries (Oh, 2010). The initial findings found irregularities in a subsidiary's account regarding fictitious trade debtors and creditors amounting to RM456 million. Furthermore, the auditor found that the subsidiary had financed the payment of fictitious trading creditors through borrowing and recycling the cash through other business entities, and the evidence shows payments being made to non-existent creditors using the bank trade facilities (Fong, 2007a; Oh, 2010). Further investigations found another accounting irregularity, which is a bogus payment of RM211 million for the purchase of assets for production lines at the subsidiary.

The finished dish. The Securities Commission started its investigation into the company books after the release of the third quarterly interim report. The commission viewed the results as too good to be true. In December 2007, the commission charged three individuals – the former Executive Chairman, Executive Director, and Financial Controller – for giving false revenue figures to the Malaysian Stock Exchange as follows:

- RM1.03 billion reported in its consolidated accounts for the year ending 30 April 2006
- RM 230 million in its consolidated quarterly report for the financial period ending 31 July 2006
- RM238 million in its consolidated quarterly report for the financial period ending 31 October 2006
- RM306 million in its consolidated quarterly report for the financial period ending 31 January 2007

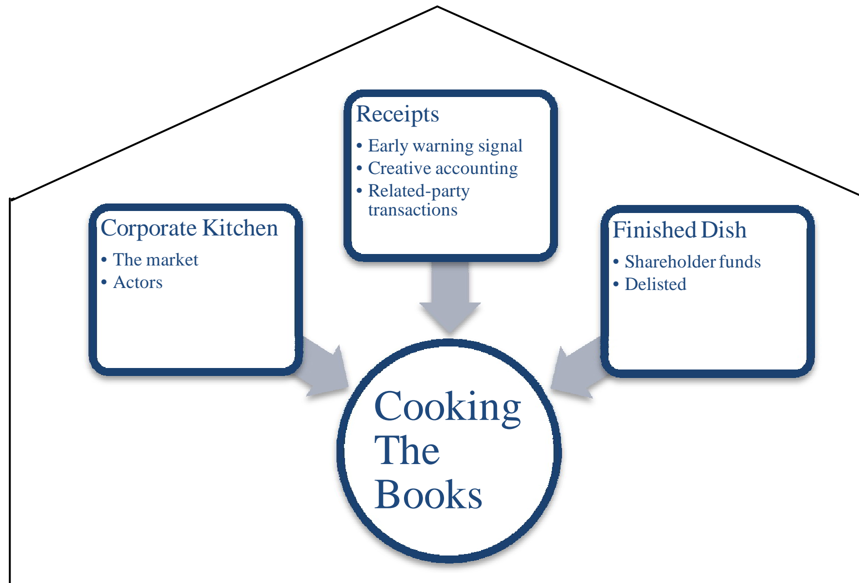
Based on the above figures, a large amount of its past revenue had been falsified, so it failed to submit its regularization plan to the Stock Exchange. For the financial year ending in 2007, the company had incurred a net loss of RM1.27 billion and a negative cash flow of RM897 million. Therefore, the company could not survive as its financial health had deteriorated and it was delisted in April 2008.

The shareholder loss can be examined by seeing a drop of 85% of the company share price over the period of three months after the news become known to the public (from as high as RM0.60 to RM0.04).

4.3 Discussion

The qualitative analysis software helped us in mapping the cooking-the-books activities, as shown in figure I.

Figure I: Mapping Cooking-the-Books Activities



The corporate kitchen. As seen from figure I, both companies were new listed companies involved in promising business activities related to transportation and information technology, possibly the main reasons why the businesses became involved in cooking-the-books activities. This is because the managers had to manage the business earnings due to the influence from the market about the business growth potential and promising future profit, although the managers and investors knew that the market for the company products was very young and untested for marketability and profitability growth (King, 2013). Therefore, the managers were focused on financial results, not operating results. As a consequence, they had to smooth the income to avoid market punishment of the company shares for not meeting analysts' expectations or contractual obligations from the lenders (Karpoff et al., 2008).

The recipe. Based on figure I above, the first early warning signal for the activities is overstated financial performance. The second red flag is the business's inability to pay its creditors. Both situations result from fine work of related-party transactions and earnings management carried out by the top management to falsify the financial statement. For example, under the normal audit engagement and business internal control system it is difficult to identify and trace the transactions until the above events happen when the business requires a special audit (Gordon et al., 2007). As a result of that difficulty, the managers intentionally engaged in cooking-the-books activities because they made the financial transactions become so complex that no one could really determine which transactions were legal and which were not.

The more detailed activities they carried out were only discovered after the special audit. For example, they overstated the reported earnings made through a subsidiary by setting up a dummy supplier and falsifying purchase documentation and transactions for materials and assets (Fong, 2007a, 2007b; Oh, 2010; Zaimee, 2007). A renowned similar case is that of Enron Corporation in 2001, in which the managers established Special Purpose Entities to hide the business debt and overstate the business income (King, 2013). Even though there is a rule to govern either in the accounting standards or in the corporate governance code for the business to follow, abuse of it has become a challenge for the Asian capital market and the rest of the world (OECD, 2009).

Another issue that arises is why the middle managers, especially the accountants and financial managers, did not report the cooking-the-books activity undertaken by the top management to the regulatory body? The reason could be the pressure received from the top management and therefore the fear of losing their jobs if they reported the activity.

This is because in the law provision the top management, especially CEOs and CFOs, are the people responsible for the financial affairs of the company, not other people, such as accountants or financial managers. Furthermore, the CEO is the person who certifies the accuracy and completeness of financial reports.

The finished dish. As stipulated in figure 1, the impacts from the activity are the loss of shareholder funds and delisting from the exchange. In the case of Enron, the shareholder funds amounted to more than $11 billion. In both companies, the total loss was more than RM1 billion. However, at the time of publication, the legal penalties were only a small part of the total losses experienced by the business and its shareholders. In the case of Transmile, the shareholder funds were decreased to a negative RM289 million in 2007 and the directors were only fined a total of RM1.9 million (Koh, 2010). Thus, the investors and Minority Shareholder Watchdog Groups want the regulators to take more thorough action against them to restore investor confidence in the stock market (Zaimee, 2007).

5. Conclusion

This study investigated the cooking-the-books activities undertaken by two companies that have been labelled as causing a Malaysian mini Enron financial scandal. The result of the study showed that the involvement of the top management may be because of self-indulgence, a loophole in the regulatory governance, and a lower penalty imposed under the existing law. We posit four potential factors for why both companies engaged in the activities: (i) opportunistic managerial behaviour in those two companies as evidence to cover up the activity by reporting a higher profit than the actual one, (ii) opportunistic actions by the analyst and investor because the business was involved in a growth potential business and they should be cautious of overly strong growth in companies, (iii) weakness in the internal control systems and operational systems as well, and (iv) the role of monitoring and detecting by the regulators because the regulator should investigate, for example, in both cases, why there was a significant increase in the companies' reported earnings.

Acknowledgement

The authors acknowledge financial support from The Universiti Utara Malaysia and the anonymous reviewers for their assistance and comments in this research.

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