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## A preliminary study on fraud prevention and detection at the state and local government entities in Malaysia

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### Abstract

This study examines the occurrence of fraud and identifies the prevention programs in place at the State and Local Government entities in Malaysia. Issues related to fraud are of interest due to the frequent coverage by the media which has affected public confidence. The findings suggest that fraud is a significant problem, and the main causes of fraud are poor management practices and economic pressure. Interestingly, the study finds that, in most cases, management did not take firm action against the culprits when they were caught and found guilty. Most fraud incidents were discovered through the internal audit review, employee notification and accidental discovery. The findings also reveal that most of these entities did not have effective policies and procedures for dealing with fraud.

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*Keywords:* Fraud; internal control; state and local government; Malaysia

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### 1. Introduction

Fraud is defined as ‘any crime which uses deception as its principal modus operandi’, and thus embraces a wide range of deviant behaviors by individuals and organizations, some of which are not always criminal but ‘morally dubious’ (Wells, 1997). It is a crime that has received relatively little attention compared to other types of crimes (Levi, 2008). According to Croall (2007) and Levi (2001), fraud can be a multi-dimensional crime committed

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generally by: (i) law-abiding corporations against individuals or other corporations; (ii) organized criminals against individuals and corporations; and (iii) individuals against other individuals or organizations. From the legal point of view, fraud is defined as a deception deliberately practiced to secure unfair or unlawful gains. According to Glover and Aono (1995), fraud involves a misallocation of resources or distorted reporting of the availability of resources, which is contradictory to the elements of sound and prudent management.

Fraud, if not effectively prevented and detected, could result in serious damage to an organization. In Malaysia, fraud is not an unusual occurrence, whether in the private or public sectors. In the private sector, a series of financial scandals has been reported. These include the cases involving Meganmedia, Transmile and Sime Darby Bhd. On the other hand, in the public sector, it is the Auditor General's (AG) report that highlights 'suspected' fraud cases. There have been a number of cases that have been highlighted in the report. However, despite several shocking revelations, these cases can only be classified as 'suspected' since they have yet to be proven in the Court of Justice. In fact, most of the time, these cases are only classified as 'mismanagement' which will simply involve disciplinary action. Based on the lack of punishments taken on the suspected fraud or mismanagement reported by the AG, it is not surprising that state and local governments are so susceptible to fraud.

Despite numerous efforts to strengthen financial controls and institute good governance at the local and state government levels, the number of fraud cases is still on the rise, in fact becoming more severe – a clear signal that some form of action should be taken to curb this escalating crisis. However, before arriving at a viable solution for fraud prevention, it is essential to first understand the root causes of fraud and what the current practices on fraud detection and prevention are.

To date, besides the AG's report, studies that investigate the occurrence of fraud and its mitigating factors are scarce in Malaysia. Considering the huge damaging effect of fraud, a better understanding on the effectiveness of prevention, detection and discovery of fraud is urgently needed. Thus, the objective of this study is to provide an overview of fraud cases in the State and Local Government entities in Malaysia. The study also aims to seek the internal auditors' opinion to identify the best fraud prevention mechanisms that should be in place. The results of the study will allow us to better understand the nature of fraud and best possible ways to prevent its occurrence, in the context of the State and Local Government entities.

Our paper is organized as follows. In the next section, we discuss prior studies and outline the research design. We then discuss the results of the questionnaire survey and interview. We conclude with summary and suggestions for future research.

## **2. Prior studies and method**

### *2.1. Prior studies*

Black's Law Dictionary defines fraud as 'all multifarious means which human ingenuity can devise, and which are resorted to by one individual to get an advantage over another by false suggestions or suppression of the truth. It includes all surprises, tricks, cunning or dissembling, and any unfair way which another is cheated'. Under Common Law, in order to establish that fraud activities have taken place, the following elements must be present: (i) a material false statement made with intent to deceive; (ii) a victim's reliance on the statement; and (iii) damages have occurred. Fraud can take a variety of forms, such as embezzlement, insider trading, self-dealing, lying, failure to disclose facts, corruption, accounts manipulation, kickbacks, phantom vendors, and many more (Ziegenfuss, 1996). While the list of activities which could be considered as fraud is immense, there are common elements of fraud. As suggested by Albrecht et al. (2006) and Kranacher et al. (2011), the three elements are: action, concealment and conversion. 'Action' represents the execution and methods of the fraud (e.g., embezzlement, kickback); 'concealment' represents hiding of the fraud act; and 'conversion' is the process to legitimize the ill-gotten gains.

Over the last 60 years, a number of theories have been proposed to differentiate fraud from other types of financially motivated crimes (e.g., burglary and snatch theft). An excellent review of the evolution of these theories can be found in Dorminey et al. (2012). Cressey (1953), based on interviews among white-collar convicts, proposed three criteria for a criminal violation of trust: (i) a non-shareable financial problem; (ii)

knowledge of the workings of a specific enterprise and opportunity to violate the position of trust; and (iii) the ability to adjust one's self-perception that violating this trust does not constitute criminal behavior. Thus, he hypothesized that for fraud to occur, the following criteria must be present: (i) perceived pressure; (ii) perceived opportunity; and (iii) rationalization. Today, this model is known as the 'Fraud Triangle'.

According to the "Fraud Triangle" model, perceived pressure from a non-shareable financial problem (which may come from perceived social stigma or sense of pride) creates the motivation for a crime. Meanwhile, perceived opportunity is the perception that the entity's internal control measures are weak, and the possibility of being caught is remote. Rationalization is the justification of the fraudulent action where the fraudster tends to consider his dilemma as a special exception rather than as a trust violator. Through rationalization, the fraudster is able to reduce the cognitive dissonance (i.e., conflicting attitudes, beliefs or behaviors) and hence, proceed without feeling guilty. In general, Cressey (1953) suggested that with non-shareable financial problems, perceived opportunity with little fear of detection and defensible excuse, an individual may commit fraud even though the person is a respected figure and not under economic pressure.

Fraud will impair efficiency, productivity and innovation since it siphons away resources to non-constructive activities, thus limiting an organization's ability to manage, grow and succeed. If the organization happens to be a government entity, the loss from fraud means a portion of resources has not been converted into services to benefit the citizens. A study conducted by the Association of Certified Fraud Examiners in 2012 reported that the typical organization loses five percent of its revenue to fraud each year. This figure translates to a potential projected global fraud loss of more than USD3.5 trillion (Association of Certified Fraud Examiners, 2012). In the United Kingdom (UK), the cost of fraud is estimated at £2.2 billion a year for local government alone, and around £73 billion throughout the UK (The Local Government Fraud Strategy, UK, 2011).

In Malaysia, fraud cases in the public sector always attract the attention of the politicians as well as the public at large. Several cases can be classified as shocking. For instance, it was reported in the 2012 AG's report that the deceased were among the recipients of welfare benefits in some states for several years. In the 2012 report, the AG also questioned a RM303,813 travel claim, made by a senior officer from the Communications and Culture Ministry, for a four-day study trip to Geneva, Switzerland, which the auditors felt was worth only RM50,000. There were also several cases where some government departments paid for their purchases at overly inflated prices. Similarly, in the private sector, it was reported that in 2006 alone, there were 6,921 cases of commercial crime and another 2,892 cases involving falsification, fake currency notes, credit cards and other offences (Buang, 2008).

A Report on the Local Government Fraud Strategy (2011) in the UK suggests a three principle approach to fight fraud, i.e., acknowledge, prevent and pursue. The start of the process is to acknowledge the threat of fraud, as well as the opportunities for possible savings. In other words, this strategy suggests the implementation of risk assessment and fraud resilience check. The next is prevention, which is often the most efficient way to secure savings. However, once the fraud activities have been committed, it is vital to pursue the fraudsters and deter others. Since fraud is an acquisitive crime, then in order to deter offenders, it is important that they are brought to justice and do not profit from their illegal actions.

Coram et al. (2010) stressed on the importance of effective internal audit function as part of the framework of internal control to fight fraud. Their study suggested that organizations with an internal audit function are more likely to detect and self-report fraud through misappropriation of assets than those that do not. The results also highlight the importance of having an in-house internal audit function which is found to be more effective in detecting and self-reporting fraud than when the internal audit function is fully outsourced. Generally, the establishment of internal control is effective, particularly to prevent individuals from committing a fraudulent act. However, such preventive control will be less efficient when there are collusion and management override. In this circumstance, tone at the top, an open, transparent corporate culture, and opportunity for reporting inappropriate behavior are much more effective (Trompeter et al. 2013).

## 2.2. Research design

This study was conducted in the year 2006. The population of this study encompassed all State and Local

Government agencies with an internal audit department. During the period, nine state government agencies, 12 statutory bodies and 15 local governments (totaling 36 entities) had their own internal audit departments.

The study utilized questionnaire and phone interview approaches in order to answer the research questions. The questionnaire is adapted from Ziegenfuss (1996) and KPMG fraud survey (2003). There are eight questions on various aspects with seven close-ended questions and one open-ended question. The questionnaire is divided into five parts: (i) General information; (ii) Reasons for fraud occurrence; (ii) Types of fraud; (iii) Discovery of fraud; (iv) Actions taken by entities; and (v) Fraud preventive mechanisms. The questionnaires were distributed to the heads of the internal audit department of the 36 State and Local Government entities with internal audit department. As a step to maximize the response rate and in order to achieve better understanding, phone interviews were conducted for the open-ended part of the questionnaire.

### 3. Results

#### 3.1. Sample selection

Table 1 describes the sample selection and response rate of respondents. Out of the 36 questionnaires mailed, a total of seven respondents completed the survey for a response rate of almost 20%. Out of the total, four were from State Development Corporations and three were from City Council entities. Interestingly, none of the state government entities returned the questionnaire. Table 1 below shows a detailed percentage of responded questionnaires. The low response rate is not unexpected due to the nature of the study which requires the respondents to disclose very sensitive information.

Table 1. Sample selection and response rate

Agencies	#		Response	
			#	%
State Governments	9	0	0	0.0%
Statutory bodies	12	4	4	33.3%
Local Authorities	15	3	3	20.0%
Total	36	7	7	19.5%

#### 3.2. Fraud occurrences

The respondents were asked questions on their perception of fraud. The survey results suggest that the majority of the respondents agree that fraud causes significant problems to the State and Local Government entities nowadays. However, 29% and 14% of the respondents disagree or are not sure about the matter, respectively. The respondents were asked about what they believe to be the main reasons that trigger fraud at the State and Local Government entities. As illustrated in the Table 2, most respondents believe that the poor management practices are the main reasons for fraud. Meanwhile, economic pressure was revealed as the second top contributing factor.

Table 2. Reasons for Occurrence of Fraud

Reasons for Occurrence of Fraud	%
Poor management practices	86
Economic pressure	57
Weakened society values	29
More sophisticated criminals	14
Inadequate training of those responsible for fraud detection	14
Lack of government intervention	14
Advances in computer technology	14
Increased workload	14
Others – Political interest	14

Surprisingly, weakened society values is ranked third in terms of contributing factors. In addition, inadequate training of those responsible for fraud detection, lack of government intervention, advances in computer technology and increased workload are also identified as the contributing factors. Remarkably, one of them has, in

fact, stated “political interest”, as one of the motives for committing fraud.

### 3.3. Internal auditors and fraud

This present study further explored internal auditors’ awareness of fraud in the organization that the respondents are working for. The study discovered that all the respondents indicate they are aware of fraud occurrence at the workplace and agree that their organizations have been victims to this white-collar crime in the past twelve months. The survey questionnaire asked respondents about the type of fraud suffered most frequently by their organization. Results indicate that the types of fraud most frequently committed are - misappropriation of funds and false claims for hours worked or overtime done. Manipulation of accounts is the third top type of fraud. Together, these three types of fraud are cited as the most common types of fraud experienced by respondents with scores of 60% of all reported fraud. In addition, false documentation, theft and check forgery and counterfeiting are also reported to occur in these organizations. Among other types of frauds which are not in the list, but were added by the respondents, are bribery and misappropriation of assets. Table 3 below presents the results.

Table 3. Types of fraud committed

Types of Fraud	%
Misappropriation of funds	22
False claims for hours worked/overtime	22
Accounts manipulation	17
False documentation	11
Theft	11
Check forgery and counterfeiting	6
Accounts receivable manipulation	0
False financial statement	0
Others - Bribery	6
- Misappropriation of assets	6

### 3.4. Fraud discovery mechanisms

With regards to effective fraud detection, the results in Table 4 show that the fraud is detected mostly during internal audit review. Notification by employees is the second most common mechanism of fraud discovery. Other top mechanisms include accidental discovery, external audit and anonymous/public notification (i.e., whistle blowing).

Table 4. Fraud discovery

How fraud is discovered	(%)
Internal audit	100
Employee notification	71
Accidental discovery	57
External audit	43
Anonymous letter/notification	43
Internal control	29
Specific investigation by management	29
Others	14
Police notification	0

The respondents were then asked about the actions taken by them or their organizations after fraud discovery. Table 5 below summarizes all the responses received pertaining to action taken by management in response to fraud. All of the respondents indicate that they or their organization initiate investigations once the incidents of fraud come to their knowledge. Most of the fraudsters were disciplined, but none were terminated. Interestingly, the law enforcement authorities were notified in only 14.3% of the cases. While some negotiated for settlement, none was brought to the Court for civil recovery. The results show that more firm action must be taken against fraudsters if the entity wants to become more effective in deterring future perpetrators. There are also instances where the State and Local Government agencies allowed the perpetrators to resign or simply keep quiet about the

issue.

Table 5. Actions taken

<b>Actions Taken</b>	<b>%</b>
Investigation	100
Disciplinary action, not terminated	71
Review by audit committee	43
Set an example	43
Immediate dismissal	29
Permitted employee(s) to resign	29
Negotiated settlement	29
Keep it quiet	29
Reported to law enforcement	14
Others	14
Civil action for recovery	0

3.5. Fraud prevention

Having effective strategies to prevent fraud is crucial (to be successful). Management can overcome the difficulties of handling fraud and its related dilemma by setting up policies and mechanisms to manage fraud. In the last section of the survey questionnaire, respondents (internal auditors) were asked to score the most effective mechanism to prevent fraud at the State and Local Government entities. Among the most effective measure (i.e., perceived to be very effective and somewhat effective) to curb fraud as indicated by respondents is that the organization should provide a hotline or toll-free number to facilitate fraud reporting. Having computer security policy in place is also deemed as necessary to prevent fraud. Other most cited mechanisms include the importance of having a fraud investigation policy, as well as code of conduct or work ethics policy. Having a policy on how to report fraud, however, is viewed as ineffective. This possibly reflects respondents’ lack of confidence that action will be taken or will be addressed appropriately by authorities. Table 6 summarizes the responses.

Table 6. Preventive mechanisms

<b>Mechanisms</b>	<b>VE (%)</b>	<b>SE (%)</b>	<b>IN (%)</b>	<b>DK (%)</b>
Have a policy on reporting fraud	-	14	43	-
Have a fraud investigation policy	-	43	14	-
Have a code of conduct or ethics policy	-	43	14	-
Have a computer security policy	28	28	28	-
Require submission of conflict of interest form	-	28	43	14
Have fraud related program	14	14	14	14
Conduct pre-employment criminal background check	14	-	28	-
Have a training manual specific to fraud	14	14	14	-
Have a hotline or toll-free number in place for reporting fraud cases	28	14	14	-

Note: VE = very effective; SE = somewhat effective; IN = ineffective; DK = do not know.

Further, in response to the open-ended question on the best way to reduce imminent fraud in the government entities, several suggestions were made by the respondents. The suggestions include: educate and create awareness among the staff on integrity, foster ethical values, focus on fraud prevention, establish a proper written policy and procedure, maintain the adequacy and effectiveness of control, reduce politics, Board of Directors should strongly support fraud prevention and continuous supervision.

Overall, results of this study clearly demonstrate that respondents acknowledge that their organizations do not have effective policies or a fraud mechanism structures in place that can reasonably assure them that fraud will be prevented.

#### 4. Conclusion

The purpose of this study is to provide an overview of fraud cases in State and Local entities in Malaysia. We also aim to identify the best fraud preventive mechanisms that should be in place. The findings of this study highlight that poor management practices are the main contributing factors of fraud. Thus, non-existence or ineffective internal control, lack of actions against fraudsters and poor oversight by management must be checked if the State and Local Government entities in Malaysia are serious in combating fraud. Most of the fraud cases are discovered through the work undertaken by internal auditors. This has pointed out the importance of internal auditors as crusaders to safeguard government property. In order to be more effective, internal audit function should be established as part of the framework of internal control at all State and Local Government entities in Malaysia. Perhaps, it is also timely for those agencies to beef up their internal control policy and enforcement to be consistent with the advancement of today's technology. The internal audit department should also be given the authority to handle their tasks and it is vital that they are independent of management. This is crucial in order to allow them to carry out their duties without 'fear or favor'.

The State and Local Government agencies must report all fraud cases to authorities, so that due action can be taken. Keeping the fraud cases under wraps or simply allowing the culprit to resign is not the right method as it signals that the management or authorities are always ready for negotiation if the fraudsters get caught.

The study, however, is not without limitations. The results of this study need to be interpreted with care and caution. Low response rate, though not unexpected, could limit the generalization of the results. Future studies should consider larger sample size or different government agencies, such as by including agencies without the internal audit department, and federal government agencies. This might be useful in order to gain evidences that are more conclusive. In attempts to conduct the interview, we encountered situations where some of the respondents did not want to participate for fear of not getting approval from the heads of their organization. The fact that fraud is considered as strictly confidential, sensitive and not to be discussed openly, might hinder the respondents from sharing their experiences and thoughts. This might be out of fear that the revelation might tarnish the organizations' reputation. Future studies should consider including respondents from different levels of authority, such as heads of department, accountants and disciplinary committee members in order to get information that is more detailed.

Nonetheless, it is hoped that the findings from this study could be utilized to enhance existing policies to strengthen integrity and accountability in the public services.

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