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Fraudulent financial reporting and company characteristics: tax audit evidence

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Abstract

Purpose – The purpose of this paper is to examine the relationship between fraudulent financial reporting and firms' characteristics, i.e. size, type of ownership and audit quality in companies audited by the Inland Revenue Board of Malaysia (IRBM) after the implementation of a self assessment system in Malaysia.

Design/methodology/approach – The paper employs an empirical research design, using data on companies audited by IRBM. The hypotheses of the study are tested using both univariate and multivariate statistical methods.

Findings – It was found that company size and audit quality have significant negative relationships with fraudulent financial reporting.

Research limitations/implications – The sample of companies used in this study is unlisted companies and the results are not generalisable to listed companies. Listed companies may have more stringent rules for listing and have better corporate governance mechanisms within the company as control.

Practical implications – The paper's findings may assist IRBM in identifying possible cases for audit in the future.

Originality/value – The paper describes the first empirical study that uses real tax cases where the non-compliance with the Malaysian statues and tax laws are used as the measurement of the fraudulent financial reporting.

Keywords Malaysia, Fraud, Financial reporting, Taxation, Auditing

Paper type Research paper

1. 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/organizations to deceive or mislead investors and creditors through information in accounting statements.

Without a proper monitoring mechanism, the use of the self assessment system (SAS), which was first introduced in Malaysia in 2001, has indirectly provided opportunities to taxpayers to commit misstatements in financial reports for the purpose of lowering the profit and subsequently, reduce tax. Through SAS, taxpayers have more

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freedom in reporting their income since this system allows the Inland Revenue Board of Malaysia (IRBM) 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 taxpayer. Under this system, taxpayers 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 taxpayers will submit all their tax information honestly and voluntarily (Marshal *et al.*, 1997).

However, to further ensure that the taxpayers comply with the guidelines and report their income accurately, the IRBM conducts tax audits. Before the introduction of SAS, tax audits were only performed on certain cases where more information and clarification were needed; tax audit was not one of the main activities of the IRBM before the introduction of SAS. However, since the introduction of SAS, tax audit has become one of the core activities of IRBM (Enforcement Department Report, 2005). Results from audit findings show that some taxpayers are engaging in fraudulent financial reporting as a means to reduce their tax liabilities. From an initial examination of the data at IRBM, in 2002 alone, a total of 1,850 audit cases were solved, resulting in tax and penalties amounting to RM77.03 million as compared to the previous year of RM51.25 million. Therefore, Marshal *et al.*'s (1997) 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. Therefore, this study examines if firm characteristics have any association with fraudulent reporting in Malaysia. The findings from this study may reveal new indicators that tax auditors can use in tax audit. It is imperative to have a good model to select possible cases to be audited because it would result in an improvement of the tax administration efficiency and result in more accurate prediction of actual cases of manipulation. Without a proper tax audit selection method, the government would spend millions of ringgit in auditing wrong cases and losing tax income due to manipulation.

Past studies on fraudulent financial reporting relate fraudulent acts with earning management activities (Guenther, 1994; Roubi and Richardson, 1998; Northcut and Vines, 1998), audit quality (De Angelo, 1981; Jeong and Rho, 2004) and director's composition in a company (Beasley, 1996). Nearly all the 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 audits carried out by IRBM on unlisted companies in Malaysia. Specifically, this study examines the relationship between companies' characteristics with the types and amount of fraudulent reporting that were submitted to IRBM for tax purposes. This study uses real tax cases where the non-compliance with the Malaysian statues and tax laws are used to measure fraudulent financial reporting. To the best of our knowledge, there is little published research on the issue of fraudulent financial reporting using real data from tax audit findings.

This paper is organized as follows. Section 2 reviews the literature related to fraudulent financial reporting to develop the research hypotheses. Section 3 presents the research method, which includes samples, measurement of research variables and model. Section 4 deals with the results and discusses the research findings results and discussions. Section 5 concludes this study.

2. Literature review

Fraudulent financial reporting discovered during the tax audit process is treated as a form of tax non-compliance committed by the company[1]. There are several acts of fraudulent financial reporting that are found in a tax audit, namely, understatement of sales, overstatement of purchases, transfer-pricing, charging unallowable expense and allowances as well as making income reducing stock adjustment. Such activities are committed by companies because they have the tendency to report lower profit to reduce tax. The propensity to carry out fraudulent reporting to reduce the tax burden exists through earning management activities in terms of income shifting between assessment years. Guenther (1994) reveals that fraudulent financial reporting occurs surrounding the period of changes in income tax rate and it is performed through earning management techniques. Guenther (1994) found that, in general, firms involved in earning management activities 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 the available accounting options. This finding is supported by Roubi and Richardson (1998), who provided 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 the period 1985 and 1988.

According to Northcut and Vines (1998), there was an attempt to increase corporate tax through the Tax Reformation Act 1986 by certain political groups in the USA. The groups use effective tax rates to support their claim that most companies pay a small amount of tax or totally neglect to pay any tax at all (Northcut and Vines, 1998). This scenario exposes companies to the risk of political scrutiny. As a result, it influences companies to choose accruals that will reduce income and the risk of political exposure. As such, companies can justify the small amount of tax paid to the government.

In addition to the intention to reduce tax, companies would choose appropriate accounting policies that can reduce profit to reduce 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 of the company, which will result in an out flow of cash from the company to the government through the significant amount of tax to be paid or payments to the many claims made by employees and users (Watts and Zimmerman, 1978).

In general, the management can choose accounting techniques and estimates that 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 the management of real transactions. However, in some circumstances, 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 tax saving. Therefore, control mechanisms and attempts to reduce such behaviour should come from within 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) studied companies that were scrutinized by the public authority for fraud in the financial statement. The result shows that financial statement fraud appears to be influenced by the composition of the board members. The results indicate that the 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 somewhat suggests that the independence of the board directors contribute to good quality financial reporting.

Apart from independent directors, the presence of external auditors also reduces fraud in financial reports. In studying the relationship between audit quality and company size, De Angelo (1981) suggested 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 improves the audit quality supplied by larger audit firms. In protecting their valuable reputation, it is expected that larger audit firms will comply more with accounting standards and audit procedures in preparing financial statements, thus resulting in less misstatement of financial reporting that could be uncovered in tax audits.

However, the difference in the quality of audit services between large and small audit firms may not occur in all countries. In Korea, Jeong and Rho (2004) found 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 the Korean environment, auditors did not perceive that they would face the 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 deter auditors to provide poor quality audits (Jeong and Rho, 2004).

Studies on tax compliance suggest that the possibility of being audited by tax authorities is a significant factor determining the level of a firm's compliance. A study by Bradley (1994) on 471 large-sized companies concludes that the "audit by authorities" factor partly contribute to tax compliance. According to Rice and Slemrod (1992), the decision regarding company's taxes that needs to be reported to tax authorities was made based on the tax liabilities, penalties for possibilities being traced due to under-reporting of income, and probabilities of being audited. Using the Tax Compliance Measurement Program database in the USA, results presented by Rice and Slemrod (1992) reveal that compliance by public companies is higher compared to non-public companies. In addition, the group of companies under the tight control of laws such as banks have a higher compliance rate compared to companies that are not controlled by laws. This is because public companies and certain companies under the tight control of laws are always monitored and audited by authorities (Rice and Slemrod, 1992).

The literature review provides the insights that fraudulent financial reporting is related to accruals management, and the likelihood that it can occur is dependent on the effectiveness of the board of directors and audit quality. We extend prior research by looking at the types of control that exist in unlisted companies in Malaysia[2]. This issue is particularly important in unlisted companies operating in Malaysia because the ownership of these companies tends to be more concentrated and controlled

by individuals or families (La Porta *et al.*, 2000). On the other hand, studies on tax compliance thus far, focus more on taxpayers' attitude and factors influencing tax compliance at the individual taxpayer 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 the tax audit. Most studies in the past focused on the common misstatement of financial statement for the purpose of misleading users such as investors and creditors. In this research, we focus on the tax authorities as one category of user of financial statement.

2.1 Company size

The political cost theory introduces a political dimension that can influence the choice of accounting policies (Watts and Zimmerman, 1986). A high level of profit would attract the attention of the politicians to introduce tax for the benefit of the public, i.e. the voters. It would also cause the employees and consumers, to make various claims such as an increase in salary, various benefits to the workers and a price reduction (Watts and Zimmerman, 1986). 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 for 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 the potential political costs associated with high profitability and market dominance. According to Zimmerman (1983), the political cost relates to company size because the larger the company, the more likely that they are visible and, therefore, are more exposed to government examination and wealth transfer. In keeping with the political cost theory, this research investigates whether company size affects accounting choices in a way that would reduce profits to avoid attention from the government as well as to prevent cash outflow that will be borne by the companies.

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

H1. There is a positive relationship between company size and fraudulent financial reporting.

2.2 Type of control or ownership structure

A company's type of control is also likely to be associated with the misstatement in financial reporting. Section 139 Income Tax Act (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 sole ownership. In discussing the protection of outside investors, the issue of ownership concentration in a 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, there are 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 the ITA (1967). Consistent with Claessens *et al.* (2000) who found that the 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 are inclined to use the profits of the company for their own benefit rather than 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. Therefore, inspired by past studies, such as Claessens *et al.* (2000), La Porta *et al.* (2000) and Morck *et al.* (1988), we predict that this form of company (controlled companies) has a greater tendency to be involved 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, controlled companies are defined as companies that fall under the definition of Section 139 ITA (1967). The second hypothesis is developed as follows:

H2. There is a positive relationship between the type of control of the company and fraudulent financial reporting.

2.3 Audit quality

Company auditors play an important role in ensuring that financial statements released to users present the true and fair view of the company financial status. DeAngelo (1981) suggests that a good proxy to audit quality is the audit firm's size because large audit firms will lose more if they give low-quality services due to the firms' reputation in the market. DeAngelo (1981) found that auditors from the Big 6 audit firms give better quality services compared to smaller auditors or Non-Big6.

In another study, Carcello and Nagy (2004) use auditor's specialization and auditor's firm size as proxies for audit quality in their study. In a complex environment, audit specialization may also be used as an indicator for audit quality because specialized auditors would have more familiarity with the industry environment and would be able to perform a better audit. The result reported by Carcello and Nagy (2004) shows a negative and significant relationship between auditor specialization and misstatement in the client financial statements and, therefore, suggests 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 a less complex environment. Therefore, in our case, we envisage that the effect of reputation is more important than the effect of familiarity with the industry environment indicated by industry specialization.

In Belgium, a study conducted by Bauwhede *et al.* (2003) found no significant relationship between the size of audit firm and earnings management. The plausible explanation could be due to the institutional environment in Belgium. Nevertheless, a study conducted in Malaysia by Mohd-Saleh *et al.* (2004) discovered 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 the size of audit firm and fraudulent financial reporting.

3. Research method

3.1 Samples

The data used comprises the completed tax audit cases conducted on unlisted companies by the IRBM Kuala Lumpur branch in 2004[3]. There were 1,635 completed cases audited by 26 IRBM branches throughout Malaysia. We only managed to obtain permission from the IRBM to sample the audited cases conducted by the IRBM's branch in Kuala Lumpur. This branch had a total of 623 cases, which represents 38 per cent of the completed tax audit cases in 2004. The other 25 branches have a percentage of completed tax audit cases ranging between 0.4 and 8.8 per cent. In essence, the majority of the audited cases were completed by the Kuala Lumpur branch.

Owing to multiple audited years, the 623 completed tax audit cases only involved 470 companies. We only selected 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 to these changes. However, there are some small variations in the starting time (one or two years before 2004) of the tax audit. We acknowledge that the chargeable income threshold on the 20 per cent tax rate of these unlisted companies was changed from RM100,000 to RM500,000 for the year of assessment, 2004. Consequently, firms may have had the incentive to shift income from year 2003 to 2004 in order to reduce tax. However, the announcement for the change in chargeable income was only made in September 2003. Firms may have had the capacity to manage their earnings through actual transaction or using accruals in the few months before they closed their account. If the actual transaction was used, the case is clear. If a firm was selected to be audited and found that it had committed fraudulent financial reporting, the firm would be sampled. All targeted firms must have an understatement of sales, overstatement of purchases, inventories adjustments, unallowable expenses, allowances adjustments or other adjustments.

Since most companies are audited for several years of assessments, only those firms being audited in the latest assessment year were examined to avoid the overlapping of cases. The tax audit in the latest assessment year would usually take into consideration all the adjustments from previous years of assessment. From the total of 470 subjects that were audited at Kuala Lumpur Branch, only 396 cases were finalized at the time the study was conducted. All of these 396 finalized audited cases were selected and examined[4]. Non-completed cases were not selected because there is no basis to conclude that these companies have made any misstatements.

3.2 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 control. The size of audit firm is divided into two categories; big-sized audit firms, and small and medium-sized auditors. Big-sized audit firms or famously known as the Big 4 in Malaysia are audit firms such

as PricewaterhouseCoopers, 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.

The IRBM uses the total amount of sales to determine the size of the company. Table I shows the classification of the size of company used by IRBM. Consistent with prior studies, in this study, the size of the company is represented by the natural log of total sales (Mohd-Saleh *et al.*, 2004; Jung and Kwon, 2002).

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 IRBM's audit officers and also by examining financial statements that are sent to the IRBM by taxpayers to be audited. Code 1 is given to a controlled company and code 0 is given to a non-controlled company.

3.3 Measurement of dependent variable

The dependent variable used is misstatements of financial reporting that are 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 obtain the total income without misstatement (TRUEINC), the total amount of misstatements (MISSTATE_AMOUNT) are added back to the unaudited income and considered as additional income. The measurement for this dependent variable, MISSTATE_RATIO is the MISSTATE_AMOUNT divided by the TRUEINC.

Because the sample comprises 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.

3.4 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 their study on the 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 because some industries are subjected

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

Table I.
Size of the company based on sales

to certain regulations and may have different incentives to use strategies to make fraudulent financial reporting compared to other industries.

3.5 Research model

The empirical model to test the hypotheses is as follows:

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

where:

MISSTAE_RATIO_i	=	MISSTATE_AMOUNT/TRUEINC.
MISSTATE_AMOUNT	=	Total amount of misstatement.
TRUEINC	=	Total income + MISSTATE_AMOUNT.
AUDIT_i	=	Audit Quality (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.

4. Results and discussion

4.1 Company characteristics

We use the 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, that is, 50 per cent of the sample, i.e. 396 companies, are small-sized companies and the rest of the 198 companies are large-sized companies.

Table II shows the type of industry, audit quality (proxied by audit firms size) and form of company's control for the sample. There are seven industries based on the IRBM's business code. The majority (40.1 per cent) of the companies are from commercial industry, followed by 26.8 per cent from service industry, 13.6 per cent from manufacturing industry, 12.6 per cent from construction industry, and the rest are plantation and real estate industry. Other industries represent a total of 4.3 per cent. Although there appears to be an irregular distribution pattern across industries, the effect is controlled in the regression analysis. We have included dummy variables for each industry to control for variations across industries that could have a significant effect on the results.

	Quantity	Percentage
Industry		
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
Total	396	100.0
Audit firm size		
Big4 auditors	50	12.6
Non-Big4 auditors	346	87.4
Total	396	100.0
Type of control		
Controlled companies	193	48.7
Non-controlled companies	203	51.3
Total	396	100.0

Table II.
The types of industry, auditors and company control

A total of 346 companies (87.4 per cent) use services from small-sized audit firms whereas 50 companies (12.6 per cent) use big-sized audit firms or "Big 4". These figures show that there is an inclination of the sample companies to use services from small-sized audit firms. This is because all of the companies are unlisted small companies, which are small in size and 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 II that the sample is fairly divided between controlled and non-controlled company. There are a total of 193 companies (48.7 per cent) classified as controlled, whereas the rest of the 203 companies (51.3 per cent) are non-controlled companies. This is consistent with Claessens *et al.* (2000) who found a significant control by families in companies from east Asian economies.

4.2 Descriptive test

From Table III, 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

Variables	Min.	Max.	Mean	SD
Log of total sales	4.695	9.419	6.875	0.603
Income	0.000	2.632	0.317	0.377
Understatement of sales	−0.845	4.359	0.801	0.320
Overstatement 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

Table III.
Descriptive statistics

and other adjustments show 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 that 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.

4.3 Misstatements of financial reporting and company's characteristics

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

4.4 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 *et al.*, 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 V.

The R^2 for this test using the Tobit regression is 0.1028. The result of this test shows that *H3* is supported, where there is a significant negative relation between the size of audit firms and fraudulent financial reporting. This result suggests that Big-4 audit firms (that is a proxy for audit quality) are able to constrain financial misstatements activities committed by companies. Table V also shows that *H1* is not supported. In contrast, this study found that there is a significant negative relation between the 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 and Hillison, 1990) and, therefore, would be negatively related to misstatement in financial reports. For this reason, the study discovered that when there is better internal level of control within

Type of misstatements	Company's control χ^2 (p)		Size of audit firms χ^2 (p)		Size χ^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)

Note: Significance at: *$p < 0.10$ and **$p < 0.05$

Table IV.
χ^2-test on company's characteristics and the distribution of misstatements

Variables	Coefficient	*Z*-statistic	Probability (*p*)
Constant (α_0)	0.989	3.698	0.000
AUDIT (α_1)	−0.176	−2.531	0.011 *
SIZE (α_2)	−0.120	−3.202	0.001 **
OWNER (α_3)	0.006	0.152	0.879
MANF (α_4)	0.092	0.782	0.434
COMC (α_5)	0.127	1.169	0.242
AGRI (α_6)	−0.100	−0.424	0.671
SERVICE (α_7)	0.058	0.529	0.596
ESTATE (α_9)	0.233	1.096	0.273
CONTRUC (α_8)	0.349	2.953	0.003 **

Notes: Significance at: *0.05 and **0.01; R^2 0.1028; $AUDIT_i$ = audit quality (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

Table V.
Tobit regression

a company, as indicated by the size of the company, then the chances of committing financial misstatements will decrease.

The test result for the second hypothesis is 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 of the independent variables chosen are not able to illustrate the magnitude and possibilities of misstatements committed. This suggests that the magnitude and possibilities of misstatements cannot be explained by most factors investigated in this study. There could be other factors that explain the occurrence of financial statement misstatements in companies such as the level of managerial ownership, the strength of corporate governance mechanisms and whether founding families are still managing the companies. All these issues are beyond the scope of this study. It is also interesting to note that there is a positive relation between the construction industry and misstatement made by companies. This result implies that there is a higher propensity of companies in the construction sector to be involved in actual manipulation of accounts compared to other industries.

5. Conclusion

From the findings of this research, it is concluded 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. It should be noted that the sample of companies used in this study is unlisted companies and the results are not generalisable to listed companies. Listed companies may have more stringent rules for listing and have better corporate governance mechanisms within the company as control. This study also utilizes a sample from Kuala Lumpur branch only. Results may not be generalisable to other branches as the environment within which the companies operate could be different.

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 findings also show that company size 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 fewer misstatements 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 scrutiny from the public and regulators and enforcement of law and regulations, and subsequently, they develop a better corporate governance monitoring system. Based on the findings, the tax audit policy should pay more consideration to small- and medium-sized companies, as these companies are more susceptible to commit misstatements for the purpose of tax evasion. It is possible that small- and medium-size companies do not 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 with past studies such as DeAngelo (1981), this study provides evidence that companies using services from the Big4 audit firms are less likely to commit fraud as compared to companies using the services of smaller auditors. This result suggests that Big4 size audit firms give better audit services to avoid risks associated with low-quality services. In 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 because of the possibility that the auditor would give lower quality audit services compared to those engaging big size audit firms.

Notes

1. 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 (ITA, 1967).
2. Section 139 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.
3. This year is selected because it was the latest year of assessment at the time the research was carried out. Kuala Lumpur Branch is an IRBM branch that is responsible for company tax return and audit.
4. We believe the characteristics, i.e. size, owners and industries of companies operating in Kuala Lumpur and other cities in Malaysia are similar. However, our results may not be generalisable to companies outside Kuala Lumpur due to the unique business environment in each city. For example, businesses in Penang are dominated by the Chinese ethnic group and businesses in Kelantan are governed by an Islamic state. These unique environmental factors could have some influence on the relationships found in this study and this issue is beyond the scope of this study.

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