WHITE-COLLAR CRIME AND STOCK NEXUS: EMPIRICAL STUDY FROM ANNOUNCEMENT EFFECT

Samuel Liew Wei Siew

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WHITE-COLLAR CRIME AND STOCK NEXUS:
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SAMUEL LIEW WEI SIEW

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ABSTRACT

WHITE-COLLAR CRIME AND STOCK NEXUS: EMPIRICAL STUDY FROM ANNOUNCEMENT EFFECT

By
Samuel Liew Wei Siew

(White-collar crime victimization has been found in many studies to be more serious than conventional crime. The financial loses incurred can never be quantified with certainty. Victims of the crime are often stigmatized for a long period of time. The existence of white-collar crime can cause much damage to the reputation of the companies in Malaysia and hurt the image of the country as a whole. Recent survey reports and statistics suggest that the number of crime is still growing and it cannot be left unchecked.)

A share price event study confirms a negative announcement effect of white-collar crime in Malaysia. Negative abnormal performance is found after the day of announcement for 10 continuous trading days. The stock market in Malaysia is thus concluded to be inefficient. Other findings concern the causes, indicators, discovery, and regulations of white-collar crime. Opportunistic causes are perceived to be the most common causes of the crime in Malaysia, whereas the most apparent indicators relate to the behavior of an individual. Internal controls are then found to be very important in detecting and preventing white-collar crime in a company. The research
paper also finds education to be an effective element in regulating white-collar crime in Malaysia.

The stock market, albeit not efficient, appears to have the power to discipline unethical companies when shareholders dispose their stocks. It is hoped that companies will be deterred from engaging in illegal conducts. The other findings aim to increase stakeholders' awareness towards the facts and implications of white-collar crime in Malaysia. It is imperative for every potential and existing investor to have some basic understanding of white-collar crime before they are able to fight the crime in Malaysia.
ABSTRAK

NEKSSUS JENAYAH KOLAR PUTIH DAN SAHAM: 
KAJIAN EMPIRIKAL DARI KESAN PENGUMUMAN

Oleh

Samuel Liew Wei Siew

Menurut kajian-kajian, pemangsaan jenayah kolar putih telah menjadi lebih serius 
daripada jenayah konvensional. Jumlah kehilangan kewangan tidak boleh dinyatakan 
dengan kepastian. Mangsa-mangsa jenayah sering kali diaibkan selama tempoh yang 
panjang. Kewujudan jenayah kolar putih boleh menyebabkan banyak kerosakan bagi 
reputasi syarikat-syarikat di Malaysia dan mencederakan imej negara secara 
keseluruhannya. Laporan tinjauan baru-baru ini dan perangkaan-perangkaan 
mencadangkan jumlah jenayah masih meningkat dan ia tidak boleh dibiarkan begitu 
sahaja.

Kajian acara harga saham mengesahkan satu kesan pengumuman negatif disebabkan 
oleh jenayah kolar putih di Malaysia. Prestasi luar biasa negatif dikesan setelah hari 
pengumuman selama 10 hari perdagangan selanjur. Oleh sebab itu, pasaran saham 
di Malaysia boleh disimpulkan sebagai tidak cekap. Penemuan lain membincangkan 
sebab-sebab, penunjuk-penunjuk, penemuan, dan peraturan-peraturan jenayah kolar 
putih. Kebanyakan kejadian jenayah kolar putih berlaku di Malaysia kerana banyak 
kesempatan wujud untuk individu-individu melakukan jenayah, manakala penunjuk-
penunjuk yang paling ketara ialah perubahan tingkah laku seorang individu. Dari
segi pengesanan dan pencegahan jenayah kolar putih, kajian ini mendapati kepentingan kawalan-kawalan dalaman dalam sebuah syarikat. Kertas kajian ini juga menemui kepentingan pendidikan sebagai satu unsur yang berkesan dalam pengawalan jenayah kolar putih di Malaysia.

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CHAPTER 1
INTRODUCTION

1.1 Overview

The term “white-collar crime” has been given many definitions by different criminologists at different times. It has first been popularized in 1939 by Edwin Sutherland, who was both a criminologist and a socialist. He defined the crime as one “committed by a person of respectability and high social status in the course of his occupation” (Sutherland, 1949). Viewed as being too restrictive, Edelhertz, a criminologist too, defined the crime as “an illegal act or series of illegal acts committed by non-physical means and by concealment or guile, to obtain money or property, to avoid the payment or loss of money or property, or to obtain business or personal advantage” (Edelhertz, 1970). Edelhertz’s wider definition of the term is preferred for the purpose of this study and it can be used interchangeably with terms like “economic crime”, “corporate crime”, “business crime”, “financial crime”, and/or “commercial crime”.

White-collar crime continues to hit the headlines across Malaysia (KPMG, 2009) and it remains a serious issue influencing organizations globally (PricewaterhouseCoopers, 2009). Well-established companies like Enron, Worldcom, Global Crossing, and Arthur Anderson in the United States (US) suffered a serious stock market collapse as a result of their corporate governance scandals (Hilb, 2008). The findings of Enron and Worldcom show evidence of manipulation and weaknesses in accounting, and misleading financial reporting (Cheah & Lee, 2009). In Malaysia, companies like Sime Darby Berhad, Alliance Financial Group Berhad, and Kenmark Industrial Co
(M) Berhad had also experienced a nose dive in their share prices following the announcement of suspected fraud and abuse of authority. Kenmark, for instance, was wiped out of some Ringgit Malaysia (RM) 100 million in market value over merely a week’s time (“What’s Going,” 2010). Sime Darby, on another instance, lost some RM2 billion in its energy and utilities division in the financial year ended June 30, 2010 (“Sime Darby,” 2011, p. N22).

Corporate fraud, one of the many categories of white-collar crime, always finds its way to corrode the confidence and trust that investors have in a country (KPMG, 2009). The survey done by KPMG (2009) shows that theft of cash, theft of inventory, fraudulent expense claims, and kickbacks are the most common types of corporate fraud committed in Malaysia. The other survey which was conducted by PricewaterhouseCoopers (2009) found out that the most common types of white-collar crime perpetrated worldwide were asset misappropriation, accounting fraud, as well as bribery and corruption. The effect of the press announcement of such crimes requires serious attention as the likely adverse effect on the share price of the alleged companies may lead to possible economic damage of the country concerned.

1.2 Background of the Study

During the 1990s, the Malaysian government initiated the move of privatizing key industries and it led to the rapid increase of companies being listed (Salleh & Ahmad, 2008). Malaysia then experienced a consistent real economic growth between 9 and 10 percent per annum from 1990 to 1996. Consequently, the question of accountability and governance was less eminent and the lack of it became the raison d’être for Malaysia and other East Asian countries to suffer the Asian Financial Crisis.
in 1997 and 1998 (Salleh & Ahmad, 2008, p. 2). The amount of losses, as shown by the Commercial Crimes Investigation Department (CCID), incurred from white-collar crime cases rose from RM153 million in 1992 to RM4,600 million in 1998 (Lim, 2005). The number of cases also saw a significant rise from 4,386 in 1992 to 10,390 in 1998.

The technological advancement was believed to have contributed to the drastic rise in white-collar crime. Criminals have become more sophisticated and the post-1990s era witnessed a change in the modus operandi of white-collar crime (Lim, 2005). They have ventured into highly specialized crimes like “high-tech check scams” (cloning of checks), ATM/credit card fraud, share scams, “Flight by Night” scams, Internet fraud, and money laundering (Lim, 2005).

In recognition of the economic damage suffered from the financial crisis, the Malaysian government formed a committee to reassess the corporate framework and to establish a better governance structure altogether. The Malaysian Code on Corporate Governance was thus formulated in the year 2000 to reduce opportunities for the commitment of white-collar crime. Other deterrent methods include the amendment of legislation and the enforcement of the law through the establishment of an agency known as the Commercial Crimes Investigation Department or CCID.

Despite the concerted efforts, the number of white-collar crime cases in Malaysia, as reported by Berita Nasional Malaysia (Bernama), continues to climb – rising from 10,160 in 2007 to 17,311 in 2008 (“White-Collar Crimes,” 2009). Bernama also reported the total financial losses for the year 2008 to be approximately RM846
million. Emergence of new crime methods may have contributed to the rise in the number of cases and it poses new challenges to related agencies to equip themselves with the necessary skills to combat white-collar crime in the country.

Set upon this background, the focus of this study is on the public listed companies, which were charged with white-collar crime by the Securities Commission (SC), in Malaysia. The period of this study is from 1996 to 2010, covering both the Asian Financial Crisis in 1997/98 and the sub-prime mortgage crisis in 2008/09. As shown by the statistics in the CCID and reported by Bernama, the frequency of white-collar crime occurrences was higher than usual during the crises.

1.3 Rationale for the Study

The occurrences of fraud, as surveyed by KPMG (2009), are expected to rise continually for a couple of years. These findings will prove to be detrimental to the companies in Malaysia when investors, local or foreign, remain to have little faith towards the country's business ethics. It is imperative, with the increasing number of occurrences, that corporate Malaysia understands whether or not the stockholders will drive down the value of the company's stock when the commitment of crime is made known to them. The existence of such a reaction would mean that the announcement effect of white-collar crime in Malaysia is deterrent in nature. Therefore, the general purpose of the research is to investigate and identify the announcement effect of white-collar crime towards the stock performance of the companies in Malaysia.

The other purpose of the study is to heighten the awareness of the employees across the organizations in Malaysia about combating white-collar crime. The employees
play an important role as whistleblowers in exposing the existence of white-collar crime in their organizations. Therefore, they should be educated and have the understanding of the causes, indicators, discovery, and regulations of white-collar crime to combat it effectively. The gaining of knowledge about the indicators or red-flags, for example, will intensify the employees’ sense towards the existence of white-collar crime when they come across the elements of crime in their organizations.

The fundamental reason of combating crime as a nation is the motivation behind conducting this research. Rooting out white-collar crime at all levels in Malaysia should start from increasing the awareness of the people towards the problems presented by the increasing number of white-collar crime in Malaysia. The problems do not merely concern the economy of the country, but also the well-being of the people in Malaysia and the effects they can have on the future generations.

1.4 Problem Statement

In a study carried out by Global Financial Integrity (GFI) (2011, p. i), illicit financial flows for the years 2000-2008 from developing countries record an average of US$1.26 trillion outflow annually. The main sources of the illicit money are corruption, kickbacks, tax evasion, and theft of cash. Malaysia is ranked fifth among all developing countries in the world in terms of the largest cumulative illicit outflows during 2000-2008, recording a total of US$291 billion (GFI, 2011, p. 16). Among the developing countries in Asia, Malaysia is ranked second after China (US$2.18 trillion) (GFI, 2011, p. 24).
Evidently, the reports published by KPMG (2009) and GFI (2011) show that the occurrences of white-collar crime in Malaysia are rampant. According to the statistics shown by the CCID, the number of white-collar crime cases investigated by the police in 2003 was 11,714 cases and it involved about RM579 million, and in 2004 the number of cases declined (9,899) but the amount of losses rose to about RM836 million (Lim, 2005). For the year 2008, the amount of losses was about RM846 million, but the number of cases climbed significantly to 17,311 (“White-Collar Crimes,” 2009).

KPMG (2009) found that “49 percent of all respondents experienced at least one fraud during the survey period” (p. 2) from 2006 to 2008. The value of fraud found in the survey was RM63.95 million and KPMG (2009, p. 2) believed that the amount of losses could be far larger than the reported ones. In addition, only 56 percent of the respondents managed to recover their misappropriated assets, if not fully, partially (KPMG, 2009, p. 2).

Apart from the loss of assets, victims of white-collar crime could suffer some sort of psychological, emotional impact, and, as a result, their physical health may deteriorate (Kempa, 2010). Spalek (2001) applied the word “stigmatized” to describe the victims as they lost their trust towards the financial community. Apart from the psychological response of distrust or cynicism (Friedrichs, 2007), the Canadian Securities Administration (CSA) also found that victims of white-collar crime often experience stress, anger, depression, loss, and isolation (Kempa, 2010, p. 253).
In fact, Friedrichs (2007) identified the different costs related to white-collar crime as direct costs, indirect costs, physical costs, and other costs. White-collar crime victimization, according to him, is more serious and significant in terms of numbers and consequences than conventional crime. The difficulty in quantifying white-collar crime in terms of number of occurrences and costs may explain “the reasons why this type of crime victimization does not inspire the same level of concern as conventional crime victimization” (Friedrichs, 2007, p. 54).

The problems created by white-collar crime have been proven to be alarming to the country. The two recent publications of KPMG (2009) and GFI (2011), among others, can cause much damage to the reputation of the companies in Malaysia and hurt the image of the country as a whole. Foreign investors may be discouraged to allocate their capital in the country as a result. The well-being and the livelihood of the citizens of Malaysia could also be affected through white-collar crime victimization and it could last for a significant number of years, if not for the rest of the victims’ lives.

1.5 Objectives of the Study

1.5.1 General Objective

The primary purpose of the study is to investigate the announcement effect of white-collar crime towards the stock performance of public companies in Malaysia. The study involves understanding the reaction of the share prices towards the announcement of illegalities in the companies. The magnitude of the reaction will also be quantified to measure the announcement effect.
1.5.2 Specific Objectives

The specific objectives of the study are as follows:

i. to empirically examine the rational efficiency hypothesis in Malaysian stock market using announcement effect due to white-collar crime incidents;

ii. to identify the common causes of white-collar crime in Malaysia;

iii. to explore the common indicators or red-flags of white-collar crime in Malaysia;

iv. to investigate the effectiveness of the various methods of discovery/detection of white-collar crime in Malaysia; and

v. to examine the effectiveness of the different regulations of white-collar crime in Malaysia.

1.6 Significance of the Study

The significance of the share price event study is found in the market control of white-collar crime via the financial markets or, more specifically in this study, the stock market. Share price reaction may have some deterrent effects towards unethical behaviors as stockholders punish the unethical company, when its crime is made known to the public, by driving down its stock value. This study purports to investigate whether or not such market control exists in Malaysia. Although the decline of stock value may be due to other possible explanations, they are not part of the scope of this study.

The other contribution of the study is to provide the stakeholders, including employees, auditors, and directors, with a basic understanding of the causes, indicators, discovery methods, and regulations of white-collar crime. Equipped with
such an understanding, the stakeholders can make informed decisions to reduce the number of occurrences of white-collar crime in Malaysia. The increase of awareness among the stakeholders is the beginning of a new climate in Malaysia to combat white-collar crime proactively.
CHAPTER 2
LITERATURE REVIEW

2.1 Categories of White-Collar Crime

One of the many ambiguities of white-collar crime lies in the definition of the term itself. Naturally, defining the range of white-collar crime has become a difficult task for many researchers (Nelken, 1997). Given this complexity, researchers have to understand many different fields, including economics, management, law, sociology, psychology, and organizational theory (Dinitz, 1982; Geis, 1984; Slapper & Tombs, 1999). As far as communicating about examples of white-collar crime is concerned, confusion among both researchers and practitioners is pervasive in nature (Gottschalk, 2010a).

The types of white-collar crimes subject to the recent survey conducted by PricewaterhouseCoopers (2009) are asset misappropriation, accounting fraud, bribery and corruption, intellectual property infringement, money laundering, tax fraud, illegal insider trading, market fraud involving cartels colluding to fix prices, espionage, and others. There is no apparent categorization and the list is not exhaustive. Lim (2005) categorized the white-collar crime in Malaysia as criminal misappropriation of property, criminal breach of trust, cheating/fraud, forgery/credit/Automated Teller Machine (ATM) card fraud, counterfeiting currency, defamation, product piracy, product counterfeiting, cyber crime, offences of communications and multimedia industries, offences of printing and publication, banking/financial fraud, loan sharking, securities fraud/listing offences/insider trading, commodities fraud, money laundering, insurance fraud, maritime fraud, offences of
company, tax evasion, customs and smuggling offences, immigration and human trafficking offences, bribery and corruption, exchange control violations, consumer fraud, pollution offences, and occupational offences. No classification is made too.

Gottschalk (2010a), however, classified white-collar crime into four main categories only, namely: corruption, fraud, theft, and manipulation. He defined corruption as "the giving, requesting, receiving, or accepting of an improper advantage related to a position, office, or assignment" (p. 443) and its sub-categories are kickbacks, bribery, extortion, and embezzlement. The sub-categories for fraud are identity fraud, mortgage fraud, and occupational fraud; for theft are theft of cash, intellectual property theft, and fraud; and for manipulation are laundering, cyber crime, bid rigging, and insider trading. Such a classification allows researchers and practitioners to organize their thoughts at ease when mapping crime.

2.2 Announcement Effect of White-Collar Crime

The literature on the effect of information releases on share returns is well-established (Hines, McBride, & Page, 1999). Feroz, Park, and Pastena (1991) discovered a stock market reaction to the announcement of the disputed issue, but not to the announcement of the resolved matter at a much later date. In the study conducted by Hines et al. (1999), the results demonstrate no price reaction to press notices because the Financial Reporting Review Panel (the Panel) did not release any information until the issue was resolved. The results are entirely different if according to the findings of Rao (1997), and Voon, Puah, and Entebang (2008) because the information released on the announcement date contains ongoing disputed issues and
not issues which have achieved resolution. The share price is found to react negatively to the announcement of white-collar crime on the day of the announcement.

Foster (1986) identified three factors determining whether an announcement has information content, namely (i) the capital market's expectation as to the content and timing of the release; (ii) the implications of the release for the future distribution of security returns; and (iii) the credibility of the information source. The press notice issued by the Panel in Hines et al. (1999) was considered to be highly unexpected because the Panel did not release any information to the public until resolution. The implications of the Panel's release towards the future returns of the security in question were somewhat detrimental as it might reduce the public's faith towards the company. As far as the credibility of the information source is concerned, the Panel is a reputable body established by the government. Therefore, if according to the three factors advocated by Foster (1986), the press notice issued by the Panel should have high information content and caused a change in share prices. However, the findings of the study demonstrate otherwise. There is no evidence of a price reaction on the day of announcement. Such findings can perhaps be attributed to the leakage of information as the Panel does not have any power to stop others from disclosing information before an official notice is issued.

The findings in the studies by Rao (1997) and Voon et al. (2008) are more straightforward in agreement to the three factors identified by Foster (1986). The announcement date of unethical conduct in Rao (1997) is defined as the date when a report is first published in the Wall Street Journal. The date of announcement is highly unexpected to the public and the implications are undoubtedly detrimental as it
is the first time the public is made known of the conduct in question. In the study by Voon et al. (2008), however, the announcement date is set as the date a company is charged for committing corporate crime according to the information in the Securities Commission Malaysia’s (SC) official website. The announcement date might not be unexpected and the detrimental nature of the implications might have worn off because the news of the unethical conduct had already spread gradually to the public even before the companies were charged. In such circumstances, it is necessary to test not only the significance of average abnormal returns, but also the significance of cumulative abnormal returns (Jong, 2007).

It is worthwhile to note that Hines et al. (1999), Rao (1997), and Voon et al. (2008) shared a common limitation. There are relatively few organizations which have been subject to the research due to data availability. Since the data points for testing market reaction are few, the accuracy of the results may be undermined. Future research relating to the announcement effect of white-collar crime should include more companies to achieve a more accurate result.

2.3 Causes of White-Collar Crime

The theories explaining the occurrences of white-collar crime are numerous and they can basically be divided into theories explaining the occurrences by group and individual. The former involves two streams of research which are labeled as organizational theories and managerial theories of white-collar crime (Gottschalk, 2010b). The organizational theories are usually explained using the monopolistic model, which implies that "potential criminals have no other choice but are forced to join the criminal organization if they decide to commit a crime” (Gottschalk, 2010b, p.