Financial Fraud Prevention Through Strengthened Corporate Governance: A Discourse

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Abstract

Basically, this study is an attempt to discuss and dissect the extent at which financial fraud and other related sharp practices can be prevented through solidification of corporate governance structure in financial transaction in the world over. Thus, this research paper delves into the pivotal role that corporate governance plays in mitigating the occurrence of financial fraud within the realm of institutions. By examining various structures, policies, and practices, the study exposes how robust corporate governance frameworks act as a fundamental line of defense against fraudulent activities. Through comprehensive analysis of case studies, regulations, and sectoral practices, this research highlights the multidimensional impact of effective corporate governance in fostering transparency, accountability, and ethical conduct, thereby strengthening the resilience of organizations against financial fraud. The findings underscore the imperative of continuous enhancement of corporate governance structures to fortify the organization's integrity and sustain stakeholder trust amidst evolving financial landscapes. The paper recommended adoption of ethical leadership, that will foster a culture at all levels as role models for ethical behavior and accountability; integration of Information Technology (IT) such as Ai, data analytics, and block chain to bolster fraud detection, risk assessment, and transparency; continuous comprehensive Risk Assessment (RA) to identify vulnerabilities; Regular Internal Audits that assesses the effectiveness of internal controls, risk management, and fraud prevention strategies, encouragement of strong Stakeholder Collaboration (SC) for the facilitation of a collective effort against fraud, and among others.

Keywords: Accountability, Corporate Governance, Crime Prevention, Financial Fraud, Organizations, Transparency

1. Introduction

There has been growing wave in recent years of the pivotal roles of corporate governance in ensuring sound financial reporting and deterring fraud and corruption that has pervaded the business of government and organized private sectors across the world (PAUL, Yakubu and Apeh, 2020; PAUL and Ofuebe, 2020). Therefore **Sáenz González and García-Meca (2014) asserted that** while corruption is prevalent in emerging countries, there is increasing focus on the degree of its likelihood to affect the effective functioning of governments machineries and economies (Gill and Kharas 2007; Aidt 2009).

More so, there are much debates and proposition around fraud prevention, detection and control which has so far fallen on the shoulders of auditors, given the high-profile corporate collapses of recent years. But ultimately, ICAEW Insights (2023) said, it is the responsibility of management to improve their own approach to managing fraud risk. Hence, Cohen and Hanno (2000, 134) perceived the definition of corporate governance to be "those oversight activities undertaken by the board of directors and audit committee to ensure the integrity of the financial reporting process." From a broad perspective, Shleifer and Vishny (1997) and Zingales (1998a) quoted by Gillan (2006) views governance systems as the complex set of constraints that shape the ex post bargaining over the quasi-rents generated by the firm thereby making corporate governance as the ways in which suppliers of finance to corporations assure themselves of getting a return on their investment.

Thus, as auditors step up their efforts to curb fraud, so too must organisations. For example, Rezaee (2005) averred that:

> Financial Statement Fraud (FSF) has received considerable attention from the public, press, investors, the financial community, and regulators because of high profile reported fraud at large companies such as Lucent, Xerox, Rite Aid, Cendant, Sunbeam, Waste Management, Enron Corporation, Global Crossing, WorldCom, Adelphia, and Tyco. The top executives of these and other corporations were accused of cooking the books and, in many cases, were indicted and subsequently convicted. The collapse of Enron has caused about $70 billion lost in market capitalization which is devastating for significant numbers of investors, employees and pensioners. The WorldCom collapse, caused by alleged financial statement fraud, is the biggest bankruptcy in the United States history. Loss of market capitalization resulting from the reported financial statement fraud committed by Enron, WorldCom, Qwest, Tyco, and Global Crossing is estimated about $460 billion (Cotton, 2002).

According to Sharma, Khatter and Mathur (2023), corporate governance is the framework of rules, practices, and processes by which a company is directed and controlled. They noted further that, it encompasses the distribution of rights and responsibilities among different stakeholders, such as shareholders, management, customers, suppliers, financiers, government, and the community. In the context of institutions, corporate governance plays a paramount role in

ensuring the soundness, transparency, and ethical conduct of these financial entities.

Fraud is dynamic, and fraudsters evolve faster than any regulation or corporate internal controls. These criminals are sophisticated, exploiting new weaknesses and constantly adapting to technological detective efforts. Nonetheless, the recent corporate scandals have understandably led to a heightened focus on, and societal discomfort with, management's misappropriation of assets. It is this area on which internal auditors will be expected to train increased attention to avoid future reputational damage to companies, auditors and, vitally, capital markets. Organisational culture will play a critical role in shaping an environment where employees at all levels are encouraged 'to do the right thing' and feel they can raise concerns directly to all levels in the organization.

The importance of strengthening corporate governance against fraud is hinged on the given that regulators are mandating new governance practices and that fraud firms are likely to be expending scarce resources on governance improvements after fraud detection, it is important to document whether these improvements provide any economic benefits. Evidence that governance improvements do indeed provide economic benefits would support the basis for these rules and firms' expenditures on enhanced governance. However, it could very well be the case that these improvements do not provide any economic benefits and are merely window dressing or road-show and thus an inefficient use of resources. Providing evidence on either case adds to our knowledge of improving the quality of the corporate governance mechanisms that monitor the financial reporting and ethical practices. Consequent upon the above discourse, this study shall;

i. review relevant literature on the subject matter;

ii. re-examine the importance of corporate governance and why it should be strengthened, and

iii. Recommend possible remedial measures to strengthening corporate governance for organizational effectiveness against financial fraudulent practices.

2. Statement of the Problem

As Rezaee (2005) maintained, Financial Statement Fraud (FSF) has cost market participants, including investors, creditors, pensioners, and employees, more than $500 billion during the past several years. Also, capital market participants expect vigilant and active corporate governance to ensure the integrity, transparency, and quality of financial information. Financial statement fraud is a serious threat to market participants' confidence in published audited financial statements. Financial statement fraud has recently received considerable attention from the business community, accounting profession, academicians, and regulators.

Financial statement fraud continues to be a concern in the business community and the accounting profession as indicated by recent Securities and Exchange Commission (SEC) enforcement actions and the Corporate Fraud Task Force report. This paper sheds light on the

factors that may increase the likelihood of financial statement fraud.

The problem of financial fraud in organisations is multifaceted for instance, in the multivariate tests conducted by Chen, et al (2006) it is challenging that firms that have a high proportion of non-Executive Directors on the Board are less likely to engage in fraud. This evidence is consistent with outside directors monitoring the actions of managers and thus helping deter fraudulent acts. Firms that have chairmen with shorter tenures are associated with higher incidences of fraud. Short-tenure may imply the chairman lacks experience in the firm and so deterring fraud is more difficult. Board meeting frequency is positively associated with fraud. This may imply that a firm's questionable or illegal activities where discussed by the board over a number of meetings. There is weak evidence from the multivariate analysis that firms where one person occupies the positions of both the Chairman and the CEO have higher frequencies of fraud. This finding is consistent with the argument that handing one person a lot of power (Chairman and CEO positions) makes it easier for that person to abuse their power and engage in fraudulent activities. Duality of chairman and CEO positions reduces the checks and balances in the top management of the firm. This research shall answer the question of:

i. What is the position of relevant literature on the subject matter?

ii. How important and relevant is corporate governance and why should it be strengthened? and

iii. What are the remedial measures to adopt in strengthening corporate governance for organizational effectiveness against financial fraudulent practices?

3. Methodology

The study adopted a case study research design because it "takes a more holistic approach to the single case like field, institution, person, and setting" Clarke (2019: 4) and PAUL and Ofuebe (2024). Moreover, "case studies tend to examine a real-life phenomenon, not to make statistical inferences concerning the wider population" (Taherdoost, 2016; Yin, 2015).

The research further adopted a qualitative approach. The adoption of this design is consequent upon the submission of Nilsen et al. (2013) and Umar (2018) that studied on the impact of the implementation of a particular policy adoption (PAUL and Ofuebe, 2024). The need to strengthen corporate governance in the perception of this study is hinged on policy implementation adherence, oversight, and compliance that is a germane case in both legal, management and social sciences. Hence, the study is based on verifiable facts (Creswell, 2003; Creswell & Creswell, 2017).

4. Review of Relevant Literature

The amount of corporate governance research has increased dramatically during the last decade (Chen, Firth, Gao and Rui, 2006). Sharma, Khatter and Mathur (2023) research listed the best Practices and Strategies for Fraud Prevention. They noted a wide range of financia activities that involves; Risk Assessment and Management by conducting a thorough risk assessments to

identify vulnerabilities, evaluate potential threats, and implement risk mitigation strategies. This proactive approach enables institutions to allocate resources effectively and prioritize fraud prevention measures. Secondly is internal Controls and Monitoring which includes segregation of duties, access controls, and regular audits, are essential to detect and prevent fraudulent activities. Continuous monitoring of transactions, accounts, and activities helps identify anomalies and triggers immediate actions. Thirdly is employee Training and Awareness on educating employees about fraud risks and prevention measures. Regular training programs help employees recognize red flags, adhere to ethical standards, and report suspicious activities promptly. Fourthly is the whistleblower Protection by establishing mechanisms for employees and stakeholders to report fraud without fear of retaliation encourages the timely disclosure of fraudulent activities. Whistleblower protection policies promote transparency and accountability within the organization. They lastly identified Technological Solutions such as artificial intelligence (AI), Machine Learning (ML), and data analytics assist in identifying patterns of fraudulent behavior, enabling institutions to prevent fraud in real-time.

Farber (2005) posited that empirical evidence indicates that weak corporate governance is associated with financial reporting fraud, but little is known about the actions that fraud firms take to improve their weak governance after fraud detection and, perhaps more importantly, how effectively these actions restore investor trust. He highlighted that the importance of the relation between the quality of governance mechanisms and the credibility of the financial reporting system, it is surprising that little about the nature and extent of this relation is known. Farber (2005) findings suggest that fraud firms and, perhaps more importantly, the market, view improving the quality of governance mechanisms as a way of restoring trust after fraud.

In Rezaee (2005) submission, the reliability, transparency, and uniformity of the financial reporting process allow investors to make intelligent decisions. He noted that published audited financial statements that reflect a true and honest financial performance instead of a rosy picture and inflated and fraudulent earnings are useful to market participants, including investors and creditors. Enron, WorldCom, and other corporate scandals, earnings restatements, customized and managed pro forma earnings have undermined investors' confidence in the quality and reliability of the financial system. Rezaee work further argued that capital markets participants (e.g. investors, creditors, analysts) make investment decisions based on financial information disseminated to the market by corporations. Thus, the quality, reliability, and transparency of published audited financial statements are essential to the efficient allocation of resources in the economy.

According to Beasley, Carcello, Hermanson and Lapides (2000), it is critical to be attuned to unique fraud opportunities that exist within individual industries. In addition, it is fundamental, when assessing governance mechanisms, to compare firm-specific findings to relevant industry benchmarks. For example, financial institutions in general have more frequent audit-committee meetings and are more likely to have an internal audit function than are companies in the other two industries. They finally wrote in their submission that, it is important for auditors to recognize that weak governance mechanisms are associated with financial fraud across a number

of time periods and organisations. Any time the governance structure is weak, auditors should evaluate the resulting impact on the audit.

Coram, Ferguson and Moroney (2008) argued for good corporate governance system from significant public and regulatory attention that has attracted a crucial part of an internal audit function with public concern about the prevailing high level of fraud within organizations.

In the view of **Sáenz González and García-Meca (2014), a**lthough the United States and European research has documented improvement in earnings quality associated with corporate governance characteristics, the situation in Latin America is questionable, given the business environment in which firms operate, which is characterized by controlling family ownership and weak legal protection. Their research results found that when a country implements controls aimed at behaving ethically, reducing corruption, strengthen the rule of law or improving the effectiveness of government, these seem to increase the quality and transparency of the financial information issued by firms, so improving ethical behavior of their managers and, consequently, showing a reduction of discretionary accruals.

5. Importance of Corporate Governance

According to Beasley, Carcello, Hermanson, and Lapides (2000), corporate governance plays critical roles in the advancement of business environment and audit processes of organisations. They asserted that strong governance has long been considered crucial for enhancing the long-term value of stakeholders in the business environment. Quoting Levitt (2000b), they said in the new technology-driven information age, strong corporate governance is more than good business practice — it is an indispensable component of market discipline. In the view of Blue Ribbon Committee (1999) and Ramsay (2001), recent demands from investors and others for greater accountability from corporate boards and audit committees will likely further enhance the quality of managerial accountability, stewardship and ultimately result into more efficient capital markets performance (Usman, PAUL and Ochala, 2013). In a succinct submission, Beasley, et al (2000);

> The importance of an active involvement in strategic issues by corporate governance mechanisms is evident in the corporate governance survey conducted by the National Association of Corporate Directors (NACD) and Deloitte & Touche LLP (NACD 1997). The report states (NACD, 5) that the "governance focus has been shifting away from regulations and relationships and toward performance and planning". In fact, the study found that the four most important governance issues (in order of importance) are corporate performance, strategic planning, chief executive officer (CEO) board relations, and shareholder relations. Thus, there is an increasing recognition in practice that to ensure that firms effectively cope with changes in their environment, boards must adopt a more proactive, strategically focused perspective.

In another development, despite the importance of corporate governance, there is surprisingly little professional guidance on how and which factors to consider in assessing the strength of corporate governance when developing an audit strategy (Beasley et al, 2000). However, for auditors, the adoption by their clients of a perspective that goes beyond the audit committee and a monitoring approach may reduce the client's overall business risk and in turn may potentially affect subsequent audit risk assessments. As Beasley, et al (2000) further argued, this knowledge along with consideration of corporate governance factors could then affect the assessed level of inherent and control risks, thereby affecting the nature, timing, and extent of audit work. For instance, in a new client acceptance situation where a potential client is facing an uncertain and highly competitive environment, auditors may assess whether the company is sufficiently taking advantage of the expertise of its board of directors to develop strategies to ensure long-term survival and growth. This information could in turn influence an auditor's assessment of potential business risk and affect client acceptance and continuance recommendations (Cohen and Hanno 2000). For governance factors to affect audit plans, the auditor must first recognize and properly assess the strength of corporate governance and, second, appropriately weight and use this evidence to develop an audit plan. If the governance structure is strong, an auditor could potentially reduce sample sizes (e.g., number of locations visited for the evaluation of inventory) and thus reduce the extent of costly substantive testing. Ultimately program plans affect the evidence obtained and, thus, the quality of audit decisions.

6. Findings and Discussion

Regulators, perhaps in response to the recent flurry of highly publicized financial reporting frauds are considering or have enacted rules intended to strengthen the quality of corporate governance. Much of the debate surrounding these proposals revolves around the idea that stronger governance is associated with more credible financial reporting. Hence, this study found from the above discourse that:

- **i.** The importance of corporate governance in the sustainability of business environment and audit processes cannot be overelaborated.
- **ii.** Corporate governance in refers to the mechanisms, policies, and practices that guide the decision-making and operational processes within organisations. It involves establishing a clear organizational structure, delineating the roles and responsibilities of the Board of Directors, Executive Management, and other stakeholders.
- **iii.** It encompasses fostering a culture of accountability, transparency, and compliance with regulatory standards.
- **iv.** Effective corporate governance ensures that the interests of various stakeholders are balanced and protected. It safeguards against conflicts of interest, unethical practices, and mismanagement.
- **v.** In the realm of financial fraud prevention, a robust corporate governance framework acts as a bulwark against fraudulent activities by establishing controls, oversight mechanisms,

and accountability structures that minimize the potential for wrongdoing.

7. Concluding Remarks and Recommendations

In conclusion the recent reported financial statement fraud and resulting decline in the stock market show the importance of the quality of financial reports and audit functions as well as the understanding of what may have caused the occurrence of accounting scandals. Collapses of high profile companies (e.g. Enron, WorldCom, and Global Crossing) have left a dirty smear on the effectiveness of corporate governance, quality of financial reports, and credibility of audit functions. These alleged financial.

In light of the comprehensive analysis of the role of corporate governance in preventing financial fraud within establishments, several key findings and insights emerge. This paper provides recommendations for strengthening corporate governance practices, and outlines the implications for both organisations and regulatory authorities. Through a meticulous exploration of diverse dimensions, it becomes evident that robust corporate governance is paramount in preventing financial fraud. Governance apparatuses restructure the ethical culture of institutions, influence transparency, and guide risk management. Transparent reporting, effective internal controls, and stakeholder engagement contribute to an environment that deters fraudulent activities. Technological advancements, ethical alignment, and vigilance in governance processes play critical roles in safeguarding the integrity of organizations. Based on the insights gleaned from this research, several recommendations emerge to enhance corporate governance practices for fraud prevention:

i. Ethical Leadership: Foster a culture of ethical leadership at all levels, with leaders serving as role models for ethical behavior and accountability.

ii. Information Technology Integration: Embrace technological advancements such as AI, data analytics, and block chain to bolster fraud detection, risk assessment, and transparency.

iii. Comprehensive Risk Assessment: Conduct regular and thorough risk assessments to identify vulnerabilities, adapt to emerging threats, and design preventive measures.

iv. Regular Internal Audits: Establish a rigorous internal audit process that assesses the effectiveness of internal controls, risk management, and fraud prevention strategies.

v. Stakeholder Collaboration: Facilitate open channels for engagement with stakeholders, including shareholders, employees, customers, and regulators, to create a collective effort against fraud.

vi. Continuous training and retraining of organizational employees should be always prioritized.

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