Elucidating Corporate Governance's Impact and Role in Countering Fraud

Rasha Kassem, The Open University

Abstract

**Purpose:** This paper (i) highlights the role and impact of corporate governance in combating fraud by drawing on insights from the literature, (ii) identifies gaps in the literature, and (iii) suggests new directions for future research.

**Methodology:** The paper is based on a comprehensive general literature review using multiple search engines and databases.

**Findings:** This paper finds that effective corporate governance can help reduce fraud risk, prevent fraud, and detect fraud, particularly corporate fraud, insider fraud, and asset diversion. Some companies employ corporate governance mechanisms to bolster their reputation following fraud detection. Ineffective corporate governance increases fraud risk, provides the opportunity for perpetrating fraud and reduces the likelihood of fraud detection. The paper sheds light on several governance mechanisms that could help in mitigating fraud risk, as reported in the literature. The paper categorises these governance mechanisms into four broad governance aspects, including (a) board leadership and the role of ethics; (b) board characteristics, composition, and structure, (c) ownership structure, and (d) accountability. The paper proposes a guide summarising these broad fundamental governance aspects, including specific anti-fraud controls and examples of how organisations could enhance ethical cultures and the tone at the top.

**Originality:** This is the first paper to elucidate the role of corporate governance in countering fraud and develop guidance in this area. The proposed guidance could be helpful to businesses leaders, policymakers, researchers, and academics alike.

**Keywords:** Corporate Governance; Fraud; Accountability; board Leadership; Ethics; Board diversity; Controls and Risk Management
1. Introduction

Fraud has a detrimental impact on organisations and society beyond financial losses. Fraud deceives stakeholders and results in reputational damage for businesses and loss of shareholders’ trust in corporate governance (Naruedomkul et al., 2010; Tan et al., 2017; ACFE, 2020). In some cases, fraud could result in the collapse of an entire organisation and loss of jobs and tax income. This was evident in high profile fraud cases such as Enron (Healy and Palepu, 2003) and WorldCom (Sidak, 2003) in the United States, Patisserie Valerie in the United Kingdom (O’Connell, 2019), and Wirecard in Germany (Storbeck, 2021).

The findings of recent research conducted by RUSI (2020), the world’s oldest and the UK’s leading defence and security think tank, provide evidence that the harm caused by fraud to the UK population, economy, and public funds represents a national security risk, making a compelling case for more prioritisation of fraud and the development of a national strategy to tackle it.

Research indicates that some fraud types, such as fraudulent financial reporting, could result in severe labour market penalties for executive and non-executive directors (Hoi and Robin, 2010) and lead to a higher likelihood of chairman and CEO dismissal (Azzali and Mazza, 2020). A global study by the Association of Certified Fraud Examiners (ACFE, 2020) reports that insider fraud, which is a fraud perpetrated against an organisation by its employees, directors, or management (Wells, 2011), causes a total loss of more than $3.6 billion annually. The ACFE study asserts that insider fraud is the costliest type and constitutes a significant threat to organisations. The enemy comes from within the organisations, which is unexpected and harder hitting than other fraud types.

Given its detrimental impact, academic research plays a crucial role in raising awareness about fraud and researching effective methods for countering it. Hence, the main aim of this paper is to elucidate corporate governance’s impact and role in combating fraud. It also identifies gaps in the governance literature related to this area and suggests new avenues for future research. The paper is based on a comprehensive general review of academic sources, professional sources, and policy reports.

1 Homepage | Royal United Services Institute (rusi.org)
This paper finds that effective corporate governance can help reduce fraud risk, prevent fraud, and detect fraud, particularly corporate fraud, insider fraud, and asset diversion. Some companies employ corporate governance mechanisms to bolster their reputation following fraud detection. Ineffective corporate governance increases fraud risk, provides the opportunity for perpetrating fraud and reduces the likelihood of fraud detection. The paper sheds light on several governance mechanisms that could help in mitigating fraud risk, as reported in the literature. The paper categorises these governance mechanisms into four broad governance aspects, including (a) board leadership and the role of ethics; (b) board characteristics, composition, and structure, (c) ownership structure, and (d) accountability. The paper develops a guide summarising these broad fundamental governance aspects, including specific anti-fraud controls and examples of how organisations could enhance ethical cultures and the tone at the top. The findings have implications for research and policymakers; later discussed.

This paper's main contribution is in its novelty, being the first to provide a comprehensive general review to elucidate the role of corporate governance in countering fraud. It is also the first to develop guidance on various corporate governance mechanisms that business leaders and policymakers can combat fraud. This guidance could benefit regulators aiming to introduce interventions to restore trust in corporate governance systems and businesses looking for ways to strengthen their corporate governance systems and mitigate fraud risk. It could also be helpful to researchers interested in corporate governance research and academics teaching corporate governance and aiming to embed anti-fraud education in the curriculum.

The rest of the paper is structured as follows. The following section describes the methodology employed by the current study. Section 3 explains what corporate governance entails from the lens of the agency theory. Section 4 discusses the impact of corporate governance on fraud by drawing on insights from the literature. Section 5 elucidates and identifies the specific corporate governance mechanisms that mitigate fraud, as evidenced in prior research. Section 6 presents and discusses the main findings, identifies gaps in the literature, and suggests new directions for future research. Finally, the paper ends with the conclusion and implications section.
2. Methodology

This study is based on a survey of the extant literature using multiple search engines and databases for locating academic research, textbooks, and professional/regulatory reports exploring the link between fraud and corporate governance.


The search terms that initially guided the review included “fraud and corporate governance”, “fraud”, “fraud and abuse”, “countering fraud”, “fraud risk”, “fraud risk mitigation”. To identify relevant studies, paper titles, keywords, abstracts, and primary texts were searched for these terms. Following the approach of prior studies (Grabski et al., 2011; Moll and Yigitbasioglu, 2019), the review was not limited to a particular timeframe or journal list. However, attention was paid to papers published in leading accounting journals cited in the Association of Business Schools Academic Journal Guide 2020 and previous peer-reviewed journals. The review was not limited by a particular context either given the nature of the current paper, which is a general review of the literature.

The reference list was examined to ensure that other vital contributions were not missed when a relevant paper was identified. This helped identify other relevant papers such as board diversity and fraud, auditors, and fraud detection. The search identified a total of 131 sources relevant to the current research issue (i.e., Corporate governance’s role in countering fraud).
3. Corporate Governance and the Agency Theory

Before discussing corporate governance's role in combating fraud, it is essential to understand what corporate governance entails and its relationship to the agency theory. Corporate governance refers to how organisations are directed and controlled (The Cadbury Committee, 1992). The Chartered Institute of Management Accountants (CIMA, 2015) indicates that governance denotes the generic way an organisation is run, focusing on accountability, integrity, and risk management. Hence, there are clear lines of responsibility for ethics that lead directly to the board level. A broader definition of corporate governance by Solomon (2013, p.7) is “a system of checks and balances, both internal and external to companies, which ensures that companies discharge their accountability to all their stakeholders and act in a socially responsible way in all areas of their business activity”.

Research implies that corporate governance's dominant meaning is derived from an agency theory perspective (L’Huillier, 2014). One of the much-debated and fundamental issues in contemporary corporate governance has been the agency problem, which arises due to the separation of ownership from control (Ahmad and Omar, 2016). Agency theory was developed by Jensen and Meckling (1976), where they defined the agency relationship as a form of contract between a company’s owners and its managers, where the owners (as principal) appoint an agent (the managers) to manage the company on their behalf. As a part of this arrangement, the owners must delegate decision-making authority to the management. This delegation raises questions about trust between principal and agent due to information asymmetry and different motives; hence, effective corporate governance mechanisms are needed to align principals and agents' interests.

The ultimate goal of corporate governance is to make sure that a company is run in a way that achieves its objectives and assures stakeholders that their trust has been in the right place (the Chartered Governance Institute (ICSA), 2020). Nevertheless, ensuring stakeholders’ trust and the long-term success of an organisation is not the responsibility of management and directors alone. Effective corporate governance also requires the efforts and commitment of honest and competent auditors, audit committees, employees, and effective laws and regulations. The UK Code of Corporate Governance indicates that good governance practices entail effective board leadership; true and fair financial reporting (i.e., free from fraud and error); sound controls and risk management systems; effective and independent audits and audit
committees; fair directors’ remuneration; and maintaining good relations with shareholders FRC (2016; 2018).

To sum up, corporate governance is the system by which an organisation is run and controlled. Corporate governance involves how the board of directors and management operates and is committed to integrity, ethics, and corporate social responsibility (CSR), whether the organisation has adequate internal controls and risk management system, how the audit committees and auditors are performing, and how accountability is maintained within the organisation. As such, the role of corporate governance in countering fraud will be discussed from the perspective of that broader concept of corporate governance.

4. The Impact of Corporate Governance on Fraud

Evidence from the extant literature shows a link between effective corporate governance mechanisms and the likelihood of fraud. Sabbagh (2016) reports that corporate governance affects fraud risk, and Gam et al. (2021) show a positive link between evasive corporate governance and corporate fraud. A few studies found that some companies could use effective corporate governance mechanisms to bolster their reputation after the fraud was detected. Rotenstein (2011) shows a statistically significant association between restatements involving fraud and changes to strengthen firms’ governance structures following the restatements. Marciukaityte et al. (2006) uncover that companies increased the proportion of outsider directors on their boards of directors and the boards' monitoring committees after the accusation of fraud.

Several studies provide evidence that effective corporate governance reduces fraud risk, particularly insider fraud, corporate fraud, and asset diversion. Harris et al. (2017) identify consistent evidence that good governance reduces asset diversion. Asset diversion is one of the methods used in insurance fraud and involves the theft of an insurance company’s assets (Scheetz et al., 2021). Mohd-Sanusi et al. (2015) uncover that corporate governance can reduce insider fraud in the Malaysian banking sector. Naruedomkul et al. (2010) conclude that effective corporate governance can help reduce Thailand’s fraud risk.

Similarly, Zhang (2018) found that enhanced public governance reduces the likelihood of committing fraud in China. Halbouni et al. (2016) indicate that corporate governance has a moderate role in preventing and detecting fraud in the United Arab Emirates (UAE). On the
other hand, the literature provides evidence that ineffective corporate governance contributes to fraud occurring and provides the opportunity for fraud to be perpetrated and remain undetected (Akkeren and Buckby, 2017).

5. Corporate Governance Mechanisms Recommended for Countering Fraud

Surveying the extant literature reveals various corporate governance mechanisms to mitigate fraud risk. This section groups these governance mechanisms into four related categories. Each category represents an aspect of corporate governance, including (i) board leadership and the role of ethics; (ii) board characteristics, composition, and structure; (iii) ownership structure; and (iv) accountability.

5.1 Board Leadership and the Role of Ethics

The UK code of corporate governance, which is considered a benchmark of good governance practices (Coyle, 2012; Solomon, 2013; Tricker, 2015), indicates that a successful company is led by an effective and entrepreneurial board, whose role is to promote its long-term sustainable success, generating value for shareholders and contributing to broader society. The code recommends that all directors must act with integrity, lead by example, and establish a framework of prudent and effective controls, enabling risk to be assessed and managed (FRC, 2018).

The board of directors and top management plays an essential role in mitigating fraud risk in an organisation. The tone or culture developed by executive directors and top management is the “control environment” or the “tone at the top”. Both terms reflect the integrity and ethical atmosphere created by the organisation’s leadership. The control environment is a critical component of an entity’s internal control as it sets the tone of an entity and influences the control consciousness of people within an organisation (Ramos, 2004). The Committee of Sponsoring Organisations of the Treadway Commission (COSO, 2014) suggests that critical determinants of an effective control environment include top management’s commitment to competence, integrity, and ethical behaviour; ability to hold individuals accountable; and the extent of their participation and involvement in the organisation.
Fighting fraud and unethical behaviour starts at the top of the organisation. Top management with integrity will lead by example, discourage fraudulent and unethical behaviour, and adequately discharge their responsibilities. If the tone set by top management upholds ethics and integrity, employees will be more inclined to follow those same ethical values. However, if top management seems unconcerned about ethics and fraud, employees will find it an opportunity to defraud the organisation (CIMA, 2015; Halbouni et al., 2016).

Morgan and Burnside (2014) discuss the fraud case of Olympus Corporation in Japan and indicate that an unethical corporate culture increases the risk of fraudulent financial reporting. Similarly, Reddic et al. (2017) analyse the Russian North Oil Service fraud case and conclude that unethical corporate culture increases the risk of corruption and other types of fraud. Shi et al. (2017) find that when top managers face more stringent external control mechanisms, in the form of activist shareholders, the threat of a takeover, or zealous securities analysts, they are more likely to engage in financial fraud. However, management with high integrity is less likely to commit fraud even with strong pressure and existing opportunities (Albrecht et al., 2014; Kassem, 2018).

Corporate greed and lack of integrity at the executive level have destroyed many companies, stripped shareholders of their investments, and resulted in losing jobs and pensions (Solomon, 2013; Tricker, 2015; Mallin, 2016). Management’s greed is evident in real corporate fraud cases, including but not limited to Enron, WorldCom, Patisserie Valerie, Nissan, and Wirecard. For instance, in WorldCom in the US, the company's managers and directors conspired to manipulate the company's financial statement by concealing liabilities and inflation of profits and assets. Top management communicated to employees at all levels that the code of ethics is a waste of time, and employees were continuously pressured to achieve targets regardless of the means (Jones, 2011; ACFE, 2014).

Equally, the finance manager and CEO of Patisserie Valerie in the UK colluded to inflate its profit and abused its positions to conceal loans for personal gain (Partington, 2019). The CEO of Nissan in Japan improperly disclosed his remuneration to avoid shareholders’ rage (SEC, 2019). In Germany's Wirecard case, top management colluded many fraud schemes to inflate its profitability and receive bonuses (McCrum, 2019; Riley and McSweeney, 2020). However, although top management achieved relatively short-term financial gain in these cases, they lost their reputation and jobs, and some were prosecuted.
Setting the right tone at the top requires leaders to set an ethical example of how their employees should behave in the workplace and provide a safe mechanism for reporting fraud and unethical behaviour. According to the Global Business Ethics Survey in 2020, 22% of employees globally have felt pressure to bend the rules. The pressure to bend the rules is associated with higher levels of misconduct, including fraud, discrimination, and violating the law. The survey also reports that employee pressure to bend the rules was higher among those who perceived their leaders as having a weak commitment to organisational values and ethical leadership (Ethics and Compliance Initiative, 2020). In another survey by PwC’s 2020 Global Economic Crime and Fraud Survey, 47% of companies experienced fraud, and barely one-third reported the fraud to the board. These findings indicate the importance of having an effective tone at the top.

Setting the right tone at the top also requires top management to design a code of ethics with zero tolerance to fraud and unethical behaviours, reward integrity, take corrective actions when raised by auditors, and cooperate with the auditors and audit committee. Management’s attitude towards control deficiencies and auditors’ recommendations to take corrective actions determines their integrity level (Abdullatif, 2013; Kassem, 2018). Furthermore, an effective tone at the top involves treating employees fairly and respectfully, providing fair pay, remuneration, and promotions, investing in adequate anti-fraud controls and risk management systems, holding individuals accountable for their responsibilities, and prosecuting fraudsters rather than firing them (Kassem, 2021).

Designing a written organisation code of ethics that spells out the penalties for manipulating the financial statements could also help mitigate fraud risk, as Leinicke et al. (2000) pointed out. Law (2011) indicates that the tone at the top managerial level and ethical guidelines and policies are positively associated with a lack of fraud within Hong Kong organisations. Promoting a culture of integrity within an organisation requires fostering an anti-fraud culture that includes mandatory employee fraud awareness training, establishing an easily used and understood whistle-blowing process, and setting up an effective fraud hotline. It also involves disseminating a clear written code of practice covering accepting gifts and consistently implementing disciplinary processes to violate anti-fraud policies (Ingber, 2020).
5.2 Board Characteristics, Composition, and Structure

Some studies found a link between board characteristics and structure, particularly board independence and fraud risk. Chen et al. (2006) suggest that board characteristics are essential in explaining fraud. In particular, the proportion of outside directors, the number of board meetings, and the chairman's tenure are associated with fraud incidence. Uzun et al. (2004) find that as the number of independent outside directors increased on the board of directors, audit committee, and remuneration committee, the likelihood of corporate fraud decreased in the US. Sharma (2004) reports that as the percentage of independent directors increases, the likelihood of fraud decreases. Melis (2005) analysed Parmalat's fraud case and concluded the company did not have independent directors. Lenard et al. (2012) provide evidence of the association between the corporate governance structure's effectiveness and the external auditor assessing fraud risk.

Similarly, Torchia and Calabro (2016) uncovered a positive and significant relationship between the independent directors’ ratio and the level of financial transparency and disclosure. Frankel et al. (2011) suggest that companies with less independent boards are more likely to manipulate US earnings opportunistically. Romano and Guerrini (2012) find that board independence is the sole effective mechanism in detecting financial reporting fraud in Italy. The results show that firms committing accounting fraud have a lower percentage of independent directors on the board and fewer non-executive and independent directors on the audit committee. Ghafoor et al. (2019) indicate that independence of the board provides active monitoring and oversight in reducing fraud.

In contrast, Persons (2005) concludes that board of director independence is insignificant in reducing fraud likelihood. Yang et al. (2017) did not find evidence that the percentage of independent directors in the directorate plays a role in deterring financial fraud in China. Gulzar et al. (2020) find empirical evidence that board independence does not impact the performance of listed textile companies in India.

In addition to board independence, a few studies find that board expertise and board diligence negatively and significantly reduce financial statement fraud in Nigeria's manufacturing firms (Subair et al., 2020). Anisykurlillah et al. (2020) uncover that board members’ expertise in accounting and finance could reduce instances of fraudulent financial reporting in Indonesian Islamic Banks. Cheng et al. (2008) show that the degree of activeness
of the board of directors and board independence significantly influences financial control, reducing fraud risk in China.

A few other studies report a link between board structure, composition, and fraud incidents. Vasilakopoulos et al. (2018) suggest that bank managers’ smooth income decisions may differ concerning the board structure. Previtali and Cerchietto (2017) conclude that for an effective anti-corruption strategy, larger supervisory board sizes are associated with weaker performance, and a greater external composition is preferable to an internal one. In contrast, Sehrawat et al. (2019) found that board size is irrelevantly identified with earnings manipulation. Khanna et al. (2015) find that connections CEOs develop with top executives and directors through their appointment decisions increase the risk of corporate fraud, decrease the expected costs of fraud by helping conceal fraudulent activity, and make CEO dismissal less likely upon discovery. Martins and Ventura Júnior (2020) report that the firms’ corporate governance structure influences fraudulent financial reporting mitigation, either directly or indirectly, by reducing the chances of bankruptcy or earnings manipulation in Brazil. Yang et al. (2017) uncover that when firms have less concentrated ownership, dual CEO/chairman of the directorate status, they tend to engage less in financial fraud.

There is also evidence that board duality could mitigate the risk of fraud. Sharma (2004) finds a positive relationship between board duality and the likelihood of fraud in Australia. Younas et al. (2021) find a significant negative association between CEO-chair duality and financial distress indicators. Persons (2005) concludes that fraud is lower when a chief executive officer is not the board chairman. Jia et al. (2009) indicate that China's supervisory boards play an active role when Chinese listed companies face enforcement action and could reduce instances of fraud. Inconsistently, Gulzar et al. (2020) find empirical evidence that CEO duality does not impact the performance of listed textile companies in India.

The impact of board diversity, especially gender diversity, on tackling fraud is further acknowledged in the literature. Cumming et al. (2015) find that gender diversity on boards can operate as a significant moderator for the frequency of fraud and that women are more effective in male-dominated industries in reducing both the frequency and severity of fraud in China. Equally, Capezio and Mavisakalyan (2016) show that the increase in women’s representation
on company boards is associated with a decreased probability of fraud in Australia. Lenard et al. (2017) uncover that at least one female leader decreases the likelihood of litigation for financial reporting fraud in the US. Similarly, Luo et al. (2020) report that firms with female CFOs are less likely to commit fraud than male CFOs in China. Ghafoor et al. (2019) indicate that a female's presence on the board provides active monitoring and oversight in reducing fraud. Briano-Turrent Dr. (2021) find a positive effect of female representation in boardrooms over the board’s ethical functioning, the conflicts of interest transparency index, the creation of ethics codes, and the adoption of stakeholder orientation.

5.3 Ownership Structure

Evidence from the literature indicates a link between ownership structure and fraud risk. For instance, Sharma (2004) reports that as the percentage of independent institutional ownership increases, the likelihood of fraud decreases. Ghafoor et al. (2019) indicate that dedicated institutional investors provide active monitoring and oversight in reducing fraud. Cheng et al. (2008) show that the percentage of shares held by the controlling shareholder significantly influences financial control, reducing fraud risk in China. Pucheta-Martínez and García-Meca (2014) suggest that institutional investors on boards and audit committees are effective monitors, which leads to higher quality financial reporting and, therefore, a lower likelihood that the firm receives a qualified audit report.

Shi et al. (2020) uncovered that state ownership is negatively associated with the likelihood of securities fraud commission. Firms with high state ownership are more likely to dismiss CEOs than those with low or no state ownership upon securities fraud detection. Choi et al. (2020) explore a causal relationship between firms' ownership structures and the likelihood of corporate fraud in South Korea. They find that the frequency of corporate fraud was reduced more in central firms than in non-central firms as the controlling owner's cash-flow rights dropped more. However, an opposite conclusion by Chen et al. (2006) suggests that boardroom characteristics are more important and relevant than ownership structure in explaining fraud.
5.4 Accountability

From an agency theory perspective, accountability means reporting back to the principals and giving an account of what has been achieved. Effective accountability should reduce the agency problem and fraudulent behaviour by management because it gives management a greater incentive to achieve performance levels in the shareholders' best interests. Such incentives include obtaining rewards or avoiding punishments (Coyle, 2012). Failure to enforce accountability increases the risk of opportunity for fraud as it allows fraud perpetrators and their accomplices to get away with their crimes without adequate punishments. In the meantime, it delivers the wrong message about fraud tolerance within the organisation, encouraging others to perpetrate fraud without fear of repercussions. Hence, accountability is the cornerstone of any effective corporate governance system (Kassem, 2021).

To ensure accountability, organisations should hold individuals accountable for their actions, have an effective, competent, and honest board of directors, accurate and trustworthy financial reporting system, robust internal controls and risk management systems, independent, honest, and competent auditors and audit committees (Mallin, 2016). The quality of financial reporting begins with senior management, and the decline in financial reporting quality could be related to the tone at the top, a cornerstone of quality financial reporting (Leinicke et al., 2000). Dishonest management has the power to manipulate financial reporting and deceive shareholders to achieve specific motives. Management motives to commit fraud could be financial, such as financial need, greed, keeping the job, receiving bonuses or non-financial, such as ego, coercion, ideology, revenge, or the desire to please investors (Kassem, 2017).

5.4.1 Internal Controls and Risk management

Internal controls refer to the policies and procedures in an organisation designed to ensure that the assets are safeguarded, laws and regulations are complied with, and the systems operate as efficiently and effectively as planned (Arens et al., 2014). Designing and implementing robust controls is essential in ensuring accountability. The UK Code of corporate governance requires the board of directors of listed companies to design and implement a sound internal control and risk management system (FRC, 2018).

In the US, the importance of internal controls and risk management is emphasised through the Sarbanes Oxley (SOX) Act 2002. The SOX Act was introduced following the financial fraud scandals of Enron, WorldCom, and Global Crossing and significantly impacted the US and worldwide. SOX requires organisations to implement effective internal controls and risk
management systems. It also requires external auditors to report independently on the effectiveness of audit clients’ internal control and risk management systems (PCAOB, 2002; Mallin, 2016). Tsai and Huang (2020) find that declines in stock price on securities fraud litigation announcement dates are significantly more severe for publicly litigated firms receiving US SOX 404 internal control material weakness opinions.

The Committee of Sponsoring Organisations of the Treadway Commission (COSO)\(^2\) established an internal control framework suggesting that organisations design and implement five main internal control components to ensure effective internal control and risk management systems. These control components include the control environment, control activities, risk assessment and management, information and communication, and monitoring. As discussed before, a vital aspect of the control environment is top management’s commitment to integrity and ethical values. The control activities include critical anti-fraud controls such as adequate segregation of duties, safeguards over assets and records, ensuring proper documentation, maintaining proper authorisation, and independent checks on performance. Clear information and communication flow inside and outside the organisation are essential control components. Monitoring involves the continuous review of processes and activities and taking corrective actions when needed (COSO, 2014).

Industry standards have also emphasised the importance of governance controls. For instance, the International Organisation for Standardization (ISO) issued ISO 27001, which enables organisations to manage the security of assets and includes the following fourteen controls: Information security policies, organisation of information security, human resource security, asset management, access control, cryptography, physical and environmental security, operations security, communications security, system acquisition, development and maintenance, supplier relationships, information security incident management, information security aspects of business continuity management, and compliance. These fourteen controls assert the importance of similar controls suggested by COSO, such as monitoring, investment in cyber security, conducting background checks, and physical control over assets and records\(^3\).

\(^2\) [Welcome to COSO](https://www.coso.org)

\(^3\) Source: [ISO - ISO/IEC 27001 — Information security management](https://www.iso.org/standard/49632.html)
Similarly, COBIT (Control Objectives for Information and Related Technology) helps organisations meet business challenges in regulatory compliance, risk management and aligning IT strategy with organisational goals. COBIT 5 is based on five principles that are essential for the effective management and governance of enterprise IT, including (i) meeting stakeholder needs; (ii) covering the enterprise end to end; (iii) applying a single integrated framework; (iv) enabling a holistic approach; and (v) separating governance from management. These five principles enable an organisation to build a holistic framework for the governance and management of IT that is built on seven ‘enablers’. This includes People, policies and frameworks, processes, organisational structures, culture, ethics and behaviour, information, services, infrastructure and applications, people, skills and competencies.

Prior studies assert internal control and risk management's role in mitigating the risk of fraud. Marciukaityte et al. (2006) report that improvements in internal control systems following accusations of fraud help repair a company's damaged reputation and reinstate its confidence. Zakaria et al. (2016) found that internal control weaknesses can be major contributing factors for fraud committed in Malaysia. Gao and Zhang (2018) argue that one firm's internal controls investment positively affects peer firms. It reduces its own manager’s manipulation, which, in turn, mitigates the manipulation pressure on managers at peer firms. Jha et al. (2020) find that firms in corrupt districts are more likely to have weak internal controls and restate earnings.

The literature reports various types of controls that could effectively combat fraud. One of the most important internal control components is monitoring. Subair et al. (2020) argue that boards need to be more effective in monitoring roles to reduce fraud. Harris et al. (2017) find that monitoring debt holders and government grantors, audits, and keeping managerial duties in-house are most strongly associated with lower fraud incidence. They also uncover that the likelihood of fraud is negatively associated with a conflict of interest policy and the presence of restricted donations.

---

4 Source: COBIT 5 framework for the governance of enterprise IT (itgovernance.co.uk)
Similarly, Wang (2010) concludes that investors value the creation of monitors and valuable business operations more than restructuring following financial fraud. Adetiloye et al. (2016) discuss that inadequate supervision and improper documentation process provide an opportunity to misappropriate the assets in Nigeria. Nendi et al. (2020) assert the importance of monitoring and using technology to prevent and detect fraud in Indonesia. Davis and Harris (2020) indicate specific controls that owners of small retail businesses could implement to prevent and detect occupational fraud. This includes monitoring, employee identity documents to track employee activity, separation of duties, and communication with employees.

In a recent global fraud study, the Association of Certified Fraud Examiners (ACFE, 2020) finds that the most effective anti-fraud controls include anonymous fraud reporting lines, anti-fraud awareness, and education staff, internal audit, and management review. Ali and Hashim (2020) uncovered that fraud risk assessment directly impacts Oman's good corporate governance. Earlier, Leinicke et al. (2000) suggested that the use of corporate culture audits, fraud prevention units, and background checks could reduce financial reporting fraud and improve financial reporting quality.

Ingber (2020) provides various examples of adequate anti-fraud controls in banks, including anti-fraud training and awareness campaigns to customers and staff, information security, third-party risk management, background investigations for new employees, and a fraud risk assessment committee. The role of the fraud risk assessment committee should involve defining fraud risk appetite and tolerance appropriate to each business line, reviewing anti-fraud policies and procedures, addressing relevant regulatory findings, ensuring a robust anti-fraud control infrastructure, establishing and using technology to identify fraud risk, and promoting ethical behaviour and appropriate tone at the top.
5.4.2 Auditors and Audit Committees

5.4.2.1 External and Internal Auditors

Whether internal or external, auditors play a critical role in mitigating the risk of fraud. According to the ICAEW (2005), audits serve a vital economic purpose and play an essential role in serving the public interest to strengthen accountability and reinforce trust and confidence in financial reporting. Hence, it is considered one of the critical governance mechanisms. The International Standards on Auditing (ISA 240) requires external auditors to provide reasonable assurance that the financial statements are free from material misstatements, whether due to error or fraud. ISA 240 details that external auditors should assess management integrity; assess fraud risk while considering the risk of motivations, opportunities, and rationalisation of fraud; engage in brainstorming sessions to discuss fraud risk with the audit engagement team; and report fraud when found (IAASB, 2009).

On the other hand, internal audit provides assurance by assessing and reporting the effectiveness of governance, risk management, and control processes designed to help the organisation achieve strategic, operational, financial, and compliance objectives (Institute of Internal Auditors (IIA), 2018). Internal auditors are also responsible for assessing fraud risk and, in some cases helping in the detection and investigation of internal fraud (Pickett, 2010; Iovu, 2018). Besides, internal auditors' reports could benefit external auditors (Arens et al., 2014). Cular et al. (2020) find that external auditors' reliance on the internal audit function is highest when the latter provides risk management consulting under a strong audit committee's supervision. Alzeban (2020) indicates that when internal auditors report directly to the audit committee, there is a significant positive influence on financial reporting quality. Conversely, when an internal auditor reports to the chief executive officer (CEO) or chief financial officer (CFO), there is a negative impact on financial reporting quality.

DeZoort and Harrison (2018) argue that auditors play a critical role in managing fraud risk within organisations and find external auditors perceiving the most detection responsibility for financial statement fraud, while internal auditors report similar detection responsibility for all fraud types. Ergin (2019) argues that fraud detection is dependent on internal auditors and external audit design. Fera et al. (2022) highlight that firms having a high quality and sustainable corporate governance system tend to have fewer critical audit matters arising from the audit process and then disclosed in the audit report.
Law (2011) indicates that internal audit effectiveness is positively associated with a lack of fraud within Hong Kong organisations. Similarly, Westhausen (2017) emphasises the role of internal audits in preventing and detecting fraud. Alzeban (2019) concludes that companies demonstrating higher internal audit compliance with standards have better financial reporting quality. Martins and Ventura Júnior (2020) note that audit-related practices reduce earnings manipulation. Lauck et al. (2020) find that external auditors elicit client-employee disclosures of known fraud by actively promoting statutory whistleblower protections. Nguyen et al. (2019) find that higher audit quality leads to a deterioration in corporate misreporting.

Despite the vital role that external auditors play in deterring fraud and reinforcing accountability, external auditors’ failure in detecting material misstatement due to fraud over the years cast doubt over the value of external audits as a governance mechanism in countering fraud. However, the reality is that external audits are required by law, and auditors are obliged to assess and respond to fraud risks. Ungureanu (2012) establishes the importance of external financial audits in improving corporate governance and suggests that external audits must manifest in a governance system to avoid fraud. For that reason, it is crucial to explore ways to improve auditors’ skills in countering fraud.

A few studies indicate how to improve auditors’ fraud risk assessment and response skills. For instance, Kassem (2019) and Nguyen et al. (2021) suggest that knowledge of how financial reporting fraud schemes are committed and concealed could help auditors design effective audit tests to assess fraud risk. And, it could help those charged with governance design effective fraud prevention and detection techniques, and auditors could use help from forensic specialists to uncover accounting fraud. Herron and Cornell (2021) argue that auditor creativity characteristics and the creativity of the work environment are related to auditors' recognition of and responses to fraud cues, implying how an emphasis on standardised audit procedures in response to firm oversight may diminish auditor creativity. Simon et al. (2020) conclude that auditors who make holistic fraud risk assessments are more concerned about high-risk fraud schemes than auditors who employ fraud risk decomposition. Durkin et al. (2020) observe that auditors who read a metaphor related to concerns about the honesty of the sources of information (client-sceptical metaphor) or concerns about one's own ability to detect problems (self-sceptical metaphor) assessed higher levels of fraud risk. Bauer et al. (2020) find that seeking informal advice or thinking like an advisor helps auditors effectively revise audit plans to identify fraud risk.
5.4.2.2 Audit Committees

Audit committees serve the interests of investors and other stakeholders through their independent oversight of the annual corporate reporting process, including the audit of the company’s financial statements, and have an essential role in ensuring quality. The audit committee reports the external auditor's work and concludes the annual report (FRC, 2020). Vera-Muñoz (2005) emphasises the role of audit committees in ensuring the integrity of financial reporting. Equally, Benson and Burton (2018) emphasise the role of audit committees in corporate governance, ensuring accountability and reducing fraud risk.

Law (2011) reports that audit committee effectiveness is positively associated with a lack of fraud within Hong Kong organisations. Almqtari et al. (2020) conclude that audit committee attributes and audit quality significantly affect financial reporting quality. Ghafoor et al. (2019) report that effective audit committees and active monitoring and oversight reduce fraud. Cormier et al. (2010) show that audit committee size and the extent of voluntary governance disclosure reduce information asymmetry in Canada.

A few studies reported that specific characteristics could enhance audit committees’ abilities to mitigate fraud risk. Persons (2005) uncovered that fraud is lower when the audit committee comprises independent directors, has fewer directorships with other companies, and has longer tenure. Similarly, Owens-Jackson et al. (2009) find that the likelihood of fraudulent financial reporting is negatively related to audit committee independence and the number of audit committee meetings. Abbott et al. (2000) find that firms with audit committees composed of independent directors and meet at least twice per year are less likely to be sanctioned for fraudulent or misleading reporting. Mnif and Borgi (2020) report that audit committee independence and the number of meetings held by the audit committee are positively associated with the extent of compliance with IFRS. Besides, audit committee industry expertise and financial accounting expertise are associated with a higher level of compliance. Ashraf et al. (2019) uncover a reduction in the likelihood of material restatement, information technology-related material weaknesses, and more timely earnings announcements at firms with audit committees with information technology expertise. However, Persons (2005) inconsistently concluded that audit committee expertise is not significant in reducing fraud likelihood.
6. Findings, Discussion, Literature Gaps, and Future Research

This paper elucidates the impact and role of corporate governance in countering fraud based on a comprehensive literature review. Regarding the impact of corporate governance on fraud, the present paper finds that effective corporate governance can help reduce fraud risk, prevent fraud, and detect fraud, particularly corporate fraud, insider fraud, and asset diversion. Some companies employ corporate governance mechanisms to bolster their reputation following fraud detection. On the other hand, inadequate corporate governance mechanisms increase fraud risk, provide the opportunity for perpetrating fraudulent activities, and reduce the likelihood of fraud detection.

The paper sheds light on several governance mechanisms that could help in mitigating fraud risk, as reported in the literature. It then categorises these governance mechanisms into four broad governance aspects, including (a) board leadership and the role of ethics; (b) board characteristics, composition, and structure, (c) ownership structure, and (d) accountability. The paper proposes a guide (see Table 1) summarising these broad fundamental governance aspects, including specific anti-fraud controls and examples of how organisations could enhance ethical cultures and the tone at the top.

(Insert Table 1 here)

In the first governance aspect, board leadership and the role of ethics, the paper highlights the link between board leadership and ethics. The findings reveal that fighting fraud starts from the top of the organisation. If the tone set by top management upholds ethics and integrity, employees will be more inclined to follow those same ethical values. However, if top management seems unconcerned about ethics and fraud, employees will find it an opportunity to defraud the organisation. Prior research asserts that unethical top management and corporate culture increases the risk of fraudulent financial reporting, corruption, and other types of fraud.

To set an effective tone at the top, executives and top management should (i) set an ethical example of how their employees should behave in the workplace, (ii) provide a safe mechanism for reporting fraud and unethical behaviour, (iii) design a code of ethics with zero tolerance to fraud and unethical behaviours, (iv) reward integrity, (v) take corrective actions when raised by auditors, (vi) cooperate with the auditors and audit committee to ensure a fair and trustworthy financial reporting process, (vii) treat employees fairly and with respect, and provide them with fair pay, remuneration, and promotions to reduce the risk of motives and
rationalisation to commit fraud, (viii) invest in adequate anti-fraud controls and risk management systems, and (ix) hold individuals accountable for their responsibilities by imposing strict penalties on those who commit fraud or engage in any other unethical behaviour. Additionally, shareholders must consider appointing executive directors and top management with high integrity levels to ensure top leaders’ commitment to ethics. A summary of anti-fraud controls and how to main an effective tone at the top is provided in Table 1.

Several studies focused on the link between board independence and fraud risk in the second governance aspect, *board characteristics, composition, and structure*. Their results indicate that more independent non-executive directors on the board of directors, audit committee, and remuneration committee matter in countering fraud. That is because the board's independence provides active monitoring and oversight in reducing fraud. In addition to board independence, a few studies suggested that board expertise, particularly in accounting and finance, could help reduce fraudulent financial reporting. Similarly, some evidence indicates that board duality, the frequency of board meetings, and board size could help mitigate fraud risk.

Nevertheless, a few studies reported no evidence of the impact of board independence, board duality, board size, and frequency of board meetings on reducing fraud risk. These mixed results lead to inconclusive evidence, which calls for more future research in this area. In addition to these mixed results, there is very little evidence on the link between the frequency of board meetings, chairman's tenure, board members’ expertise, and fraud risk. Besides, another under-researched area is the link between board members’ expertise and countering fraud. In particular, what specific knowledge and skills would enable board members to tackle fraud?

An interesting finding by one study shows that the connections CEOs develop with top executives and directors through their appointment decisions increase the risk of corporate fraud, decrease fraud detection, helps conceal fraudulent activity, and make CEO dismissal less likely upon discovery. However, given the scarcity of research in this area, this conclusion is premature and requires more future research evidence.

An emerging research stream in board diversity reports that gender diversity also matters in countering fraud. In particular, prior studies results suggest that women are more effective in male-dominated industries in reducing fraud's frequency and severity, the increase in women's representation on company boards is associated with a decreased probability of fraud and that firms with female CFOs are less likely to commit fraud than male CFOs.
Some also found that female's presence on the board provides active monitoring and oversight in reducing fraud and that there is a positive effect of female representation in boardrooms over the board's ethical functioning, the conflicts of interest transparency index, the creation of ethics codes, and the adoption of stakeholder orientation. Although there is evidence supporting the impact of female directors on mitigating fraud risk, some research questions remain unanswered. For example, why are female directors more likely to reduce fraud risk than male directors? Did organisations that collapsed as a result of fraud have any female directors?

About the third governance aspect, *ownership structure*, a few studies provide evidence of the relationship between ownership structure and fraud risk. In particular, their findings show that as the percentage of independent institutional ownership increases, the likelihood of fraud decreases and that institutional investors provide active monitoring and oversight in reducing fraud. The percentage of shares held by the controlling shareholder significantly influences financial control, reducing fraud risk. State ownership is negatively associated with the likelihood of securities fraud commission, and firms with high state ownership are more likely to dismiss CEOs than those with low or no state ownership upon securities fraud detection. However, an opposing argument indicates that boardroom characteristics are more important and relevant than ownership structure in explaining fraud. Given the little evidence on the link between ownership structure and fraud risk, future studies should investigate whether there is a link between ownership structure and fraud risk. If so, what form of ownership structure should be considered and why?

This paper finds streams of research covering the fourth governance aspect, *accountability*. A summary of prior studies’ results reveals that failure to enforce accountability increases the risk of opportunity for fraud as it allows fraud perpetrators and their accomplices to get away with their crimes without adequate punishments. In the meantime, it delivers the wrong message about fraud tolerance within the organisation, encouraging others to perpetrate fraud without fear of repercussions. Hence, accountability is the cornerstone of any effective corporate governance system.
To ensure accountability, organisations should hold individuals accountable for their actions, have an effective, competent, and honest board of directors, accurate and trustworthy financial reporting system, robust internal controls and risk management systems, independent, honest, and competent auditors, and audit committees. The literature reports various types of controls and accountability considerations that could effectively combat fraud which this paper summarises in Table 1.

A critical argument in this paper is that the quality of financial reporting begins with senior management, and the decline in financial reporting quality could be related to the tone at the top. Dishonest executives and top management have the power to override robust internal controls and manipulate financial reporting to achieve specific motives. For that reason, internal or external auditors and audit committees play a vital role in reinforcing accountability and reducing fraud risk. Prior studies indicated that when internal auditors report directly to the audit committee, there is a significant positive influence on financial reporting quality compared to when they report to the CEO or CFO. Additionally, external auditors are more likely to depend on internal auditors’ reports under the supervision of a strong audit committee. As reported in the literature, some factors are crucial for improving audit committees’ abilities to counter fraud. This includes audit committees’ independence, tenure, number of audit committee meetings, expertise in information technology, industry, and financial accounting, and audit committee size. However, only a few studies explored this area, implying the need for future studies investigating ways to improve audit committees’ skills in countering fraud. Besides, inconsistent findings concerning audit committees expertise lead to inconclusive evidence and call for more future research in this area.

Despite the vital role that external auditors play in deterring fraud and reinforcing accountability, external auditors’ failure in detecting material misstatement due to fraud over the years cast doubt over the value of external audits as a governance mechanism in countering fraud. This does not mean that the vital role external auditors are expected to play in corporate governance should be overlooked. External audits must manifest in a governance system to avoid fraud, as Ungureanu (2012) suggested. If fraud happens when external audits are in place, imagine what could happen if the audit function is not there?. Future research should explore ways to improve external auditors’ skills in deterring fraud to restore trust in this critical governance mechanism. This paper finds that only a few studies examined how to enhance auditors’ skills in fraud risk assessment, implying a need for more studies in this area. Some of the recommended methods for improving auditors’ skills in fraud detection by prior studies
include providing anti-fraud education to the auditors, avoiding standardised audit procedures in response to fraud, focusing more on holistic fraud risk assessments, encouraging auditors to read a metaphor related to concerns about the honesty of the sources of information, and seeking advice on countering fraud.

Finally, this paper recommends that future research looks into the governance controls introduced by ISO and COBIT and compare business practices with best practices suggested in those standards. Additionally, future studies could analyse governance failures resulting in real fraud cases through the lens of the proposed guidance by this paper.

7. Conclusion and Implications

This paper elucidates the impact and role of corporate governance in countering fraud based on a comprehensive literature review. Regarding the effect of corporate governance on fraud, the present paper finds that effective corporate governance can help reduce fraud risk, prevent fraud, and detect fraud, mainly corporate and insider fraud. Corporate governance can also help minimise asset diversion. Some companies employ corporate governance mechanisms to bolster their reputation following fraud detection. On the other hand, inadequate corporate governance mechanisms increase fraud risk, provide the opportunity for perpetrating fraudulent activities, and reduce the likelihood of fraud detection.

Concerning the role of corporate governance in countering fraud, the paper sheds light on several governance mechanisms that could help mitigate fraud risk, as reported in the literature. The paper categorises these governance mechanisms into four broad governance aspects, including (a) board leadership and the role of ethics; (b) board characteristics, composition, and structure, (c) ownership structure, and (d) accountability. The paper develops a guide (see Table 1) summarising these broad fundamental governance aspects, including specific anti-fraud controls and examples of how organisations could enhance ethical cultures and the tone at the top.
The findings have important implications for policymakers and future research. From the research and academic perspective, this paper draws researchers’ attention to gaps in the corporate governance literature which can open up research debates and new research avenues. This study’s proposed guidance could be helpful to researchers interested in corporate governance research and academics who aim to embed anti-fraud education in the curriculum. Raising the future generation’s awareness of corporate governance's role in combating fraud could prepare and educate future auditors, managers, and executives about their role in combating fraud and what good corporate governance entails.

From a policy and practice perspective, this paper's findings could alert regulators to the impact and role of corporate governance in combating fraud. There is less emphasis on ethics and fraud in the UK Code of Corporate Governance, which is considered a benchmark for good governance practices. This study’s proposed guidance can help business leaders and policymakers mitigate fraud risk. For instance, business leaders could use this guidance in designing adequate controls that could assess and manage fraud and risk management risk. The guidance could be helpful to policymakers in developing future Governance Codes. The Financial Reporting Council (FRC) in the UK may find the guidance useful and timely, given that the FRC has recently identified fraud risk as a priority area in its future audit inspections (see News I Financial Reporting Council (frc.org.uk)).

Additionally, although this paper highlights the essential role internal auditors play in reducing the risk of fraud, internal audit still is not a legal requirement. This paper recommends that regulators and policymakers globally consider internal audits a legal requirement to encourage organisations to invest in such a vital governance mechanism. So far, only an external audit is legally required despite its limitations.

Like any other study, this paper has its limitations. This paper focuses on the UK corporate governance code, and governance frameworks in different jurisdictions have not been considered. The reason for this pertains to the consideration of the UK governance code as a benchmark for good governance practices by several sources (Coyle, 2010; Solomon, 2013; Tricker, 2015). Despite its limitation, this is the first study to provide a comprehensive review of the literature to highlight the role and impact of corporate governance in countering fraud and also the first to develop guidance in this area.
References


ICSA. (2020). *What is corporate governance?* Retrieved from What is corporate governance? (icsa.org.uk)


Storbeck, O. (2021). *Wirecard fraud 'started more than a decade ago*. Retrieved from Wirecard fraud ‘started more than a decade ago’ | Financial Times (ft.com)


