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# FINANCIAL FRAUD RISK MANAGEMENT AND CORPORATE GOVERNANCE

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## Abstract

*Risk management is important so that risk is assessed, understood and appropriately managed. This is important both for conformance and performance. It is essential that strategic planning and management decisions are made appropriately in the context of the risk appetite of the corporation and its various stakeholders – especially its shareholders. If a company does not have a good understanding of risk, the likelihood of conformance and performance failure is high, this implies good internal and external corporate intelligence. Large global corporations have a significant impact on economies around the world. These entities are subject to intense competition and require investor and customer confidence to underpin their activities. Poor governance adversely affects customers and investors, and makes corporation uncompetitive. This can also affect entire economies. In the context of the Global Financial Crisis (GFC), the collapse of the US investment bank Lehman brothers demonstrates that corporate failure can hurt economies globally. The failure of Lehman Brothers to properly manage and understand risk is a clear example of the failure of good governance.*

**Keywords**: Fraud Risk Management, Corporate Governance, Good Governance, Fraud,

## INTRODUCTION

The upsurge of financial scandals in the era of the 21st century raised awareness of deep-seated fraudulent activities (Kerr and Murthy 2013). Financial statement fraud has cast an increasingly adverse impact on the individual investors and the stability of global economies (Zhou and Kapoor 2011). The failure of Enron has caused about a $70 billion lost in the capital market. The Computer Security Institute reported a significant increase in financial fraud cases recently (Reddy et al. 2012). The rise of many fraudulent occurrences is a serious inhibitor for potential investors because fraudulent financial reports have created a substantial negative impact on company reputations and market value (Hogan et al., 2008).

Financial statements are basic documents to reflect a company's financial status (Beaver 1966). Fraudulent financial reports are perpetrated to increase stock prices or to get loans from banks (Ravisankar et al., 2011). Financial statement fraud detection is vital because of the devastating consequences of financial statement frauds (Ngai et al. 2011). Fraud behaviours are often subtle in the beginning (Chivers et al., 2013), therefore, it is difficult to detect them. Regulations play an important role to emphasize the responsibility of auditors to assess the risk of fraudulent financial reporting adequately (Srivastava et al. 2009). However, detecting frauds remains difficult because of the lack of a commonly accepted definition of reasonable assurance, limitations of audit methods and the cost constraints (Spathis, 2002; Hogan et al., 2008).

The board of directors is the body that oversees the activities of an organisation. The board has a wide range of roles and functions that address both performance and conformance. It is preferable that the roles and responsibilities of the board be explicitly set out in a written chatter or constitution. The board must ensure appropriate procedures are in place for risk management and internal controls, and it must also ensure that it is informed of anything untoward or inappropriate in the operation of those procedures. Any major operation issues will also be brought to the attention of the board for appropriate consideration and decision making.

Despite these expectations, in many high-profile corporate collapses it is apparent that the board was informed about key business decisions or simply chose to comply with management. For example, in the case of a former prominent Australian company, HIH Insurance, it was apparent that the major takeover of another company, FAI

Insurance, was undertaken without rigorous debate at board level or due diligence being carried out before the transaction was finalised (CPA, 2016).

Companies that can demonstrate good corporate governance practices have advantages. With the increasing globalisation of business and competition for capital, companies that can provided assurances that the company is being appropriately managed the cost of capital. Furthermore, the expansion of company shareholdings to a broader base (in many countries, small shareholders are becoming increasingly common, either by direct investment or indirectly through their superannuation plans), combined with more organised and active shareholders lobby groups, is placing more scrutiny on company management (Drever et al., 2007, p. 153). In this paper, a review of the risk management and corporate governance principles is made in order to identify weaknesses in corporate governance and also to identify how to improve. It then proposes a focus on improvement for risk management and the corporate governance benefit.

## RISK MANAGEMENT

Risk management is defined as the "process of understanding and managing risks that the entity is inevitably subject to in attempting to achieve its corporate objectives (CIMA, 2005). For an organisation risks are potential events that could influence the achievement of the organisation's objectives. Risk management is about understanding the nature of such events and where they represent threats, making positive plans to mitigate them. Fraud is a major risk that threatens the business, not only in terms of financial health but also its image and reputation.

Risk management is also an increasing important process in many businesses and the process fits in well with the precepts of good corporate governance. In recent years, the issue of corporate governance has been a major area for concern in many countries. In the UK, the first corporate governance report and code of best practice is considered to be the Cadbury Report in 1992, which was produced in response to a string of corporate collapses. There have been a number of reports since, covering provisions around area such as executive remuneration, non-executive directors, and audit committees. The principles of these various report have been brought together to form the Combined Code on Corporate Governance (Combined Code).

### The Need for Governance

Governance describes the overall guidance of organisations and focuses on achieving strong performance while ensuring compliance with obligations. Effective governance is very important and poor governance has often led financial disasters for individual companies, and even whole economies. Governance is the system by which companies are directed and controlled, and accountability is assured. While the concept is usually associated with corporate governance, that is the governance of large listed corporations, similar governance principles should apply to all enterprises. Governance relates to the responsibilities of the board of directors towards investors and other stakeholders, and involves setting the objectives and direction of the company and is distinguished from the management of the enterprise on a daily basis, which is the job of full-time executives.

The governance of enterprises is broadly structured by the law, not just corporate law but also employment law and so forth. It is the first duty of directors to ensure that the enterprise operates with in the law. However, beyond requiring a board of director's exercise certain duties such as the duty of care and diligence, corporation law gives considerable scope for directors to exercise decision-making in the best interests of the company. It is here where the skills of governance become critical: the capacity to understand and interpret the strengths and weaknesses of the enterprise, and how to direct the enterprise towards business success while maintaining accountability and good relationships with all stakeholders. Good governance is a hallmark of enterprises that achieve improving and sustainable performance even in changing and unpredictable environments.

Good governance aims to ensure that organisations are properly run in the best interests of their shareholders, including the optimal performance of national and international economies. At an organisational level, the behavioural styles and business management practices of managers (and other employees) or directors can result in outcomes that are not in the best interests of shareholders and other stakeholders. These situations can range from relatively minor technical breaches of policies or practices, to more serious cases where excessive risk-taking or poor controls place the ongoing survival of the organisation at risk (CPA, 2016)

Many other countries have also produced reports on corporate governance, usually accompanied by codes of best practices. For example, South Africa has had the King Report (version I and now II) since 1994, Malaysia has had its Code of Corporate Governance in place since 2000 and Sri Lanka issued the Rules on Corporate

Governance as part of its Listing Rules in January 2007 (CPA, 2016)

Corporate governance requirements in the US are now largely set out within the Sarbox legislation, as previously mentioned (US Congress 2002, Sarbanes-Oxley Act 2002); these requirements extend beyond the US, capturing any company that is SEC listed and its subsidiaries. Some other countries have also introduced a statutory approach to corporate governance, such as that in the US, although none are currently as comprehensive. A number of international organisations have also launched guidelines and initiatives on corporate governance, including the Organisation for Economic Co-operation and Development (OECD) and the European Commission.

In extreme cases, public organisations may be run more as personal fiefdoms where personal greed is put ahead of the interests of shareholders and other stakeholders. To reduce undesirable consequences for shareholders and other stakeholders and to ensure personal accountability, organisations need an appropriate system of checks and balances in the form of corporate governance framework. This framework emphasises both conformation and performance as vital elements of the way the companies are run.

## The Role of the Board

As corporations grow in size, there is also a separation of the ownership and management. Over time, the legal duties and responsibilities of directors have evolved to protect the interests of the owners, who are not able to observe closely the daily occurrences within a corporation. In most jurisdictions, there is a core group of director's duties and responsibilities that have arisen from either statue or case law. The key duties are to:

- Avoid conflict of interest and where these exist, ensure they are appropriately declared and as required by law, otherwise mange correctly
- Act in best interests of the corporation
- Exercise powers with proper purposes
- Retain discretionary powers and avoid delegating the director's responsibility
- Act with care, skill and diligence
- Be informed about the corporation's operations, and
- Prevent insolvent trading

Consequently, the board of directors should have implemented a strategy settings design to identify potential events that may affect the entity (Gelinas, Dull & Wheeler, 2012). These strategy settings reflect in a framework which is called "Enterprise Risk Management" (ERM).

In formal corporate governance principles, managers are the agents of the board responsible for pursuing the vision of the company as developed by the board, and fulfilling the strategic direction determined by the board. The CEO in most companies is also a director and a member of the board (and there are often other executive directors such as the CFO of the company). These executives' directors have a full role working with the board to advance strategic direction and establish the policies and value of the company. Once these are decided, it is the manager's duty to actively pursue these, and the board's role is to monitor the results for the business.

Of course, in reality the interface of governance and management is more complex. Often boards and management respect and understand the different roles and have a commitment to make the relationship work. However, sometimes tensions do emerge, for example, in the choice of strategy. Because of rapidly changing markets and technology, boards often have to be continuously engaged in strategic decisions, unlike in the past. At times, managers may feel that the board is becoming too involved in the implementation of strategy when it is the management team who have operational experience required to guide strategy to success. On other occasions, the board may feel that managers are making significant strategic decisions without properly securing the approval of the board (CPA, 2016).

Skeet (2015) examines this issue from the perspective of both the board of directors and the management team. When CEOs are asked what issues contribute to the board and management being at cross purposes, they point to two main factors: directors acting 'out of position' and attempting to play a management role; or a conflict of interest where, even if disclosed, directors are not able to place the interests of the organisation above their own or those of the group they are representing.

Often what boards interpret as arrogance of the CEO and the management team can be, in reality, a lack of experience, strategic direction differences or deceit. These can all lead to the management team withholding information from the board. Board members should consider what information they do not currently have and then request this additional information if they feel the CEO and the management team may be concealing

something. This is a legal right of the board, and the management team is not permitted to suppress this information, once requested. The board is able to draw on multiple points of view when making decisions, which is strength of shared governance (Skeet, 2015). For example; there was a tension occurred some years ago at BHP Billiton when a newly appointed CEO began negotiating for major acquisitions without fully consulting the board. The board became concerned about the serious risk implication of the CEO's actions, and the contract of the CEO was terminated. With the appointment of another CEO, the BHP board was careful to agree on a series of protocols regarding the scope for independent decision-making by the CEO on financial and other matters, and the issues that always needed to be brought to the board for consideration. These protocols appear to have worked well, and in other large corporations, similar, clear understanding exists between board and executive management on their respective roles and powers (CPA, 2016).

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It is certainly the case that it is management at the sharp end of delivering the aspirations of the board for the company. Boards of directors are often highly skilled at financial analysis, strategic thinking and policy development, but it is the managers who have to implement all of these, which requires considerable intellectual, operational and intellectual skills. It is the management who must inspire employees with the goals of the enterprise, delight customers with the quality of the product or service, convince suppliers and distributors that the company deserves their full support, and keep stakeholders onside (CPA, 2016).

Ensuring that there is the energetic commitment of managers to their task of realising the vision of the board and making the success of the company is ultimately the role of the CEO, who is the essential link between the governance mechanisms and the operational mechanisms of the company.

## INTERNATIONAL PERSPECTIVES ON CORPORATE GOVERNANCE

Globalisation has caused major changes in the way incorporations are run. Inevitable changes in the size and the structure of companies, including their ownership structures, have had a substantial effect on the way corporations are controlled. For example, many traditional Australian companies, some listed on ASX, are now effectively controlled by owners in diverse locations such as the United States, China, Singapore, India, the United Kingdom and Germany. These owners are subject to governance standard that differ from those in Australia. Even so, listing in Australia means that they must comply with Australian governance standards in addition to those of their own country (CPA, 2016)

### United Kingdom

In 1991, following a series of high profile corporate collapses, the London Stock Exchange, together with industry and accounting and finance professionals, established the Cadbury Committee. The Cadbury report, *Financial Aspects of Corporate Governance* (CFACG, 1992), gave recommendations to companies that have been adopted in varying degrees by the European Union, the United States, the World Bank and many other countries and regions. The recommendations on governance had an important feature that is still used today – the concept of 'comply or explain'. This approach meant that if a company chose not to comply with a governance recommendation, the company had to identify the non-compliance and then explain it to shareholders. This may also be described as 'if not, why not' reporting.

### United States

The Committee of Sponsoring Organisation of the Treadway Commission (COSO) was formed in 1985 to sponsor the National Commission on Fraudulent Financial Reporting. Its 1994 report, Internal Control-Integrated Framework (COSO, 1994), provided a detailed definition and discussion of internal control. In 1999, it reported on fraudulent financial reporting (COSO, 1999). Important findings included the frequent involvement of the CEO and CFO in frauds, captured boards that were dominated by insiders, and unqualified opinions by auditors despite the fraud.

In response to a loss of investor confidence following corporate scandals in the United States, the US Congress passed the Sarbanes-Oxley Act in 2002. The purpose of the Act was to protect investors and provide guidelines for financial reporting.

### Australia

The Ramsay Report (Ramsay 2001) examined the adequacy of Australian legislative and professional requirements regarding the independence of external auditors and made recommendations for changes. Some parts of the report were concerned directly with audit independence and others were designed generally to enhance audit independence; for example; establishing audit committees and board to oversee audit independence issues. In 2002, the Australian Stock Exchange (since renamed Australian Securities Exchange) responded to calls for it to play a greater role in corporate governance through the establishment of the Corporate Governance Council. The Council released the first edition of its *Principles of Good Corporate Governance and Best Practice Recommendations* (ASX CGC 2003). These were revised in 2007 and titled Corporate Governance Principles and Recommendations. The 2007 revision was amended in 2010. The third edition was released in 2014.

Again, the Australian government released a discussion paper (CLERP, 2004) in the aftermath of the collapses of, among others, Enron in the United States and HIH Insurance in Australia. This paper known as Corporate Law Economic Reform Program (CLERP) outlined proposals for audit and financial reporting reform, as well as other legislative proposals, to improve corporate governance practices in Australian companies. This report was passed by the Australian Government, coming into effect on 1 July 2004. There are many other international organisations that focus on improved corporate governance. Many of them, such as the Business Roundtable, an association of chief executives of leading US companies, and The International Corporate Governance Network (ICGN), a not-for-profit body founded in 1995, have produced their own recommended codes and guidelines.

## OECD PRINCIPLES OF CORPORATE GOVERNANCE

The OECD (Organisation for Economic Co-operation and Development), with members and funding sources from countries with major market-oriented economies, has developed international best practice principles of governance which was first published in 1999 (OECD, 1999) and were updated in 2004 (OECD, 2004) with a new first principle giving a broad view of governance including performance. A review of these principles started in 2014 and following an extensive consultation, the updated principles were released in September 2015, entitled G20/OECD Principles of Corporate Governance (QECD, 2015). These principles were considered as the international best practice by referring to specific guidance, codes and recommendations on corporate governance produced by the OECD and the Financial Reporting Council of the United Kingdom, who were become global leaders in the development of corporate governance principles. It also considers the ASX Principles, as they also provide leadership in corporate governance.

**The OECD Principles specify six principles:**

- Ensuring the basis for an effective corporate governance framework
- The rights and equitable treatment of shareholders and key ownership functions
- Institutional investors, stock markets, and other intermediaries
- The role of stakeholders in corporate governance
- Disclosure and transparency; and
- The responsibilities of the board

## DISCUSSION

Although corporate governance is usually linked to management, there is a strong bond between corporate governance and ethics and/or social responsibility of the business. Corporate governance encourages a trustworthy, moral, as well as ethical environment. From this point of view governance takes into account the transparency of the internal and external audit, the sincerity of the managers regarding the company’s financial results and financial statements, the manager actions towards the small stakeholders and many more (Panfilli 2012). Organization for Economic Co-operation and Development (OECD) considers that corporate governance has the role to specify the distribution of rights and of responsibilities between different categories of people involved in the company like: board of directors, executives, shareholders and others, establishing rules and procedures for making decisions on the activity of a certain company. OECD also mentions that corporate governance is at the same time, both a set of relations between management, board of directors, shareholders and

other interested groups and the structure through which company sets the objectives and the necessary means to reach those, but also the system of incentives offered to the board of directors and management in order to increase the objectives in the interests of shareholders and society.

Poor ethical leadership, lack of personal integrity, mismanagement, fraud, corruption, and violation of corporate governance rules are the main contributors towards bankruptcy and financial failures in large organizations. Most of these organizations have comprehensive corporate governance codes in place, implemented by the left brain Big Four accountancy firms (PwC, KPMG, Ernst & Young and Deloitte), McKinsey, America's Top Corporate Governance Law Firms, which apparently are not working at all. They made things worse and created a stable basis for more corruption (Ramperad & Fawumi, 2015). Current approaches to corporate governance are extremely formal, bureaucratic, cosmetic, not holistic and non-authentic, and therefore provide no protection from potentially catastrophic ethical failures. A sustainable and innovative solution to this global epidemic is needed urgently. It is time that awareness that corporate governance cannot be controlled effectively with formal and exhaustive rules, regulations, guidelines, and procedures only. It is about decency and personal integrity and this must be cultivated from within. Personal integrity has no need of rules and laws.

It must be a way of life: To quote what Plato said in 340 BC: "Good people do not need laws to tell them to act responsibly, while bad people will find a way around the laws". Research shows that a large percentage of the world's population is bad (Rampersad & Fawumi, 2015) For example, America has around 5% of the world's population, and 25% of its prisoners. Roughly one in every 107 American adults is behind bars. Among them are also many Executives, leaders and professionals. Most corporate governance programs make things worse by creating a stable basis for more corruption and are doomed to fail. Why is the lesson from Plato not learned and focus on creating a culture of good people, in which personal values are aligned with the laws and embedded in the mind of the people, instead of focusing on laws (corporate governance) only? An innovative methodology was launched for creating a culture of good Chairman's, Presidents, CEOs, CFOs, managers and employees, in which high ethical values are aligned with their corporate governance rules, regulations and guidelines and embedded in their mind (Ramperad & Fawumi, 2015).

Many law, accounting and business management professors at the US top schools are blamed for most of the corporate governance failures. They lack both emotional and spiritual intelligence. This inner process starts with self-knowledge, or knowing, which leads to wisdom. Between knowing and wisdom lies an enormous distance which can be reduced by systematic application of the authentic governance system. This will help them to create balance between the left and right sides of their brain. The left half of their brain has mainly an analytical, logical and quantitative function, while the right half of their brain has an intuitive and holistic function. They do not have a proper balance between the left and right sides of their brain. These professors and most of their graduates use the left side of their brain only; because of this, they miss opportunities that allow them to become more adept at using the right hemisphere of the brain and to deal with complex corporate governance problems in an integrated and authentic way. This is also the main reason why Harvard Business School professor Kaplan's balanced scorecard implementations fail and lack sustainability (Ramperad & Fawumi, 2015).
Many public company shareholders have been unpleasantly surprised by major accounting charges resulting from previously undisclosed enterprise risks. These charges typically come without warning in prior audited financial statements. Public shareholders have a right to wonder why they have not received warnings of these risks in prior audited financial statements and question the effectiveness of the board of directors in performing its oversight role (Lipman, 2012). Most directors of public companies focus on the tone at the top of the organization. However, these same directors do not necessarily know whether that "tone" reaches throughout the organization and may fail to assess the culture of the organization. Independent directors cannot adequately perform their oversight role without receiving enterprise risk information from lower-level employees.

Independent directors who rely on independent auditors to disclose unasserted claims arising out of enterprise risks should be aware of the very limited duties of independent auditors in investigating such risks. Typically, this issue is handled by the independent auditors by having top management of the company represent in writing to the independent auditor that they are not aware of unasserted material contingent liabilities and having the company's counsel agree to advise management of any such contingent liabilities. However, top management may not themselves be aware of such unasserted enterprise risks because of silos within the organization or because of the reluctance of employees to use hotlines. Even if management knows of possible contingent liabilities they might incorrectly determine that these liabilities are immaterial. Independent auditors currently are not required to check on the effectiveness of these employee hotlines or the employee culture, including the willingness of employees to use hotlines to report enterprise risk (Lipman, 2012).

## RECOMMENDATION

After considering risk management and corporate governance principles employed by a different country, it is clear that all the policies and principles adopted were mainly focussing on how to avoid and minimise risk and also to maintain good corporate governance. It can also take into account the self-interest characteristics of individual. This study recommends various contributions in order to improve and effectively enforce the principles and policies stated.

**1. Establishing of a Forensic investigation team**

Whenever an allegation arises, it is recommended that the Forensic Investigation Team head by a qualified Forensic Accountant should handle the investigation. This is to ensure the board and the management are not acting in any favour or bias.

**2. Formulate a response**

- The objectives of the investigation should be clearly identified along with resources required, the scope of the investigation and the timescale.
- The objectives will be driven by the organisation's attitude to fraud and the preferred outcome for dealing with fraud.
- An action plan should be prepared and roles and responsibilities should be delegated in accordance with the skills and experience of the individuals involved.
- The individual in overall control of the investigation should be clearly identified, as should the powers available to team members.
- Reporting procedures as well as protocols for handling and recording evidence should be clearly understood by everybody.

**3. Follow up action**

- There are lessons to be learned from every identified incident of fraud.
- The organisation's willingness to learn from experience is as important as any other response.
- Large organisations may consider establishing a special review to examine the fraud with a view to recommending improvements to systems and procedures.
- Smaller organisations may consider discussing the issues with some of its more experienced people, with the same objectives in mind.
- It is important that recommended changes are implemented promptly.

## CONCLUSION

The secret of a successful company is the ability of its board and senior management to assess its principles and policies in order to make decisions that achieve the correct balance over time. While the best corporations do this well, poorer corporations do it less effectively and those that do it worst almost inevitably cease to exist. The many rules and expectations confronting corporations, along with the relationships must be understood and managed. It has been identified that both conformance and performance are central components of corporate governance. Both aspects of corporate governance must be satisfied so that diverse international societies achieve effective utilization of the capital resources employed in their enterprises. The United Kingdom is one of the world's most important investment locations. This is due to the fact that their corporate governance practices was deemed to be the best practice which other nations like New Zealand and Australia were willing to follow and incorporate it to their governance practice. The rules relating to investment in and through the London Stock Exchange have provided leading-edge practical approaches that have been followed successfully in many jurisdictions. Without vigilance, good governance is often forgotten in strong economic times, only to be remembered when financial trouble arises.

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