The Role of Corporate Governance in Fraud Reduction - A Perception Study in the Saudi Arabia Business Environment

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The purpose of this study is to investigate the perceived role of corporate governance in reducing the level of fraud. It examines three major components of corporate governance (internal audit, internal control, and external audit). A survey of 160 executives yielding a response rate of 43.8% was used. The main findings of regression analysis indicate that among the three corporate governance components, internal audit is perceived as the most significant in reducing fraud level. The in-depth investigation of the components' dimensions (existence, implementation, and effectiveness) indicates that the effectiveness dimension is the most significant in reducing the fraud level.

INTRODUCTION

The incidence of financial fraud is increasing and has been a central feature in a number of financial scandals in recent years (Bunget, 2009). In spite of the fact that the cost of fraud is difficult to estimate because not all fraud is discovered and not all uncovered fraud is reported (Farrell and Franco, 1999), different endeavors have been made to estimate fraud. For example, it has been estimated that six percent of US companies' revenue in 2002 was lost through fraud committed by employees (Holtfreter, 2004) and of the 491 Australian and New Zealand companies who responded to the KPMG survey in 2004, almost half had experienced a fraud costing them $457 million (KPMG, 2004). Therefore, the entire business community has become more aware of the threat of fraud and the need to be vigilant when searching for instances of fraud following the well publicized corporate collapses earlier last decade (Coram et al., 2008).

On the other hand, the importance of good corporate governance has received significant public and regulatory attention and attracted the attention of scholars on a broad scale over the last three decades, even though these issues have long existed (Okpara, 2011). In connection with the responsibility for the prevention and detection of fraud, the International Auditing and Assurance Standards Board (IAASB) of the International Federation of Accountants (IFAC) (2009) makes it clear in the International Standard on Auditing (ISA 240) that the primary responsibility rests with those charged with governance of the entity and with management. Staciokas and Rupsys (2005) identified the elements of corporate governance to include the audit committee, external auditor, internal audit, and the Board of Directors. To secure the operations of governance of a strong company, there must be cooperation between the various components of the system of governance, internal auditors, executive management, financial management, board of directors, shareholders and external auditors (ECIIA, 2005). The statement of ECIIA (2005) holds the elements in the governance system to be responsible for the smooth functioning of business.

The aim of this study is to investigate the role of corporate governance in reducing the level of fraud. Perceptions of a conveniently selected sample of top level officials working in the audit and finance area of corporate environment in Saudi Arabia are used for this purpose. To achieve this aim, I extend prior research by examining whether different types of financial control (internal audit, internal control, and external audit), which according to previous literature form an integral part of corporate governance, have different impact on the level of fraud. In particular I classify each of the three components of corporate governance under study into existence, implementation, and effectiveness. This research work is important because for the first time, it examines the role of the three components from different dimensions (existence, implementation, and effectiveness) independently and jointly in reducing the perceived level of fraud so as to determine the significance of each component and each dimension within these components in this process.

The remainder of this paper is organized as follows: Section II provides an overview of corporate governance literature related to internal audit, internal control, and external audit and their role in fraud detection and prevention. The empirical model and data used in this investigation are outlined in Section III, followed by presentation of the results and interpretation in Section IV, while Section V concludes.

LITERATURE REVIEW

The corporate governance literature has identified three components as monitoring mechanisms to ensure good corporate governance. These are: the directorships, internal auditing, and external auditing (Anderson et., al, 1993). The Institute of Internal Auditors (IIA) added a fourth component– the audit committee (IIA, 2003). When we talk about internal audit, we should remember that it is one of the two important tools of internal controls system, while internal checks are the other tool (IIA, 2009). The importance of an effective system of internal control in securing responsible corporate governance was recognized by the Cadbury Committee in 1992. In its Report, CFACG notes that: "an effective internal control system is an essential part of the efficient management of a company", and it recommended that directors report, in their company's annual report, on the effectiveness of their company's system of internal control and that auditors report on the directors' statement (CFACG, 1992, p.27).

Internal checks, according to Coram et al. (2008) are those routine day to day administrative controls which ensure that the work of one person is complementary to that of another person, thus, the work of one person is independently proved by that of another person in the normal course of work. Therefore, no single person or group of persons would carry out a transaction from origination to completion without the involvement of others (Tunji, 2013). Stringer and Carey (2002) indicate that many of the traditional accounting controls (e.g. multiple layers of authorization, crosschecking, supervision, and segregation) are of diminished importance for effective control. An important reason for this diminishing importance is the link between organizational structure, culture and internal control design (see also Bell et al., 1997). New management techniques and organizational restructuring necessitate employee empowerment that requires a change in control culture and design. For example, it is inconsistent to empower staff to make decisions, and require them to obtain prior authorization (Stringer and Carey, 2002).

The second tool of internal control is the internal audit function which was traditionally designed to safeguard firm's assets and assist in the production of reliable accounting information for decision-making purposes (Ibrahim El- Sayed Ebaid, 2011). Nowadays, the role of internal audit has been dramatically changed. Several studies indicated that the role of internal audit in governance must take precedence over other internal audit activities, see (Audrey et al., 2004; Cohen et al., 2004; Prawitt et al., 2009). According to Okafor & Ibadin (2009) the internal audit exercise plays a critical role in improving corporate governance in organizations.

"Internal auditing has evolved into a highly professional activity that extends to the appraisal of the efficiency and effectiveness of all phases of a company's operations, both financial and non-financial. These changes have led to the formation of internal audit departments" (Zarkasyi, 2006), "and became one of the important units in the most modern [businesses] in the world" (Sharairi, 2011). "One of the strongest means to monitor financial reporting, ethics, and governance is the internal audit groups in corporations" (Bariff, 2003).

According to IIA, the objective of internal audit is to have "an independent, objective assurance and consulting activity designed to add value and improve an organization's operations… to evaluate and improve the effectiveness of risk management, control and governance process" (IIA 1999). In addition to improving the organization's operations, which is the aim of corporate governance, this definition, emphasizes the importance of evaluating and improving risk management and control (Coram et al., 2008).

On the basis of the above definition, it is obvious that the internal audit function is a crucial part of an entity's corporate governance (Coram et al., 2008). Internal audit is likely to add value through improving the control and monitoring environment within organizations to detect fraud. Due to the increasing sophistication of fraudsters which creates difficult problems for management and auditors (Bunget, 2009), there is a high need for a positive interaction between the internal audit and other components of corporate governance to operate as a synergy that works effectively towards reducing the level of fraudulent actions.

The third component that this study intends to investigate its role in fraud reduction is external audit. External auditors focused their attention on their auditees' financial information. This remains their primary area of concern but, during the past couple of decades, their responsibilities – as embodied in auditing standards – have been made more explicit and exacting. This applies, for example, in respect of assessing and reporting on auditees' status as going concerns, and detecting and reporting corporate fraud and other illegal acts (Porter, 2009).

External auditors are required by Generally Accepted Auditing Standards to form a judgment as to the level of professional skepticism to be exercised in a particular client setting and to assess the level of control risk as a facet of the audit-planning process (Wallace and Kreutzfeldt, 1991). The Statements on Auditing Standard No. 99 (SAS 99) assigns the external auditors with final responsibility for the audit to determine whether there has been appropriate communication among team members throughout the engagement about the risks of material misstatement due to fraud (Ramos, 2003). International Standard on Auditing (ISA) 240 requires external auditors to exercise their professional judgment and assess whether the risk of material misstatement of financial statement due to fraud exists (Moyes et al. 2009).

Turning to the main issue of this study, fraud is a costly problem for organizations (Burnaby et al., 2009), which affects companies of all sizes and occurs in a variety of industries (Beasley et al., 2010). Traditionally, each business is always susceptible to internal fraud from its management and non-management employees (Phua et al., 2010). According to ISA 240 fraud is defined as "an intentional act by one or more individuals among management, those charged with governance, employees or third parties, involving the use of deception to obtain an unjust or illegal advantage". Organizations that discover fraud, including embezzlement, asset misappropriation, and manipulation of financial statements are usually surprised that the incident occurred and the auditors failed to uncover it (Alleyne and Howard, 2005; O'Reilly-Allen, 2009). The empirical literature of fraud detection and prevention shows mixed results in relating fraudulent actions to poor corporate governance (Beasley et al. 2010; Cohen et al. 2004; He et al. 2009; Nieschwietz et al. 2000). As pointed out by Bozec and Bozec (2012), most studies only investigate characteristics of corporate governance components one at a time. Therefore, this study will try to investigate the impact of three components of corporate governance jointly and separately on the level of fraud as perceived by the respondents.

Abbott et al. (2012) argued that internal audit departments have a critical role in fraud prevention and play the most important role in uncovering or limiting asset misappropriation and corruption schemes. Herdman (2002) added that effective internal auditing is "crucial to the success of a company in stemming fraud and abuse, and in the preparation of accurate financial statements."

In a study aimed to assess whether organizations that have internal audit functions are more likely to detect fraud Coram et al. (2008) used a unique self reported measure of fraud primarily relating to misappropriation of assets and found that organizations with an internal audit function were more likely than those without such a function to detect fraud. Furthermore, the study found that organizations relied only on outsourcing for their internal audit function were less likely to detect fraud than those that undertake at least part of their internal audit function themselves. The finding of Coram et al. (2008) is interesting as it puts outsourcing in a different perspective from prior studies. For example, Lowe et al. (1999) and James (2003) found that financial statement users do not perceive a difference between internal audit insourcing and outsourcing. Carey et al., (2006) found that companies that outsource believe that an external provider is technically more competent.

One significant limitation of Coram et al. (2008) is that internal audit may be associated with organizations with good governance, internal control, and external audit. Therefore these other factors may play a significant role in fraud detection and prevention rather than internal audit as a standalone mechanism. In the present study this issue will be addressed by introducing all the three governance components in the model to trace their effects on fraud reduction.

Goodwin and Kent (2004) found the existence of internal auditing to be positively associated with firm size, asset composition, the presence of an independent board chair, and presence of an audit committee. This study provides some evidence that firms with good corporate governance are more likely to have an internal audit function. But one limitation of this study is that it merely sets out to predict the existence of internal audit and did not try to investigate the implementation and effectiveness of the internal audit which I argue to be the determinants of the quality of internal audit and its ability to reduce fraud.

The study of Tunji (2013) aimed to investigate the role of the existence and effectiveness of internal control system on fraud elimination and the accuracy and reliability of records in Nigerian banks. The study concluded that only the existence of effective internal system has a positive effect on fraud reduction. Finally, Josiah et al. (2012) found that there is a significant relationship between fraud detection and audit of financial statements. In the organizations surveyed, there have been cases of fraud due to poor management, lack of internal auditors, and inefficient control system.

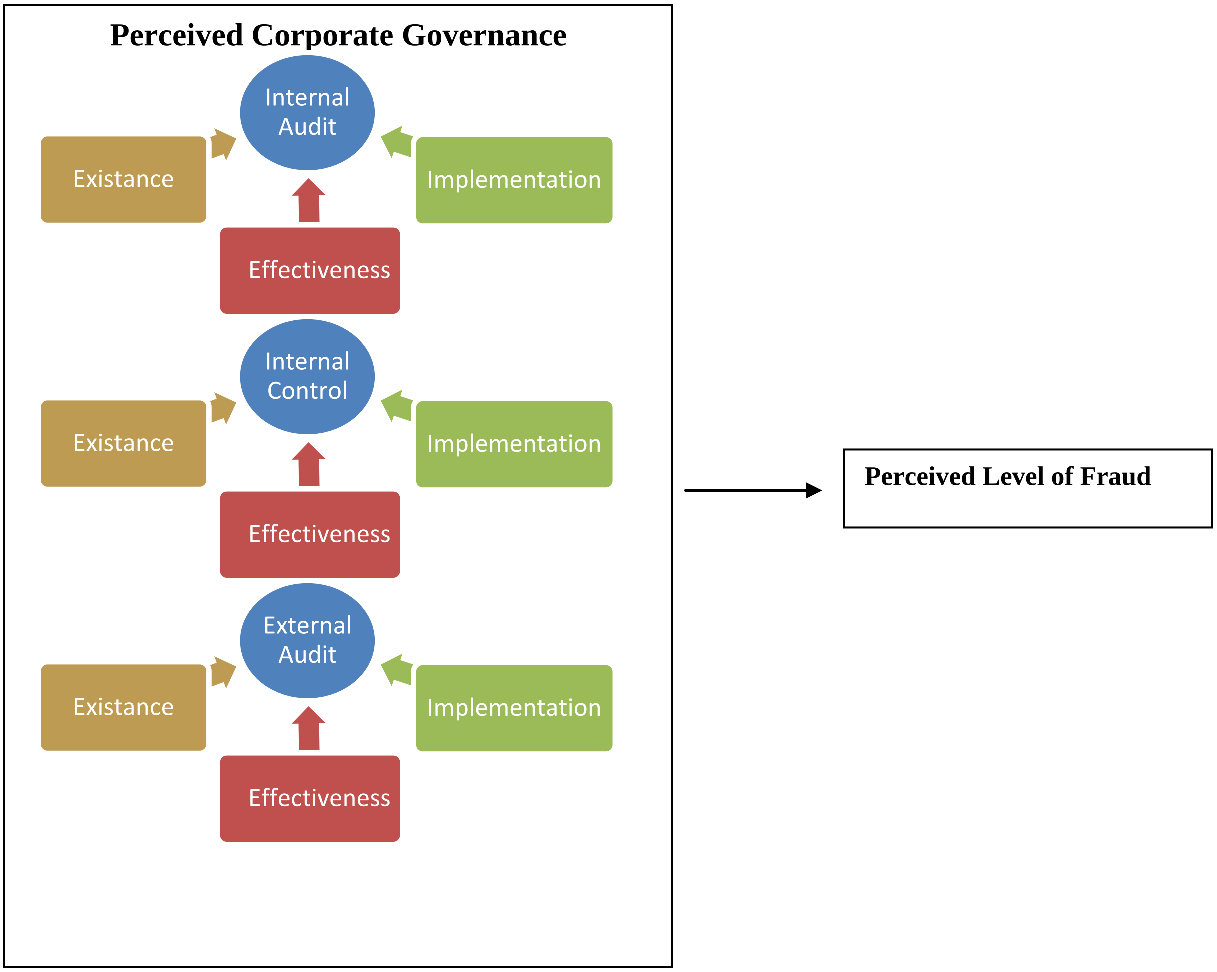
RESEARCH METHODOLOGY AND DATA

This section explains the research methodology employed, the sample selection and model development process. It also describes the dependent and independent variables of the model.

The study investigates the extent to which selected corporate governance components influence the level of fraud in business environment within the Saudi Arabia. Based on the above section of literature review, three governance components are identified to be used as independent variables. These variables are: the internal audit, internal control (internal checks), and the external audit. For each of these variables three dimensions are identified, i.e existence, implementation, and effectiveness. It is expected that the perceived level of these variables will influence the perceived level of fraud. Therefore, the perceived level of fraud is treated as the dependent variable.

Drawing on corporate governance and audit literature, a number of statements were developed to measure each of the above mentioned dimensions for each component. For example, statements like “the existence of an audit department in the organizational structure”, “the availability of sufficient staff in the internal audit department”, and “the availability of internal audit standards, rules and regulations”, are used to address the issue of the existence of internal audit. Statements like “internal auditors have sufficient authority”, “independence of internal auditors”, and “corrective actions are taken on the basis of internal audit reports” are used to measure the perceived effectiveness of internal audit. These are just examples to clarify how the research survey -self-administered questionnaire- was developed. Figure 1 below represents the model which will be examined and investigated.

FIGURE 1
THE RESEARCH MODEL



The questionnaire design followed likert scale of five points. The questionnaire comprised four sections; section one includes nine statements on the existence of all the three components of corporate governance, section two and three; implementation and effectiveness of these components include 12 statements each, while section four includes six statements measuring the perceived level of fraud. The sample included 40 organizations listed in the Saudi security market. Using convenience sampling methodology, the questionnaire was mailed to 160 respondents at the rate of four respondents at senior management level from each company. The total number of replies was 70, yielding a 43.8% response rate. Data from the 73 replies were coded into an SPSS for Windows data sheet. The questionnaire was tested for reliability using Cronbach's alpha coefficient. The test result showed that the questionnaire is satisfactorily reliable as the reliability coefficient α was more than 75% for the entire questionnaire's sections.

To test the impact of the independent variables on the dependent variable, simple and multiple regression techniques are employed. To have a deep insight of the impact of the three governance components and their identified dimensions on the perceived fraud level, various regression scenarios were performed.

RESULTS AND DISCUSSION

The mean and standard deviation for the dependent variable and the three predictor variables are presented in Table 1. The mean value of the dependent variable is moderate, while the mean values of the predictors range from low to high. The existence of all corporate governance components as perceived by the respondents is high while the implementation is moderate except for the internal audit which is low. Interestingly, the effectiveness is perceived as low, and the lowest value is that of the effectiveness of internal audit.

The overall rating of corporate governance components indicates that internal audit is perceived as low while internal control and external audit are moderate.

TABLE 1
DESCRIPTIVE STATISTICS OF VARIABLES

Variable	Mean	Std. Deviation
Fraud Level (dependent variable)	3.3833	.49986
Existence - Internal Audit	4.3904	.50858
Existence - Internal Control	4.4338	.45026
Existence - External Audit	4.3750	.49469
Implementation - Internal Audit	2.5445	.73520
Implementation - Internal Control	3.3253	.49245
Implementation - External Audit	3.7397	.45558
Effectiveness - Internal Audit	2.2767	.83309
Effectiveness - Internal Control	2.9167	.56985
Effectiveness - External Audit	2.7854	.53969
Overall Internal Audit	2.7584	.63658
Overall Internal Control	3.5361	.37277
Overall External Audit	3.5347	.31694

Simple and multiple regressions were performed to detect the impact of the three corporate governance components on the level of fraud in the Saudi business environment. Table 2 presents the results of three simple regressions for each of the independent variables and the results of a multiple regression for all the three variables entered into the equation simultaneously.

When entered independently, the coefficients of all the three components (regressions 1 to 3) are showing the expected sign and all are statistically significant at 1% level. Though the coefficient of internal audit as an independent variable in regression one has the lowest value compared to the coefficients of internal control and external audit in regressions two and three, it has the highest R square and F statistics values indicating that this model is the most significant model.

When all the three governance components are entered into the regression equation simultaneously in regression 4, only the coefficient of internal audit remains significant at 1% level while the coefficients of the other two components have become insignificant.

TABLE 2
REGRESSION ANALYSIS OF THE THREE OVERALL GOVERNANCE COMPONENTS

Regression	**1**	**2**	**3**	**4**
Constant	5.185** (.156)	6.335** (.446)	6.430** (.571)	4.975** (.462)
Internal audit	-.658** (.055)	-	-	-.688** (.093)
Internal control	-	-.835** (.125)	-	-.037 (.171)
External audit	-	-	-.865** (.161)	.045 (.176)
F Statistics	140.430**	44.308**	28.808**	44.960**
R Square	.667	.388	.295	.668
Adjusted R Square	.663	.379	.284	.653
Durbin-Watson	2.062	2.122	2.270	2.031

Dependent variable: Perceived fraud level, * Significance at the 5 percent level, ** Significance at the 1 percent level, Standard errors reported in parenthesis.

To have a deeper insight of the impact of corporate governance components on the perceived level of fraud, table 3 presents regression analysis of the three dimensions of each component. Regressions one to three presents the effect of each component's dimensions independently. In all the three regressions, effectiveness is the only dimension that appears with a significant coefficient.

Regression four in table 3 presents the results when the effectiveness dimension of all the three components is interned in the regression equation. Results clearly indicate that two of the effectiveness coefficients; internal audit and internal control are significant while the coefficient of external audit is insignificant. The internal audit is significant at 1% level while it is at 5% level for internal control, which means that the impact of internal audit effectiveness is stronger in reducing the level of fraud.

Finally, regression five of table 3 shows the results of regressing the overall existence, implementation, and effectiveness of corporate governance. Again, the results emphasize that the only significant coefficient is the effectiveness dimension of the corporate governance.

TABLE 3
REGRESSION ANALYSIS OF GOVERNANCE COMPONENTS' DIMENSIONS

Regression		**1**	**2**	**3**	**4**	**5**
Constant		4.844** (.349)	5.407** (.435)	5.653** (.579)	4.925** (.241)	5.460** (.388)
Internal audit	Existence	-.103 (.067)	-			
	Implementation	-.053 (.082)	-			
	Effectiveness	-.528** (.050)	-		-.362** (.104)	
Internal control	Existence		-.030 (.086)			
	Implementation		.041 (.093)			
	Effectiveness		-.694** (.082)		-.231* (.115)	
External audit	Existence			-.119 (.093)		
	Implementation			-.019 (.102)		
	Effectiveness			-.609** (.086)	.020 (.095)	
Corporate Governance	Existence					-.108 (.082)
	Implementation					.052 (.116)
	Effectiveness					-.687** (.086)
F Statistics		48.961**	33.906**	18.023**	50.758**	49.593**
R Square		.684	.599	.447	.691	.689
Adjusted R Square		.670	.582	.422	.678	.676
Durbin-Watson		2.006	1.835	2.031	1.811	1.869

Dependent variable: Perceived fraud level, * Significance at the 5 percent level, ** Significance at the 1 percent level, Standard errors reported in parenthesis.

CONCLUSION

In this paper I have examined the impact of three corporate governance components on the level of fraud as perceived by the users of accounting and financial information in Saudi business environment. The perception of each of the corporate governance components was measured in terms of its existence, implementation, and effectiveness. The descriptive statistics revealed that the existence of all the three components is high while their effectiveness is perceived as low, and the implementation is low for internal audit and moderate for internal control and external audit. The level of fraud is perceived as moderate.

The regression analysis emphasized the significance of corporate governance components in reducing the level of fraud. Internal audit plays the major role in reducing the level of fraud. When analyzing the impact of existence, implementation and effectiveness of these components, the results clearly indicated that mere existence and implementation of corporate governance are not enough to reduce the perceived level of fraud. It is only when there is an effective set up of these components; the fraud level can be reduced.

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