# Chapter 1
# Corporate Governance as a Tool for Fraud Mitigation

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## ABSTRACT

*Financial fraud through the falsification of financial statements is an evident problem. The restatement is enormous, and there have been developed many approaches to confront it. Profits manipulation has reached alarming proportions worldwide. The tendency of management to present a misleading image based on accounting weaknesses and gaps, to present accounting results as it wishes and not as it should according to the accounting standards, is essentially a key feature of profit manipulation. The executives' motives to falsify financial results and creative accounting practices have concerned researchers and their efforts to identify the necessary changes and improvements in accounting systems to protect the stakeholders and the public from misleading information.*

## 1. CORPORATE GOVERNANCE MECHANISM

Since 1970 Friedman defined corporate governance (CG) as the firm managements' effort to meet owners or shareholders expectations, considering basic social rules, legal requirements, and native customs. Elkington (1998), through its theory of "Triple Bottom Line", highlights three key concepts that are at the heart of the activities, which the firms should develop to ensure their viability. These are the profits

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in the sense of the financial benefits that the company creates for society, the people by meaning the human resources and the society where the business operates, and finally the planet (known as the 3Ps). The company has to grow its activity by taking into account environmental protection at the same time. Also, firms should maintain sustainability and operate in a social responsibility context. As Hemingway and Maclagan (2004), argued even if firms do not work toward this direction, eventually, market demands will lead them to adopt practices to improve their social and environmental efficiency while at the same time being financially efficient.

Bibliography had suggested five elements of CG which unable firms to confront financial hazards:

1. Firm's Culture, meaning the values, beliefs, concepts, and ways to act that an organization's members adopt and use in everyday procedures. Each organization is a smaller group of people who interact with each other. Being such, it develops a culture framework that represents itself. A firm that criticizes unethical behavior phenomena, or illicit internal competition, promotes feelings of security and trust among its internal environment and set boundaries. All these principles shape firm's image also the external environment.
2. Leadership, referring to the management. Management defines the requirements of the employee's ethical behavior and promotes education on matters of corporate ethics. Managers on higher levels may acknowledge and reward the employees who support firm's values and operate in that framework. On the other hand, top management sets the example and represents the organizational culture.
3. Co-operation among firms subgroups. Risk management, internal and external control, and guidelines compliance could be proven extremely difficult if not regulated by a system that organizes and sets goal priorities on the various departments to avoid conflicts of interest. Managers are necessary to pay attention to the internal cooperation and orientation of responsibilities.
4. Operational Systems developed to address organization needs. They need to be designed to support the firm's operations and be evaluated in regular intervals to support decision-making and strategic planning. The appliance of operational systems ensures information credibility when combined with control procedures providing constant data feed.
5. Organizational structure is the fundamental element for effective CG. When significant changes in internal and external environments occur, firm's structure should be revised and redesigned to ensure that firm does not divert out of its objectives. The organizational change mainly refers to human resources, operations, and technological issues. Top management needs to take vast decisions in such cases in order to be adjusted to the competition.

Foerster and Huen (2004) supported the idea that CG shareholders try to ensure that managers achieve satisfying returns on their invested capital. Corporate governance confronts the agency problem, which refers to the shareholders' need for assurance for their investment (Shleifer & Vishny, 1997). The Agents-managers are the third parties, assigned to act in the best interests of the owners' (Jensen & Meckling, 1979). There are conflicts of interests between principals-owners and agents; the phenomenon of information asymmetry occurs. CG guidelines have been promoted, among other tools, in order for the firms to provide essential and reliable information to the external parts of interest. The most common of them involve financial reposting. Most companies have adopted and customized these guidelines to suit their needs. It is commonly believed that firms in compliance with existing CG rules are positively evaluated by the markets and investors (La Porta, Lopez-de-Silanes, Shleifer, & Vishny, 2000).

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