



The Role of Financial Audit in the Corporate Governance Process: An In-depth Analysis

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ABSTRACT

Fraud presents a substantial risk to the overall financial integrity of the global corporate environment. This empirical study investigates practical approaches for firms to strengthen their defenses against fraud, with a focus on improving internal controls, optimizing internal audits, and implementing effective corporate governance. Fraud, which involves compromising the accuracy of financial information, poses dangers that go beyond financial losses. It also affects stakeholder trust and market confidence. Therefore, it is important for company executives, auditors, and policymakers to proactively identify and mitigate these risks. The combination of internal controls, internal audits, and corporate governance plays a crucial role in combating fraud. Internal controls provide the basic principles of financial practices, internal audits closely examine transactions, and effective company governance promotes ethical behavior, resulting in a strong framework for preventing fraud. Based on an extensive examination of existing literature, this study offers practical observations that enable businesses to identify, tackle, and prohibit fraudulent activities. Practical suggestions can help manage the relationship between internal controls, internal audits, and corporate governance. These suggestions can improve audit procedures, enhance transparency, and strengthen the reliability of financial reporting.

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1. Introduction

In the contemporary business landscape, the persistent threat of fraud poses a significant challenge to the financial integrity and sustainability of organizations worldwide (Kassem, 2022). Business sustainability represents a major factor in current times (Dima et al., 2023). As financial markets evolve and organizations navigate complex economic landscapes, the imperative to safeguard against fraudulent activities becomes increasingly crucial (Nicholls et al., 2021). This empirical research aims to contribute to the existing body of knowledge by examining practical strategies for organizations to strengthen their defences against fraud through the enhancement of internal controls, optimization of internal audits, and the fostering of effective corporate governance practices.

Fraud, encompassing various forms of deceptive practices that compromise the accuracy and reliability of financial information, poses a substantial risk to organizational well-being (Kleinman et al., 2020). The adverse consequences of fraudulent activities extend beyond financial losses, impacting stakeholder trust, organizational reputation, and overall market confidence (Gatzert, 2015). As such, the proactive identification and mitigation of fraud risks have become central concerns for corporate leaders, auditors, and policymakers alike.

The triad of internal controls, internal audits, and corporate governance emerges as a critical nexus in the organizational battle against fraud. Internal controls establish the foundation for sound financial practices by delineating processes that mitigate the risk of fraudulent activities (Rae & Subramaniam, 2008). Concurrently, internal audits play a pivotal role in scrutinizing financial transactions, ensuring compliance with established controls, and providing an independent assessment of the accuracy of financial information (Alzaban, 2019). Complementing these, effective corporate governance practices instil ethical conduct, transparency, and accountability, creating a robust framework for fraud prevention.

This research aims to offer empirical insights derived from a comprehensive analysis of existing literature. The overarching goal is to equip organizations with actionable strategies that not only detect and address instances of fraud but also cultivate a resilient organizational environment that discourages fraudulent behaviour. The research unfolds a series of practical recommendations designed to navigate the intricate interplay between internal controls, internal audits, and corporate governance. Through this exploration, this

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research seeks to provide a comprehensive understanding of fraud indicators in financial audits, emphasizing the importance of internal controls, professional scepticism, and corporate governance. The findings aim to contribute to the refinement of audit practices, promoting transparency, and fortifying the reliability of financial reporting.

2. Methodology

A comprehensive review of academic literature on fraud detection, internal auditing, corporate governance, and financial reporting was conducted to understand the theoretical foundations and current practices in the field. Data pertaining to indicators of fraud, internal control systems, corporate governance practices, and financial reporting were collected from academic sources, regulatory bodies, and industry reports. The collected data were analysed to identify common indicators of fraud, the role of internal auditors, and the significance of effective corporate governance in mitigating fraudulent activities.

The primary objectives of this research are as follows:

- **To identify indicators of fraud:** The primary objective of this research is to identify common indicators of fraud in financial reporting, internal control systems, and corporate governance practices.
- **To evaluate the role of internal auditors:** Another objective is to evaluate the effectiveness of internal auditors in detecting fraudulent activities and enhancing the integrity of financial reporting processes.
- **To provide practical recommendations:** Based on the findings, the research aims to provide practical recommendations for organizations to strengthen their internal control systems, improve the effectiveness of internal audit functions, and enhance corporate governance practices to mitigate the risk of fraud.
- **To contribute to academic literature:** Lastly, this research seeks to contribute to the existing body of academic literature on fraud detection, internal auditing, and corporate governance by offering new insights, empirical evidence, and practical implications for researchers, practitioners, and policymakers in the field.

3. Literature review

According to Weirich et al. (2020), auditing entails the systematic analysis of information in accordance with particular criteria or quality standards with the goal of delivering a well-reasoned, accountable, and unbiased judgment. This scholarly examination of financial auditing accentuates its significance in the evaluative process of financial statements within a defined reporting framework. The audit, whether internal or external, plays a pivotal role in fostering a transparent and accountable financial environment.

Financial auditing is characterized by the expert evaluation of financial statements to ascertain their accuracy and comprehensiveness in representing the entity across all significant dimensions (Horomnea & Tanasă, 2015). Internal audits involve the scrutiny of financial-accounting activities within a business through the application of internal control mechanisms. Conversely, external audits are conducted by auditors external to the entity's personnel structure, contributing to an impartial and objective assessment.

The imperative role undertaken by financial auditors significantly contributes to cultivating a high-performance business environment (Aldamen et al., 2012). Auditing not only enhances the credibility and financial stability of a firm but also serves to uphold principles of fair employment and compensation. The assertion regarding the importance of established and adhered-to formal rules, recognized and agreed upon by all stakeholders and users of audited financial statements, aligns with the findings of Aridaha et al. (2021). Rigorous business planning and the identification of areas of risk emerge as critical components in ensuring the quality of audits.

As highlighted by Kumar and Sharma (2015), shareholders frequently advocate for the implementation of regular audits and inspections as a means to augment the accuracy and reliability of financial reports. The demand for accurate financial information is justifiable, given its pivotal role as a valuable decision-making tool, providing insights into investment risk. This multifaceted understanding of financial auditing underscores its integral role in contemporary business practices, emphasizing the need for adherence to formal standards and proactive risk management to ensure the efficacy of the audit process.

3.1. A Concise historical overview of auditing practices

The audit activity originated with the emergence of accounting as a means to safeguard the assets of organizations. This was first driven by the need to examine and verify financial accounts. As per Anglo-Saxon convention, auditing refers to the examination of financial records by impartial professionals and the issuance of a judgment regarding their accuracy in terms of adherence to rules and integrity (Cassel, 2014).

The primary goal of the audit activity is to enhance the quality and reliability of the information, hence improving its accuracy. Some of the key characteristics of an audit, as stated by Bepari (2023), are:

- the professional nature of information analysis;
- expressing an independent and responsible opinion;
- compliance with professional norms, rules, and regulations.

The emergence of capital markets has led to an increased demand for ensuring the fairness and compliance of financial accounts (Francis et al., 2003). Between 1970 and 1990, considerable focus was placed on

controlling internal control activity and its quality, with full attention to accounting and auditing requirements. Currently, the primary objective of audit work is to establish a judgment on the accurate and unbiased representation of financial accounts and the prevention of fraudulent activities, both at a national and global level.

The emergence of significant financial scandals resulting from the manipulation of economic facts has prompted a heightened call for the establishment of a comprehensive set of auditing protocols and standards (Toms, 2019). As producers of accounting information demonstrate a certain degree of subjectivity in the procedures carried out, a conflict of interest occurs between them and the users of the reported information. Competent and highly trained experts known as auditors are responsible for resolving this issue. In order to attain exemplary levels of performance, their job must be founded upon a structured framework of norms and regulations.

3.2. Principles and attributes of financial audit activity

The financial audit is conducted in strict adherence to prevailing regulations, fostering confidence among investors and stakeholders (Siddiqui, 2010). Throughout the fiscal year, the financial auditor is tasked with verifying the compliance of accounting records with internal conceptual and procedural standards (Power, 1997). Additionally, the auditor must ensure that the financial statements present a fair and accurate depiction of the resources under the company's control throughout the fiscal period. Specific procedures, aligned with principles of due diligence, regularity, and financial honesty, govern the routine collection and processing of data.

The principle of prudence, considered foundational in accounting (Barker, 2015), prohibits understating assets, revenues, expenses, and liabilities. Consequently, estimates made under uncertainty employ accounting judgment with a measure of caution, precluding the creation of excessive reserves and provisions to prevent an artificial inflation of the entity's debt and expenses.

The audit report, a central element in the audit process, encapsulates the auditor's opinions on the alignment of financial statements with legal regulations and their ability to provide an accurate representation of the entity (Cohen et al., 2020). It serves as a means to convey and affirm the confidence of all users while elucidating the respective responsibilities of the auditor and the entity's management concerning the reported information. The report, adhering to objectives of objectivity, conciseness, completeness, and clarity, is designed for comprehensibility by investors and stakeholders.

3.3. Fraudulent activities and errors identified through the financial audit process

The financial challenges that precipitated the last global crisis and the current instability and inflation, characterized by the instability of US credit banks, financial market illiquidity, and the collapses of several major corporations, underscore the critical importance of robust corporate governance, effective risk management, and the prevention of fraud in financial reporting. The artificially generated wealth in the stock market contributed to global economic imbalances, eroding stakeholder trust due to instances of fraudulent financial reporting or auditor errors (Omar et al., 2017).

To bolster stakeholder confidence in auditing practices, ethical conduct, professionalism, and proactive anti-fraud measures are imperative. However, management training and cultivating a corporate culture constitute indispensable facets of effective corporate governance.

Within a corporate context, fraud is defined as a deliberate act perpetrated by individuals responsible for governance, entity management, or third parties, involving deception to secure illicit gains (Rashid et al., 2022). Conflicts can arise at all organizational levels, from management to staff members, resulting not only in financial losses but also impacting productivity, reputation, and relationships with stakeholders. Victims of fraud experience multifaceted repercussions, including loss of self-confidence, feelings of insecurity, and strained social relationships (Weiss, 2021). Perpetrators of fraud exploit specific aspects of internal control, with managerial access to sensitive information increasing the likelihood of fraudulent activities (Weiss, 2021). Corporate governance extends beyond regulatory compliance, necessitating a unified vision of company strategies, consideration of stakeholder interests, and the implementation of effective internal control.

The board of directors bears the responsibility of ensuring proper risk management, ethical practices, and oversight of corporate governance. Board members must foster moral behaviour, establish effective control policies, and grapple with voluminous and often ambiguous information about company risks (Klettner et al., 2014). Internal auditors play a pivotal role in organizing this information objectively and responsibly, necessitating auditor autonomy in both corporate governance and entity risk management. Demonstrating professional competence, assessing the likelihood of fraudulent financial presentations, and verifying the efficacy of company controls are integral responsibilities of internal auditors (Zeng et al., 2021).

The auditor, recognizing the potential for fraud at all organizational levels, including management, must address all three phases of fraud manifestation to mitigate risks. Internal control assumes a crucial role in this context, with three premises for fraudulent activity: pressure to engage in fraud, the likelihood of going undetected due to inadequate management, insufficient internal control, easy access to sensitive data, and

having an authoritative position that allows circumvention of internal control; and a motive for committing fraud, such as financial needs, loan repayment, medical expenses, or substance dependency (Emmanuel et al., 1990).

As internal auditors endeavour to grasp various scenarios and the economic landscape (Lister, 2007), studies such as Trifu et al.'s (2015) provide valuable perspectives on the complex factors influencing business operations. To prevent and detect fraud, the internal auditor must possess comprehensive knowledge of various scenarios (Lister, 2007). The audit committee should acquire a thorough understanding of information flows within the entity and a comprehensive overview of the economic environment in which the company operates. For example: studies of consumer interactions (Holtfreter et al., 2005; Gîrneală & Dobrin, 2015) could serve as valuable resources for internal auditors aiming to grasp the multifaceted landscape of online transactions. Shareholders, often lacking the time or expertise to audit managerial work, require accurate information on financial results and the portion of entity revenues distributed to executive managers. Shareholders seek insights into how executives contribute to the company's profitability and effective risk management. Director rewards and incentives should be directly tied to performance and their adept management of entity risks, thereby enhancing capital value through their decisions.

The collaborative efforts of auditors and audit committees play a crucial role in this context. Significant audit issues may include the disclosure of unusual transactions, suspicious changes in customer or supplier lists, difficulties in obtaining information, or the unavailability of key individuals in the control system. Management utilizes professional expertise and creativity to make optimal decisions, achieve superior financial results, and maintain high competitiveness. However, the pursuit of reporting enhanced performance can inadvertently foster complex and challenging-to-detect fraudulent activities under current conditions (Faccia et al., 2023). The risk of fraud is heightened during crises and economic instability, necessitating internal control to monitor financial-accounting activity and identify potential risks of errors and fraudulent activities. Organizations need to align pricing strategies with overarching financial goals, offering valuable perspectives for effective financial management (Deac et al., 2016).

The going concern principle holds paramount importance in financial statement preparation (Seyam & Brickman, 2016). The fair value concept, amidst market volatility, is currently a subject of widespread debate (Toluwa & Power, 2019). Determining fair value relies on the going concern assumption, which exhibits a high degree of uncertainty in a dynamic market environment. Various factors at the company level, such as short-term borrowings, overfunding of long-term assets, strained relationships with lenders, and capital providers, can cast uncertainty on the entity's future activity. Auditors, in such circumstances, must meticulously examine assumptions about the entity's ability to continue as a going concern, substantiating this assumption with sufficient audit evidence.

In an attempt to alleviate business bottlenecks due to liquidity shortages or the inability to secure external financing, there is a high risk of cosmeticizing financial information. Reporting non-performing economic indicators may restrict access to credit, and external factors like new competitors, market demand shifts, or industry difficulties can trigger chain reactions affecting multiple companies. Major investments without careful consideration of long-term effects can create business bottlenecks or disruptions. The continuity premise must consider all existing or potential risks.

The current crisis context and the dynamics of global markets exert pressure on current and future business. Managers must navigate downsizing effects and simultaneously seek avenues for business growth. The success of their endeavours hinges on their ability to identify and capitalize on existing opportunities while restructuring the business accordingly.

In an adverse economic environment, fraudulent reporting becomes more susceptible. Internal control, spanning all organizational levels and overseeing personnel and information technology, assumes a critical role in identifying such phenomena.

Financial statements must encompass comprehensive details about the entity while maintaining accuracy and relevance to avoid misleading users. Professional scepticism in audit engagements necessitates the validation of information from the financial accounting department through cross-referencing with other sources, thereby enhancing credibility and mitigating the risk of fraud. Inaccurate or insufficient information compromises the auditor's opinion, diminishing its reflective accuracy and credibility. Auditors, through their work, can contribute to effective risk management, fostering confidence, and enhancing client relations. However, concerns arise when auditors engage in activities beyond auditing, potentially undermining their independence.

Fraudulent reporting may arise from pressure to comply with contractual clauses for funding or renewing contracts. The intricacies of banking transactions, subjective estimates of assets and liabilities, and shareholder disputes can create an environment conducive to fraud. In times of crisis, liquidity becomes a critical concern for all economic entities, necessitating careful liquidity management as banks reduce activity and tighten financing conditions.

Companies endowed with higher liquidity gain a competitive advantage in the market. Adopting international accounting standards facilitates communication with financiers and instils confidence in the accuracy of financial reporting. Managers explore alternative financing options such as issuing shares on stock

exchanges or attracting new investors, a decision influenced by cost and risk considerations. Diversifying funding sources, while beneficial, introduces new risks and opportunities for fraud, warranting assessment by financial auditors. Fraud risks also arise from attempts to evade or avoid taxes and duties, necessitating companies to stay informed about legislative changes to prevent erroneous registrations and legal violations. The pursuit of profit in a globalized environment has led to an increased appetite for risk, often surpassing reasonable limits and exacerbating economic crises. Managers of large corporations, driven by a desire for quick profits, have employed financial levers to artificially boost profits, implementing risky and inconsistent long-term programs. The equilibrium maintained by market mechanisms and public regulatory systems has eroded, causing a loss of confidence among users in the ability of managers and auditors to manage risk. The financial crisis drew attention to audit reports issued in previous periods, with instances of unqualified opinions preceding the collapse of companies. An illustrative case is Lehman Brothers, the fourth-largest financial services corporation globally, which filed for bankruptcy in 2008 despite receiving an unqualified audit opinion the same year (McDonald, 2016).

Indicators suggesting the potential occurrence of fraud encompass various aspects (Kenyon & Tilton, 2012; Power, 2013; Kalovya, 2023). Pertaining to accounting records, potential red flags include:

- Transactions improperly recorded in terms of timing, amount, accounting period, or non-compliance with the entity's accounting policies.
- Presence of unjustified or unauthorized balances or transactions.
- Recent adjustments, exerting a material impact on the entity's results.
- Unauthorized employee access to specific information and processing systems.
- Information from diverse sources indicating the presence of fraud.

When it comes to accounting documents, specific signs include:

- Absence of essential documents.
- Lack of original records.
- Documents reflecting suspicious changes.
- Significant alterations in the balance sheet or economic indicator values.
- Unaccounted-for stock.
- Changes in records related to accounts receivable.
- Missing cheques or electronic evidence inconsistent with the entity's practices and policies for processing and maintaining financial and accounting information.

When these factors align with management's evasion or refusal to provide the necessary conditions for the normal execution of audit procedures, they collectively signify circumstances indicative of fraud and violations of the code of good corporate governance or ethical conduct within the entity. The complete eradication of fraud risk remains an elusive objective, entailing the falsification of documents and intentional concealment of facts, often involving multiple individuals across different organizational levels, including management. Fraud can manifest in various forms, including asset misappropriation, misappropriation of unrecorded amounts from customers, payments for fictitious services or goods, pension and social security schemes for deceased individuals, unprovided medical treatment, payments for fictitious delegations or per diems, and payments for unworked overtime (Wells, 2017; Siahaan et al., 2019).

Another adverse aspect within the purview of an internal audit investigation is corruption. This occurs when an employee receives personal benefits to make decisions favouring a customer or supplier, to the detriment of the company (Koven & Perez, 2021). In an attempt to project a positive image, critical events in the entity's business, such as intra-group transactions, may be omitted or misrepresented. In the absence of an effective internal control system or under various pressures to commit fraud, the risk of fraudulent activities is significantly heightened. Financial statement fraud involves deliberately misstating the values of assets or liabilities to portray enhanced financial performance, potentially resulting in direct benefits for management through activity bonuses.

The internal auditor, in the evaluation of risks and formulation of audit plans, conducts tests. If the external auditor assumes responsibility for auditing the entity's financial statements, the internal auditor scrutinizes all facets of the internal control system, identifying weaknesses that facilitate the detection of potential fraud. It is essential to note that scepticism in audit work does not constitute evidence of the certainty of fraudulent activity by management or employees; rather, it signals the possibility thereof.

4. Practical recommendations

In light of the research findings, the following practical recommendations are proposed for organizations aiming to fortify their internal control systems, enhance the effectiveness of internal audit functions, and bolster corporate governance practices to mitigate the risk of fraud:

- **Enhance Internal Control Mechanisms:** Organizations are advised to institute a comprehensive internal control framework, aligning with industry best practices. This framework should incorporate segregation of

duties, continuous monitoring, and stringent access controls to minimize opportunities for fraudulent activities. Strengthening internal controls serves as a primary defence against fraud, establishing transparent processes, fostering accountability, and diminishing avenues for unauthorized activities.

- **Invest in Continuous Employee Training:** Organizations should conduct regular training sessions focusing on ethical conduct, fraud awareness, and adherence to company policies and procedures. A well-informed and trained workforce is crucial in recognizing and reporting potentially fraudulent activities, cultivating a culture of transparency and integrity within the organization.

- **Leverage Technology for Fraud Detection:** Implementation of advanced data analytics tools and artificial intelligence in internal audit processes is recommended for analysing large datasets, identifying patterns, and detecting anomalies indicative of fraudulent activities. Technological integration enhances the efficiency of fraud detection by automating routine tasks and providing auditors with tools to analyse complex datasets more effectively.

- **Strengthen Whistleblower Protection Programs:** Organizations are urged to establish and promote robust whistleblower protection programs that ensure confidentiality and non-retaliation for individuals reporting suspected fraudulent activities. Creating a secure and anonymous reporting environment encourages employees to disclose information about potential fraud without fear of reprisals.

- **Enhance Board Oversight and Independence:** The appointment of independent directors to the board and the establishment of a robust audit committee with oversight authority over internal audit functions are essential for ensuring objectivity and independence in the review process. Independent oversight adds an additional layer of scrutiny to internal audit processes, reducing the likelihood of conflicts of interest and ensuring a more thorough examination of financial reporting practices.

- **Conduct Regular Fraud Risk Assessments:** Organizations should perform periodic fraud risk assessments, considering changes in the business environment, industry trends, and internal organizational factors. Internal controls should be adjusted accordingly to address emerging risks. Regular assessments enable organizations to proactively identify and mitigate evolving fraud risks, aligning internal control measures with the dynamic nature of the business landscape.

- **Conduct External Audits Periodically:** Organizations are advised to engage external audit firms periodically to conduct independent assessments of financial statements and internal control systems. External audits provide an external perspective on the effectiveness of internal audit functions. External audits contribute objectivity and impartiality, offering stakeholders confidence in the reliability of financial reporting and the effectiveness of internal control systems.

These recommendations are grounded in academic insights into fraud detection, internal auditing, and corporate governance practices, providing organizations with a structured approach to mitigating the risk of fraud.

5. Conclusions

Effective corporate governance constitutes a comprehensive system integrating internal and external elements within the company. The management of an entity is grounded in legal concepts, regulations, ethical considerations, sociological and behavioural aspects, human resources management, country specificity, and various strategic elements. It encompasses robust control systems, sound accounting practices, and vigilant monitoring mechanisms, leading to the mitigation of conflicts of interest between shareholders and managers, reduced costs associated with such conflicts, improved performance, and efficient utilization of all entity resources.

In conclusion, taking into account the previously mentioned aspects, it is important that auditors demonstrate a great deal of scepticism and carefully assess financial statements in order to identify any possible fraudulent activity. Strengthening the relationship between audit committees and management, grounded in professionalism, becomes a prerequisite for sound corporate governance. Such practices add value to the entity and enhance credibility in relationships with all stakeholders. To prevent fraud and restore stakeholder confidence, adherence to accounting and auditing standards, coupled with respect for corporate governance principles, is recommended.

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