# IMPACT OF FRAUD PREVENTIVE MEASURES ON CORPORATE GOVERNANCE: EVIDENCE FROM SRI LANKA

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## INTRODUCTION

Fraud has persisted for many decades, and over the last two decades, numerous significant financial scandals have arisen worldwide, including the Enron, WorldCom, and Satyam scandals (Carozza, 2002). In Sri Lanka, multiple such manifestations were visible throughout the period, and there is a need for some mechanisms or tools to detect and prevent such occurrences. Despite being a lower middle-income country, Golden Key, Pramuka Bank, Ceylinco Group, ETI finance, and the bond fraud were the most eminent corporate scandals in Sri Lanka. Nevertheless, per the Association of Certified Fraud Examiners (ACFE) (2016), the quantity of fraud and the number of enterprises affected by fraud is increasing yearly. These ever-increasing frauds continue despite controls and Corporate Governance (CG) laws. This study explores the impact of fraud preventive measures on audit and risk committees and the senior management of Banks, Diversified Financials, and Insurance companies listed on the Colombo Stock Exchange (CSE). This study was conducted at the firm level, where at least one individual replies on behalf of the organization. The Forensic Accounting preventive role (FAP) will act as a mediating variable here. GC refers to the processes and procedures that enable businesses to deliver better results for their shareholders**.** There have been numerous historical instances where corporations have displayed weak corporate governance, resulting in losses and a bad reputation. Forensic accounting might be regarded as a breakthrough in fraud detection and prevention (Bhasin, 2013).

FAP can play a critical role in fraud prevention and CG (Siregar & Tenoyo, 2015), as the majority of frauds can be averted if forensic accounting is made a mandatory**.** FAP also aids in the prevention of financial crises, not just for individual organizations but for the entire economy (Shapiro, 2012). Fraud Risk Assessment is a significant aspect of fraud risk management and a key component in achieving CG (Singleton & Singleton, 2010). According to Law (2011), FAP is concerned with the risks that are directly related to fraud, as well as their impact and likelihood of occurring. Perera and Undugoda (2020) According to the 2016 Global Fraud Survey conducted by the ACFE, firms worldwide lose roughly 5% of their annual income due to fraud. Multiplying the ACFE percentage of loss due to fraud by Sri Lanka's gross domestic product (GDP) would result in a yearly cost of over US$4.07 billion (Sri Lankan Rupees 591.95 billion) Sri Lanka ranked 89th out of 176 nations in the 2018 corruption perception index, according to Transparency International Sri Lanka in 2017.

Hence, there is limited research on the Impact of Fraud Preventive Measures on CG references in Sri Lanka. This study is directed to find retorts to this problem, which is to regulate the

distinctive influence of Fraud Risk Assessment (FRA) on Corporate Governance alongside using FAP as the mediating variable. The conceptual framework and methodology used in this study are described in the following section. The analysis findings are then presented, followed by a discussion. The final section explains the conclusions reached.

## METHODOLOGY

This study uses a descriptive cross-sectional survey design and the quantitative research method approach to identify the relationship between Fraud Preventive Measures and Corporate Governance (CG). The study targeted publicly listed companies in Sri Lanka, mainly Banks, Diversified Financials, and Insurance companies listed in CSE. The targeted respondents were from the Board of Directors, Audit and Risk Committee, Remuneration Committee, and Senior Management. The study purposively selects respondents from 60 companies. The stratified sampling technique was used in the study because it provides all the study population components with a fair and equal chance of being selected and used as a study sample. The primary data collection method was used to collect data for this study. Data were collected using a questionnaire. The conceptual framework, shown in Figure 1 below, was created using the results of a comprehensive literature review.

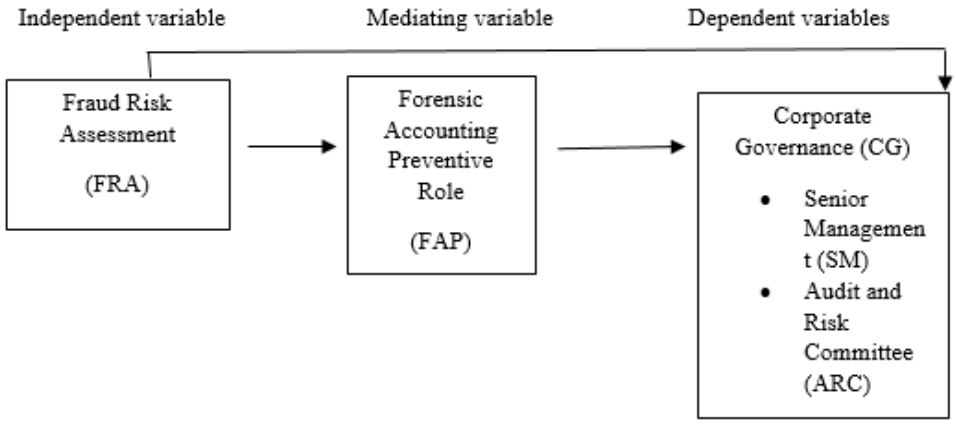


Figure 1 Conceptual Framework

Accordingly, the following hypotheses were developed.
$H_1$: There is a significant relationship between FRA and CG.
$H_2$: There is a significant relationship between FAP and Corporate Governance.
$H_3$: There is a significant relationship between FRA and FAP.

The Likert five-point scale, Model evaluation measurement model, and Model evaluation structural models were used to operationalize the selected dependent, independent, and meditating variables. The respondents' responses were measured using a five-point Likert scale, ranging from strongly agree to disagree. A questionnaire was adapted and taken from past studies for this research. Respondents have requested a total of 34 questions, including three demographic questions. FRA is measured by the questions focused on poor fraud management, poor fraud assessment, poor internal controls, a lack of ethical values, and inadequate background checks on new workers. The ARC is evaluated based on the number

of times the audit and risk committee meetings, in addition to strategic planning and performance targets. The presentation of a code of conduct, an emphasis on the code of conduct, encouragement to report illegal or wasteful acts, and the viewing of corrective actions are all utilized to determine SM. In order to evaluate FAP, updated internal control systems, employing forensic accounting in the process of uncovering frauds, having poor fraud assessment, having poor internal controls, having inadequate background checks on prospective employees and vendors, having management override the controls, having strengthened corporate governance, and having failed to comply with statutory audits that performed were considered. Data was obtained using an internet-based method, and PLS-SEM was used for analysis.

The structural model can be assessed when the validity and reliability of the measurement model have been confirmed. Multi-Collinearity occurs in the model when VIF values are five and above for specific indicators. For assessing path coefficients, the t value > 2.33 (one-tailed) and p-value < 0.05 should adhere. The path connection testing is used to assess the predictive capabilities of the structural model (Hair et al., 2017).

## RESULTS AND DISCUSSION

Table 1, when considering the descriptive analysis, shows that CG receives the highest score with a mean of 4.555. It depicts that ARC and SM impact enhancing the efficiency and productivity of CG. The mean value of FAP as the mediating variable is 4.467, which is higher than the mean value of FRA, depicting 4.406. Therefore, FAP has a more impact on CG than FRA. Overall conferring to the table, the mean of all the variables falls under the range of $4.0<X<5$. This means all the respondents agree with the variables, which depicts research variables that the respondents regard are good levels.

Table 1 Descriptive statistics

| Variable | Mean | Std. Dev |
|---|---|---|
| CG (Dependent Variable) | 4.555 | 0.585 |
| FAP (Mediating Variable) | 4.467 | 0.649 |
| FRA (Independent Variable) | 4.406 | 0.727 |

For the evaluation of the measurement model, as shown in table 2, PLS-SEM was used in accordance with the guidelines and standards provided by Ramayah et al. (2016). Eight (8) questions were eliminated because all indicators or questions had values below 0.5. Cronbach's Alpha is used to do a reliability analysis for the scales. Cronbach's Alpha's dependability coefficient often falls between 0 and 1. Greater or equal to 0.80 for a good sale, 0.70 for an acceptable scale, and 0.60 for an exploratory scale, according to Manley et al. (2021). In a reflective model, composite reliability is favored over Cronbach's Alpha as a convergent validity test. AVE represents the average commonality for each latent factor in a reflective model.

Composite reliability (CR) and AVE for CG are 0.876 and 0.506, respectively, whereas AVE and CR for FRA are 0.642 and 0.899, and AVE and CR for FAP are 0.559 and 0.926,

respectively. Indicators that are measured and reflect constructs are related in a way called outer loading. Mentioned that AVE and CR satisfied the requirement for the measurement model's adoption (Ramayah et al., 2016).

Table 2 Assessment of Measurement Model

| Variable | Cronbach's Alpha | CR | AVE |
|---|---|---|---|
| CG (Dependent Variable) | 0.836 | 0.876 | 0.506 |
| FAP (Mediating Variable) | 0.912 | 0.926 | 0.559 |
| FRA (Independent Variable) | 0.860 | 0.899 | 0.642 |

Since all the evaluation requirements for measurement, models were satisfied, and it is now possible to evaluate the structural model. Collinearity, coefficient of determination ($R^2$), effect size ($f^2$), and path coefficient were assessed for the structural model. The outcome of the collinearity assessment shows that the values of VIF for FAP and CG are 1 and 2.649, respectively; thus, multi-collinearity is not a problem. Multi-collinearity develops in a model when VIF values for particular indicators are five or higher, according to Garcia-Carbonell et al. (2015).

Table 3 The Significance of Direct Effect – Path Coefficients

| Relationship | Beta (O) | Standard Error (STDEV) | T Statistics (O/STDEV) | P Values | $R^2$ | $F^2$ |
|---|---|---|---|---|---|---|
| FRA ▼ CG | -0.421 | 0.327 | 1.301 | 0.193 | 0.499 | 0.133 |
| FAP ▼ CG | 0.989 | 0.235 | 4.210 | 0.000 | | 0.737 |
| FRA ▼ FAP | 0.789 | 0.101 | 7.792 | 0.000 | 0.623 | 1.649 |

Note: **p<0.05 (t>1.645); ***p<0.01 (t>2.33) (One Tail)

According to table 3, the relationship of FRA to CG is indirect; hence the beta value is negative. The relationship of FAP to CG and FRA to FAP is directly due to the positive effect of beta value. Additionally, the connection between FRA and CG is not significant since the t-values are lower than 2.33 and the p-values are more significant than 0.01; nevertheless, the relationship between FAP and CG and also the relationship between FRA and FAP is significant because the t-values are higher than 2.33 and the p-values are less than 0.01.

As shown in Table 4, the direct effects beta is -0.421, its t value is 1.307, and its p-value is more than 0.05, indicating that FRA CG is not statistically significant. The FRA has a strong indirect influence, or the link is wholly indirect, or complete mediation, as indicated by the indirect effect beta of 0.780 with a t value greater than 2.58 and a p-value less than 0.05. Complete mediation occurs when there is no central direct relationship, but there is a significant indirect relationship (Manley et al., 2021).

Table 4 Direct and indirect significance

| Relation | Beta-Direct Effect | t value | Significance (p<0.05) | Beta-Indirect Effect | t value | Significance (p<0.05) |
|---|---|---|---|---|---|---|
| FRA ▼ CG | -0.421 | 1.307 | No | 0.780 | 3.126 | Yes |

Note: *p<0.05 (t>1.96); **p<0.01 (t>2.58) (based on two-tailed test), Bootstrapping (n=5000)

As per the results, the connection between FRA and CG is insignificant since the t-values are lower than 2.33 and the p-values are more significant than 0.01. Therefore, it can be concluded that there is no significant relationship between the two variables under consideration. The study's findings merely run contrary to some earlier literature. According to Rehman and Hashim (2020b), there is a significant relationship between FRA and GC. However, Rehman and Hashim (2020a) discovered an insignificant relationship between FRA and CG, and FAP is taken to mediate the relationship. As a result, FRA is not significant in having a relationship with GC. Therefore, $H_1$ is considered unsupported.

However, after the bootstrapping process, the indirect impact beta of 0.780 with a t value larger than 2.58 and a p-value less than 0.05 suggests that the FRA has a significant indirect influence or that the link is entirely indirect or complete mediation. Full mediation takes place when there is a significant indirect tie but no significant direct relationship. The relationship between FAP and CG is significant since the t-values are higher than 2.33 and the p-values are lower than 0.01. So here, the $H_2$ can be taken as supported as the results. According to earlier literature, Rehman and Hashim (2020) have clearly stated a significant relationship between FAP and CG. Moreover, Bhasin (2013) has proved in his studies that there is a significant relationship between FAP and CG. So, we can clarify with these studies that it is evident that the relationship between FAP and CG is significant.

As per the final results, the relationship between FRA and FAP is significant as the t-values are higher than 2.33, and the p-values are lower than 0.01. Therefore, the $H_3$ can be clarified as supported. Rehman and Hashim (2020a) have mentioned a significant relationship between FRA and FAP. Also, Popoola et al. (2016) have mentioned that the relationship between FRA and FAP is significant. So as the final outcome depicts that there's a significant relationship between FRA and FAP.

## CONCLUSIONS AND IMPLICATIONS

This study aimed to discover the impact of fraud preventive measures on corporate governance: evidence from Sri Lanka. The researcher uses a quantitative research design to accomplish the study's objectives. The study was conducted by distributing a well-structured questionnaire to personnel working in banks, diversified financials, and insurance companies listed in CSE. The questionnaire was mainly created using prior literature. The survey instrument was sent via the internet for suitable personnel. The researcher could collect 60 responses that were used in the statistical analysis. Then, by utilizing PLS-SEM, the collected data were investigated using various statistical techniques, including descriptive and inferential approaches. The study's finding shows no significant relationship between FRA and CG, resulting in $H_1$ being unsupported. However, $H_2$ is considered supported, resulting in a significant relationship between FAP and CG, and $H_3$ is also considered supported, resulting in a significant relationship between FRA and FAP. It implies that the business can change its rules and codes by adding FAP as a stable component and part of the government control system, helping to build anti-fraud rules, spot fraud early, and stop it in its tracks. It can also help lower the cost of fraud. Thus, forensic accounting can be used as a preventive tool for potential unanticipated corporate catastrophes.

The study has some limitations, such as the fact that it only focused on a specific subset of CSE companies; more private companies would have enhanced the results, but doing so would have been outside the study's purview. Additionally, this study does not address fraud-related education, which could impact how well people grasp the FRA's function and mode of operation. This research significantly advances management practices globally, not only in Sri Lanka. The sample that the researcher has taken only from banks, diversified financials, and insurance companies, not only locally, is transforming into a fundamental requirement on a global scale. In addition, fraud affects organizations across all industries instead of companies listed in CSE. For the preceding and many other likely reasons, FAP is necessary for developing and maintaining internal controls, and FRA is necessary for preventing fraud. The results of this study will be valuable in helping regulators create specific standards that can show how firms can achieve CG.

The study's range can be expanded for future research topics by incorporating more than one respondent from each company, and responses can be obtained from all significant CG members. Future studies may also consider the organization's age and size, both of which contribute to the identification of CG. Future studies can also confirm the possibility of using FA education as a mediator because, according to the latest study, very few respondents are qualified to work as forensic accountants.

***Keywords*:** Corporate governance, fraud risk assessment, preventive role of forensic accounting, Sri Lanka

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