ISSN No:-2456-2165

A Study on Corporate Governance and Financial Fraud In the Kingdom of Bahrain

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Abstract:- This case study was conducted to determine the relationship between corporate governance and financial fraud in the different business in the Kingdom of Bahrain.

The study was conducted in order to help the stakeholders and other users of the financial statement about the possibility of those charged with governance to commit financial fraud. This study could also be a good source of information for future researches of other students particularly from AMA about financial fraud and corporate governance. The objectives of this research include analyzing the impact of board of directors on combating financial fraud in the commercial companies in Bahrain, examining the effect of audit committee size in reducing the financial fraud, understanding the impact of company ownership structure in reducing the financial fraud, studying the effects of audit firm type in reducing the financial fraud and analyzing the impact of the board composition on opposing financial fraud in the commercial companies in Bahrain.

A descriptive research was utilized in this study. Questionnaires were distributed among the financial executives of the different companies in Bahrain using Convenience Sampling method. A total of 48 sample size was identified and where questions were rated using the Likert Scale. The information gathered were analysed using the SPSS software, aside from T-test, regression and Cronbach's Alpha. The results of this research showed that there is a significant relationship between the size of the board directors, size of the audit committee, ownership structure, audit firm type and the board composition with financial fraud. It is recommended that Board of Directors should be a least six with two of them coming from external sources, managers must give more attention to investors' interests of the organization, all Corporate Governance should design measures avoid the malpractices, organizations must encourage the participation of shareholders in board meetings, companies must disclose related party transactions with the major investors and directors, and companies must utilize external board members in audit committee.

***Keywords**:- Audit, Corporate Governance, Financial Fraud, Fraud, Governance.*

I. INTRODUCTION

In the past years, scholars and researchers' attention have been directed to develop mechanisms to protect the shareholders and stakeholders' rights due to continuing revelations about mismanagement and fraud committed by the persons charged with governance in the different business organizations. Mismanagement of funds and financial fraud take different forms, however, in most cases, the shareholders and the stakeholders are greatly affected by this mechanism. They are several types of financial fraud. It includes, but not limited to, falsifying balance sheets, income statements and cash-flow statements to fool the people who read them. The fraudster may be out for personal gain, or is trying to keep the business afloat. False financial statements are one of the many varieties of accounting fraud. They can involve multiple crimes, including securities fraud and perjury.

Financial fraud may involve high ranking officials of the companies, or other employees who have the chance to commit fraud for their own interest or financial gain. This research will try to investigate the relationship of fraud and corporate governance. It will try to prove or disprove several hypotheses formulated regarding the significant impact of the different factors to fraud such as the Board of directors and its composition, size of the audit committee, company ownership and structure, among others.

➢ *Statement of the Problem*

The problem tries to determine the relationship between corporate governance and financial fraud. This will try to answer the questions of many people if the people charged with governance should be the sole responsible for the commission of financial fraud, and in that case, who will be liable to the public who were affected due to the financial frauds committed by the companies.

➢ *Hypotheses*

The following hypotheses were formulated:

- H*a: (1)* There is a significant impact of board of directors on combating financial fraud in the commercial companies in Bahrain
- H*a:(2)* There is a significant effect of audit committee size in reducing the financial fraud among commercial companies in Bahrain

- H*a: (3)* There is a significant impact of company ownership structure in reducing the financial fraud in the commercial companies in Bahrain
- H*a: (4)* There is a significant effect of audit firm type in reducing the financial fraud among commercial companies in Bahrain
- H*a: (5)* There is a significant impact of board composition on opposing financial fraud in the commercial companies in Bahrain.

➢ *Significance of the Study*

This research is significant to the different stakeholders of the company. These stakeholders will know the importance of proper governance and whether the commission of financial fraud has largely depended on the corporate governance. This will also help other researchers such as students of AMA in the future who would like to conduct the same study. They could use this study as one of their sources to support their own research in the future. This study will also help those people charged with governance. They will be able to realize the significance and the impact of how they will manage the organization. It can also be a good source of information to the government of Bahrain to be the basis of enacting laws about those people or organizations who will be caught committing fraud in the future.

➢ *Research Scope and Limitation*

The scope of the research is to determine the relationship between corporate governance and financial fraud. This study is limited only in the kingdom of Bahrain particularly to the people charged with governance such as accountants. Time is the main constraint in the conduct of the study. Questionnaires were sent to 48 different respondents in the kingdom of Bahrain who were charged with governance.

➢ *Theoretical Framework*

The theory is to determine the relationship between corporate governance and financial fraud in the kingdom of Bahrain. The framework talks about the independent variables of the study namely the size of the board of directors, audit committee, ownership structure, audit firm type as well as the composition of the board. Financial fraud is dependent upon the different independent variables mentioned. Below is the illustration of the theoretical framework.

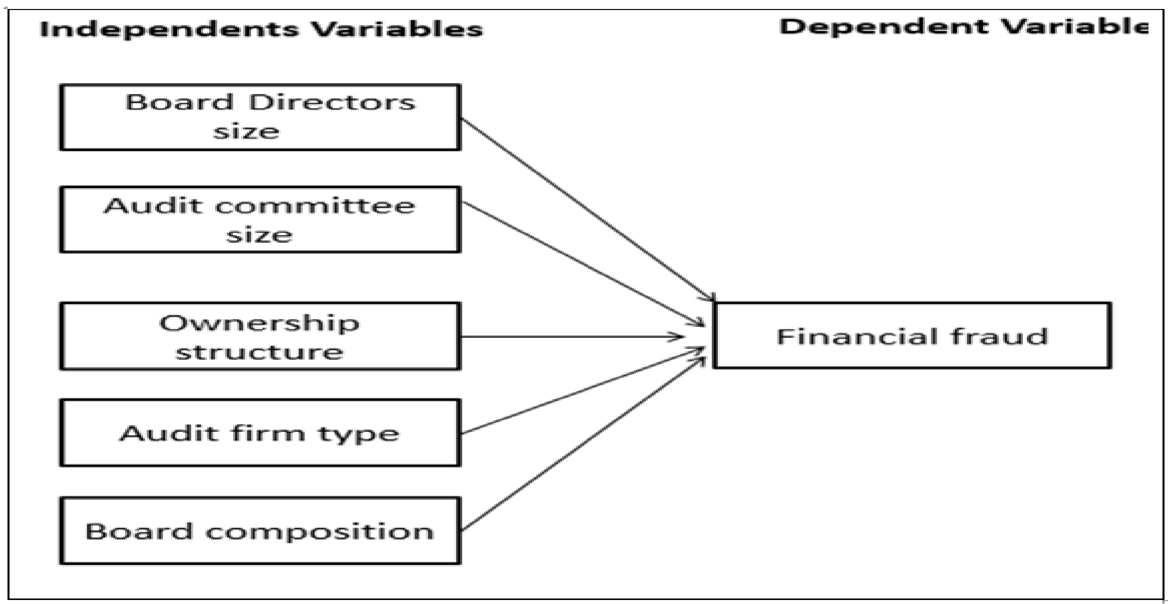

Fig 1:- Theoretical Framework of the Study

II. LITERATURE REVIEW

Corporate governance is the practice of maximizing the value of stakeholders such as investors, shareholders, employees, suppliers, community, customers and environment by suitably allocating the corporate resources. World Bank defines "governance as the exercise of political authority and the use of institutional resources to manage society's problems and affairs." Corporate governance is the collection of policies, law, processes, and customs that controlling and administrating the working of the company. It also includes the association with many stakeholders and the vision of the company which will govern the company. The external stakeholders of business corporations are shareholders, debtors, creditors, public, suppliers, etc. and the internal stakeholders are employees, owners, and board of directors. [1]

[1] *Wright, M., Siegel, D. S., Keasey, K., & Filatotchev, I. (Eds.).(2013). The Oxford handbook of corporate governance (Vol. 28).Oxford University Press.*

Corporate governance talks about the way which the organizations got financial support and organized in an economy, regarding practical decision –makings and entrepreneurial activity. In a study by Persons (2009) and Li et al (2008) indicated "that the audit committee size affects corporate disclosures". The magnitude of the committee is the sum of memberships of the group chosen by the governing bodies. Abbott, Parker and Peters (2004)[2]the findings depict that committee size has no considerable influence on quality of financial reporting.

Ownership structure can be distinguished by the level of concentration of ownership rights as well as by the identity of the owner. In general ownership structure may include inside as well as outside owners. Inside owners are managers and employees, and outside owners are individuals, organizations and state. (Zheka, 2005)[3].

Board composition make impact the strategy formation, designing of compensation policy and functioning and management of the firm. The composition may have different forms, all executives, all non-executives or mix of both. The executive director's form is adopted by the family business. Their family members play the role of directors and managers. The company's auditing committee must identify the requirement of the audit from the auditor. The auditing committee must include discus with the auditor about yearly plans, the details and depth of the audit going to undertake by the auditor, examination of certificates and the documents as a proof of independence of the auditing firm and recommend to the organization to appoint or removal of the auditor as well as the audit remuneration.[4]

Monetary extortion happens when manager is taking actions that delude stakeholders and investors. It includes lying about actualities, inability to present material data, corruption, wrong data about the company's execution, or concealing issues. There might be advantages to the monetary misrepresentation that encourage supervisors to take part in such activities, for example, performance improvement or on the other hand increments in compensation. In any case, money related misrepresentation hurts the shareholders, and particularly the individuals who hold the company's stock over long stretches. [5]

The main reason for the problems in organization has been the lack of corporate governance mechanisms to identify the financial misrepresentation and the prevention of corporate tragedies. The most of the problems related to the corporate governance is related to the legal rules talking about the duties of the mangers and the system they provide the information regarding the business to the shareholders. [6]

Accounting fraud is expressed in two form such as accounting irregularities and manipulated earnings. Financial misrepresentation has two type, errors and irregularities. These errors are depending upon the intention of the people. Errors defined as accidental mistakes and irregularities is the inaccuracies that occur. When the organization finds and accounting error in the statement, it will fix to avoid the consequences. Whereas accounting irregularity is not considers as a mistake, it means somebody is doing intentionally. [7]

III. RESEARCH METHODOLOGY

Descriptive research model was used in this study. Qualitative attributes were analyzed based on the answers of respondents. The respondents of the study include the different financial executives of the company including senior accountant, internal auditor, external auditor, financial managers, board of directors as well as the top management. A total of 48 respondents were chosen based on the convenience of the researcher. The five scale questionnaire was designed based on each variable and hypotheses of the study to obtain a comprehensive analysis and findings that supports the results of the study.

The sample design was selected based on all the functions of the financial department of the companies in Bahrain, to cover a larger number of respondents who are involved in the study trends, with a focus on the financial managers and executives, because they represent the majority in the accounting departments.

The questionnaire was used as a primary means of collecting data to obtain accurate, realistic data on the target sample's situation. The five-scale questionnaire was designed based on each variable and hypotheses of the study to obtain

[2]*Abbott I.J. Parker S. and K. Peters G.F. (2004).“Audit Committee Characteristics and Restatements.”Auditing: A Journal of Practice and Theory. 23 (1): 69 – 87.*

[3]*Zheka, V. (2005). Corporate governance, ownership structure and corporate efficiency: the case of Ukraine. Managerial and Decision Economics, 26(7), 451-460.*

[4]*Barlow, J., (2016). Corporate Governance Best Practices.Online available at https://www.boardeffect.com/blog/corporate-governance-best-practices/ .*

[5]*Connelly BL, Hoskisson RE, Tihanyi L, Certo ST. 2010a.Ownership as a form of corporate governance. Journal of Management Studies (8): 1561-1589.*

[6]*Chen, T., Harford, J., & Lin, C. (2015). Do analysts matter for governance? Evidence from natural experiments. Journal of Financial Economics, 115(2), 383-410.*

[7]*Tiscini, R., & Di Donato, F. (2004). The relation between accounting frauds and corporate governance systems: an analysis of recent scandals.*

ISSN No:-2456-2165

a comprehensive analysis and findings that support the results of the study.

For measuring the validity and reliability the pilot test was used on few samples, as well as the Cronbach's alpha to measure the internal consistency. The SPSS statistical analysis software was used to obtain many outputs such as, means scores, standard deviations, as well as the T-test, regression and Cronbach's alpha were used.

IV. SUMMARY OF FINDINGS, CONCLUSION AND RECOMMENDATION

The Cronbach's alpha for questionnaire's variables is more than 0.7 along with Cronbach's alpha value for all questionnaires was 0.976. Thus, it can be said that internal consistency of the items was achieved and the data are reliable. The responses on the variable *Board of Directors size* indicated that the general mean of the section was (3.44), while *Audit committee size* indicated that the general mean of the section was (3.43), the *Ownership structure* indicated that the general mean of the section was (3.78), the *Audit firm type* indicated that the general mean of the section was (3.57), on *Board composition* indicated that the general mean of the section was (3.23), and on *Financial Fraud* indicated that the general mean of the section was (3.68).

Simple linear regression model has been used to test the following hypotheses, where results are analysed. The first hypothesis was "*There is a significant relationship between board of Directors size and Financial Fraud".Board of Directors size* is the independent variable and *Financial Fraud* is the dependent variable. The results shows that F value was 4018.85, and Beta was 0.974 referring to positive and significant Impact (Beta p-value lesser than 0.05), as well as the adjusted R^2 was 0.913 which means that 91.3% of the dependent variable's variations were explained by the dependent variable, and in fact that is a high explanation value for the model. Therefore, the relationship is significant and the hypotheses aforementioned are accepted, as we state that board of directors' size has a significant impact on financial fraud.

The second hypothesis was "*There is a significant relationship between audit committee size and Financial Fraud". Audit committee size* is the independent variable and *Financial Fraud* is the dependent variable. The results shows that indicated that F value was 5070.32, and Beta was 1.18 referring to positive and significant Impact (Beta p-value lesser than 0.05), as well as the adjusted R^2 was 0.930 which means that 93% of the dependent variable's variations were explained by the dependent variable, and in fact that is a high explanation value for the model. Therefore, the relationship is significant and the hypotheses aforementioned are accepted, as we state that audit committee size has a significant impact on financial fraud.

The third hypothesis was "*There is a significant relationship between ownership structure and Financial Fraud". Ownership structure* is the independent variable and *Financial Fraud* is the dependent variable. The results shows that F value was 3683.74, and Beta was 1.09 referring to positive and significant Impact (Beta p-value lesser than 0.05), as well as the adjusted R^2 was 0.906 which means that 90.6% of the dependent variable's variations were explained by the dependent variable, and in fact that is a high explanation value for the model. Therefore, the relationship is significant and the hypotheses aforementioned are accepted, as we state that ownership structure has a significant impact on financial fraud.

Ownership structures are of major importance in corporate governance because they affect the incentives of managers and thereby the efficiency of the firm. Ownership structure can be distinguished by the level of concentration of ownership rights as well as by the identity of the owner. In general ownership structure may include inside as well as outside owners. Inside owners are managers and employees, and outside owners are individuals, organizations and state. Owners may also be distinguished as foreign and native ones (Zheka, 2005).

The fourth hypothesis was *"There is a significant relationship between the audit firm type and Financial Fraud".* A*udit firm type* is the independent variable and *Financial Fraud* is the dependent variable. The result shows that F value was 5672.67, and Beta was 0.772 referring to positive and significant Impact (Beta p-value lesser than 0.05), as well as the adjusted R^2 was 0.937 which means that 93.7% of the dependent variable's variations were explained by the dependent variable, and in fact that is a high explanation value for the model. Therefore, the relationship is significant and the hypotheses aforementioned are accepted, as we state that the audit firm type has a significant impact on financial fraud.

The fifth hypothesis was *"There is a significant relationship between board composition and Financial Fraud". Board composition* is the independent variable and *Financial Fraud* is the dependent variable. The results shows that that F value was 1191.27, and Beta was 0.790 referring to positive and significant Impact (Beta p-value lesser than 0.05), as well as the adjusted R^2 was 0.757 which means that 75.7% of the dependent variable's variations were explained by the dependent variable, and in fact that is a high explanation value for the model. Therefore, the relationship is significant and the hypotheses aforementioned are accepted, as we state that the board composition has a significant impact on financial fraud.

The studies of corporate governance and financial frauds in the Kingdom of Bahrain are very few and did not get the attention of researchers; more emphasis should be placed on the impact of corporate governance on financial

ISSN No:-2456-2165

fraud as a tool for anti-fraud in all its forms. The spotlight on corporate governance and financial fraud study will contribute significantly to creating a more comprehensive perspective to expose fraud and scandals patterns in terms of finance and accounting of the corporate in the Kingdom of Bahrain. The study choose five independent variables such as board of directors size, audit committee size, ownership structure, audit firm type, board composition and Financial fraud as dependent variable. Based on this variables five hypothesis were developed.

Company corporate governance is based in the organizational structure which defines the standard functions and legal behavior. Corporate governance is the way company is governed via accountability for financial and managerial performance. Prevention of fraud in the financial statement is a difficult task, so the internal and external control of the organization is integrated with the corporate governance system.

➢ Based on the findings of the study, the following are the recommendations:

- The size of the audit committee should be six and have no less than two outside members. Ideally, it is better to have most of the members from outside.
- The managers must give more attention to investors' interests in the organization.
- Rather than simply compliance with the rules and regulations, all corporate governance measures should cater to avoid the malpractices.
- Organizations must encourage the participation of shareholders in board meetings, this will increase the transparency of the company.
- Companies ought to completely unveil all party transactions with major investors and directors.
- Companies must utilize external board members in auditing committee.
- All the companies in Bahrain must apply the International Financial Reporting Standards.
- Members of those charged with governance must be clearly evaluated by the management before employing them especially on their integrity and track record.

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