

# ***Influence of Corporate Governance Structure on Financial Fraud in Listed Companies***

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**Abstract:** With the rapid development of the economy, listed companies occupy an increasingly important position in the economic system, and financial fraud has been a problem plaguing listed companies. Financial fraud not only affects the development of the company, but also causes damage to the interests of stakeholders. This paper mainly studies the corporate governance structure of listed companies in order to understand the impact of corporate governance structure on financial fraud of listed companies. Secondly, this paper also explores the methodology regarding the study of financial fraud in order to understand the motives of listed companies practicing financial fraud. This paper examines the influence of different corporate governance structures on financial fraud in listed companies by reviewing the relevant literature in academia. On this basis, this paper argues that different corporate governance structures and different components of corporate governance structures can have an impact on financial fraud in listed companies.

**Keywords:** Corporate governance structure, Financial fraud, Listed company, The board of directors, Management

## **1. Introduction**

Financial statement is an important report that listed companies need to disclose to all market entities on a regular basis, and it is also the main way for regulators and investors to understand the financial status of listed companies. Financial fraud refers to the listed companies through financial fraud and other illegal means, intentionally misreporting or ignoring the figures in the financial report and notes to the financial statements to deceive the users of the financial report, so as to obtain economic benefits, and ultimately lead to others to be harmed or suffered a loss of behavior [1]. In recent years, financial fraud has become a global problem, prevalent in both developed and developing countries. In 2020, Ruixing Coffee Company admitted to financial fraud involving 2.2 billion RMB in false transactions [2]. In 2023, the release of Evergrande's financial report immediately triggered market turmoil, and after its release, its manager, Xu Jiayin, was controlled by regulators. The continuous occurrence of listed companies' financial malpractice has brought great damage to economic development and hindered the normal and smooth development of the economy. It not only makes the majority of investors lose a lot of money, but greatly reduces the confidence of the majority of investors for investment, more seriously, it destroys the fair, just and open economic market. This paper examines the influence of different corporate governance structures on financial fraud in listed

companies. This paper can provide investors with some references and listed companies with some suggestions for the adjustment of corporate governance structure through the study of the connection between the corporate governance structure of listed companies and financial fraud.

## **2. Corporate Governance Structure**

Corporate governance structure refers to the system of a corporate to achieve the effectiveness of resource allocation and to ensure the rational and effective operation of the corporation. The corporate governance structure generally includes the board of directors, the supervisory board, the management and the general meeting of shareholders, of which the board of directors is the office of the general meeting of shareholders between meetings. The board of directors has the decision-making function for corporate strategy, the supervisory board has the disciplinary supervision function, and the management has the operational and managerial functions. These functions are divided among themselves, with mutual checks and balances, in order to promote the long-term sound development of the corporation and enhance the competitiveness of the corporation. This paper will mainly discuss the influence of the board of directors and the management on the financial fraud of listed companies.

## **3. Theories of Financial Fraud**

### **3.1. Iceberg Theory**

The Iceberg Theory, proposed by Robert, classifies factors contributing to financial fraud into two categories. One is the exposed factor that is easier to identify and control, called structural factor, and the other is the behavioural factor that is less detectable and harder to manage because it is well hidden.

Jiang Xiu applied the Iceberg Theory in the analysis of financial fraud in a pharmaceutical company [3]. He pointed out that structural considerations such as efficiency measures, hierarchy, financial resources, organisational goals, state of the art, attitudes, etc. are the more visible factors, while behavioural considerations such as feelings, values, encouragement, satisfaction, etc. are factors that are not readily apparent. These factors were further categorized into individual risk factors and general risk factors.

Individual risk factors include moral character and motivation. General fraud factors include the opportunity for fraud, the likelihood of detection, and the nature and extent of punishment for fraud.

### **3.2. Fraud Triangle Theory**

Steven first proposed a more systematic and complete three-factor theory, which is named Fraud Triangle Theory, including pressure, opportunity and rationalization. Pressure factor is the main motivation for financial fraud, originating from both managers themselves and company operations. Opportunity factor in the Fraud Triangle corresponds to structural factor in the Iceberg Theory, while pressure factor and rationalization factor are equivalent to behavioural factor.

Guo Lei, analyzing financial fraud in a listed company, concluded that the Fraud Triangle Theory effectively explains the principles behind financial fraud occurrence [4]. The study provides an example of applying the theory, identifying pressure factor, rationalization factor, and opportunity factor as the main contributors to the analyzed company's financial fraud.

Pressure factor mainly refers to the fact that due to the need to stabilise the share price or the pressure to obtain financing, the listed company has a strong incentive to revise the financial statements, which can easily lead to the occurrence of financial fraud. Besides, market factors and the pressure of transformation also play important roles in this behaviour.

Rationalization factor refers to the fact that due to the unreasonable shareholding structure of listed enterprises and other reasons, it may lead to the group leaders believing that the company's development is mainly attributable to themselves, and that it is profitable to borrow part of the funds to invest in other projects. At the same time, the failure of internal control mechanism and failure to play a good role and other reasons may also condone financial fraud.

Opportunity factor refers to the fact that stakeholders have a stronger corporate influence due to higher shareholding, which can easily lead to the failure of internal control based on institutional checks and balances, thus creating opportunities for fraud.

### **3.3. GONE Theory**

The GONE theory comprises four core factors: Greed, Opportunity, Need, and Exposure. The GONE theory states that the four factors of Greed, Opportunity, Need and Exposure work together to create fraudulent behaviour. When a fraudster is greedy, in need of money or in need of self-esteem satisfaction, he or she will engage in fraud if they have the opportunity and believe that they will not be detected afterwards, resulting in the money of the corporation being taken away. This is basically a refinement of the Fraud Triangle Theory as well.

Xu Xiangshuai et al., analyzing financial fraud in LeEco, concluded that the GONE theory is applicable in explaining the principles behind financial fraud [5]. The study provides an illustrative analysis.

## **4. The Relationship between the Parts of the Corporate Governance Structure and Financial Fraud**

### **4.1. The Board of Directors and Financial Fraud**

As the decision-making function of a listed company, the board of directors is one of the centers of the corporate governance structure.

The size of the board of directors may have an impact on the decision-making efficiency and supervision of the company. A large-scale board of directors may bring more decision-making opinions, and the decision-making may be more complicated, but the quality of the decision-making may also be higher, which is more favorable to the long-term development of the company. However, a too-large board size may result in the board being concealed and cheated by managers and not being effective in monitoring management. The decision-making process of a small-sized board may be more flexible, but at the same time, it also carries some hidden dangers. Some investors can not participate in the decision-making process of the corporation, and insiders are more likely to reach a consensus on financial fraud. Yang Qingxiang et al. found an obvious "U"-shaped relationship between the size of the board of directors and financial fraud through the study of a number of listed companies [6]. The size of the board of directors that is too large or too small both increases the likelihood of financial fraud.

As members of the corporation, independent directors play an important role in monitoring the management of the company, making recommendations and ensuring that the company is in compliance with regulations. The presence of independent directors helps increase the level of scrutiny of the company's decisions. Independent directors are usually able to think independently, are not overly influenced by management, and are more focused on the overall interests of the company. However, some studies also point out that the independence of independent directors is not absolute [7]. Independent directors are likely to be influenced by a number of factors, such as the majority shareholders of the listed company, the actual controllers, and other external entities that have an interest in the listed company. Zhao Xuanmin and Zhou Faming pointed out that independent directors have a certain role in preventing the occurrence of corporate financial fraud, but the role is

not significant [8]. Most of the independent directors of companies have not been able to achieve the expected effect of establishing this position. It may require external supervision to realize the role of independent directors.

## 4.2. The Management and Financial Fraud

The management is one of the important centerpieces of a listed company's corporate governance structure. Management is the team that carries out the operational and managerial functions of the company, and this team usually includes the Chief Executive Officer (CEO), Chief Financial Officer (CFO) and Chief Operating Officer (COO). The function of management involves the operation of the entire company; they exercise the operational and managerial functions of the company, coordinating the various departments to ensure that the company achieves its business requirements and objectives. Managers are directly involved in the management of the company's various departments, they have the greatest influence on the company's financial fraud. If managers have motives for financial fraud, they may even be able to defraud the board of directors.

The occurrence of financial fraud in a company is related to the background of the managers. The older the manager, the more they focus on stability. They rely more on experience in their behavior and take into account possible consequences. In general, they will be averse to risks. Younger managers, on the contrary, are more likely to choose risky behaviors. In addition, managers with higher education use scientific methods to evaluate and predict options when managing, and they tend to be more risk-averse, while managers with lower education tend to be more impulsive. The risky and impulsive actions usually create more incentives for financial fraud. Lu Xin et al. noted that in most cases, older managers or managers with higher education tend to be accompanied by a smaller likelihood of financial fraud, and that managers with lower education increase not only the likelihood of financial fraud, but also the severity of financial fraud [9].

Managers' early life experiences can also have an impact on the listed companies' financial fraud. Managers who experience a poor childhood are shaped unique cognitive models by their growth environment. And they are more willing to speculate when losses are uncertain, which makes their motivation to engage in financial fraud even stronger. Liu Y. et al. found that managers who had a poor childhood were more willing to engage in corporate financial fraud, but this effect will gradually disappear as they grow older [10].

Numerous studies have demonstrated that women tend to be more stable than men, and that they are mostly risk-averse. This is also true for female managers, who prefer stable company growth policies, which can play roles in inhibiting financial fraud in the company. Zhou Zejiang et al. found that female managers can indeed act as a disincentive to financial fraud in their companies, but only female CEOs instead increase the possibility of financial fraud, which seems to be related to aspects such as career experience [11].

## 5. Conclusion

This thesis discusses about the methods of studying financial fraud and the influence of corporate governance structure of listed companies on financial fraud. Through the above research, it can be learned that the corporate governance structure of listed companies has a deep influence on financial fraud. A suitable size of the board of directors can effectively avoid the occurrence of financial fraud. It is more difficult to realize the role of independent directors by only relying on internal supervision alone. Managers' age and education are both negatively related to the likelihood of financial fraud. Managers' poor childhood experiences increase the likelihood of financial fraud. Female managers can reduce the likelihood of financial fraud. This paper focuses on the relationship between the board of directors and management and the corporate governance structure, and does not explore the

influence of the supervisory board on financial fraud. Future research may be able to explore the relationship between the supervisory board and financial fraud.

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