

# Directions for Reshaping Corporate Environment to Avert Financial Crisis Caused by Frauds: A Theoretical Framework

이기열

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국가경제의 성패는 여유투자자금이 기업의 자금필요를 얼마나 잘 충족시키는지에 달려있다. 이것이 효과적으로 이루어지는 나라의 기업가는 창의적인 아이디어를 구현시킬 수 있을 것 이며, 이는 또한 많은 일자리를 창출할 수 있다. 투자자들의 의사결정은 경영자의 책임 하에 작성되는 재무정보에 근거한다. 그러나 때로는 개인적 욕심에 눈이 먼 경영자는 허위로 재무보고를 하며, 이는 재무보고에 대한 신뢰파괴를 불러와 자본시장의 기능마비를 야기시킬 수 있다. 자본시장 참여자들의 의사결정에 필요한 신뢰성 있는 정보를 제공하기 위해서 재무보고 과정에 대한 감시가 필요하다. 또한 기업의 주인인 주주는 경영에 직접적으로 관여하지 않기 때문에 그들의 투자를 보호하기위한 제도적 장치로서 이사회가 필요하게 된다. 이사들이 주주의 대리인으로서 본연의 의무를 수행하기 위해서는 경영자로부터 독립적이어야 하며, 재무 및 회계분야의 전문성을 갖춰야 한다. 그래서 외부이사가 영입이 되는데 이들은 기업정보 습득에 한계가 있다. 이러한 정보 불균형 상태를 해소하기 위해 감사위원회가 내부 및 외부 감사인들로부터 얻은 정보를 이사회에 제공함으로써 이사회가 주주보호를 위한 본연의 업무를 수행할 수 있도록 돕는다. 또한 기업의 효과적인 내부통제는 재무정보의 신뢰성 제고에 증진을 한다. 그리고 내부 감사인 들은 내부통제가 효과적으로 이루어지고 있는지 또한 취약 및 개선할 점은 없는지 꾸준히 감시하고 평가를 한다. 부정의 예방과 적발 그리고 재무보고의 신뢰성을 보장하기위해, 기업지배구조의 중추인 이사회, 감사위원회, 내부감사인 들은 서로 유기적으로 협력이 이루어져야 하며, 이러한 구조아래서 산출된 재무정보는 신뢰할 수 있을 것이며, 이는 자본시장 참여자들이 의사결정을 합리적으로 할 수 있도록 도울 것이다.

**주제어:** 도덕적 해이, 부정, 이사회, 감사위원회

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## I . Introduction

During the Medieval Ages, wealthy feudal lords employed stewards to manage their properties. The stewards, in turn, were responsible to account for what they had done with the properties entrusted to them. Since no immediate capital market to negotiate their properties existed during those days, the stewards' main duties were aimed at boosting profits by utilizing the resources efficiently and at reporting what they did with those resources. John Wesley defined a good

steward as the one who kept his master's property, not using it for himself but preserving it for the master. The good stewards can be differentiated from the bad ones in terms of operating results of the resources left to them. This notion of stewardship laid the cornerstone for today's financial reporting and rooted from the need of wealthy feudal lords to keep track of transactions on the resources which were left to the hands of others.

The Industrial Revolution transformed hand-producing skills to machine-using manufacturing processes and influenced every aspect of human's daily life. Along with the transition, the Revolution created a demand for huge capital to expand production facilities and to substantiate entrepreneurs' innovative ideas. In those days, channelling household savings to businesses faced challenges for several reasons. First, demanders for capital, such as entrepreneurs, have better and more information on the business than those who supply resources, and have incentives to inflate the value of their business ideas to lure investments. As a result, the resource supplier faced so called information deficiency problems, which let them hang back on their investment. Second, entrepreneurs might be tempted to expropriate invested capital for their own self-interests, which resulted in conflicts of interest between entrepreneurs and capital suppliers(investors). Third, capital supplier, usually household savers, generally lacks financial expertise to analyze the various business opportunities and to differentiate good business ideas from the inferior ones. These problems lessen effectiveness of the capital market in allocating economic resources to the demanders.

But the market gained its momentum with the emergence of intermediaries. The intermediaries equipped with financial expertise provided their independent evaluation on various business opportunities, and thereby, helped investors make rational decisions and distribute the resources efficiently to those with innovative ideas. Two types of intermediaries exist: information intermediaries and financial intermediaries(Palepu and Healy, 2008). Information intermediaries deliver the entity's financial information to investors for their decision making. They enhance the credibility of those information(as auditors do) and analyze the financial information. Auditors, securities analysts, and credit rating agencies are examples of information intermediaries. On the other hands, financial intermediaries, such as investment banks, mutual funds, hedge funds, and insurance companies, aggregate funds from individual investors, and invest in businesses on behalf of them. The financial intermediaries analyze and interpret financial information they were provided along with other factors affecting operation and condition of a business before they make investment decisions. Figure below shows information and capital flows between capital demanders(companies) and providers(investors).

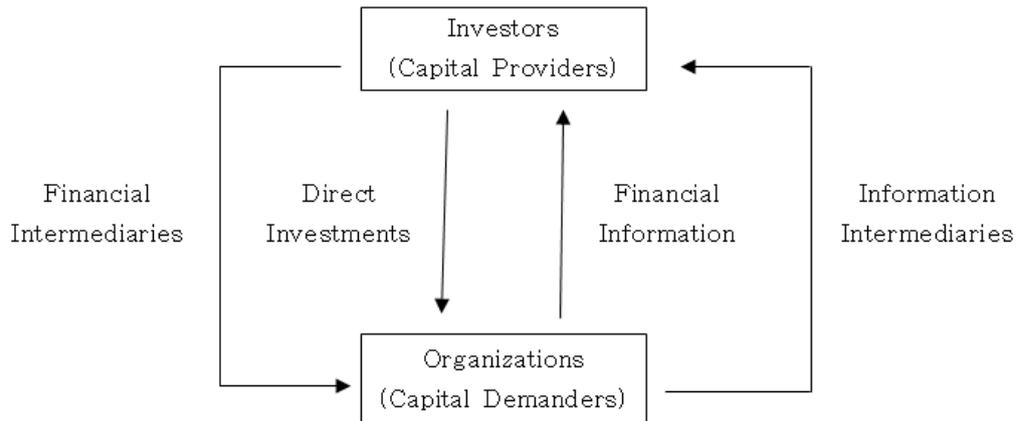


Figure : Information and Capital Flows

For the effective functioning of the capital market, intermediaries must serve as a system of checks and balances. To be more specific, information intermediaries must play the role like a filtering system.<sup>1)</sup> Reliability of financial reports is critical because rational decision makers, such as individual investors, financial intermediaries, or other stakeholder, base their investment decisions on the financial information they were provided. Unfortunately, the information is not always trustworthy due to the selfish greeds of those participated in the financial reporting process. A single incident of corporate fraud shakes public's confidence in the trustworthiness of the financial reports, thus gradually forcing capital providers(investors) to leave the market, which may give rise to collapse of the capital market and lead to demolition of the nation's economy eventually. The purpose of the current study is to suggest directions for reshaping corporate financial reporting environment to generate reliable and transparent financial reports to help various participants in the capital market make their investment decisions rationally.

This study is organized as follows. Section II discusses principal-agent relationship, followed by business fraud in Section III. Section IV suggests ways to reshape corporate environment to enhance transparency of financial reporting, followed by Conclusion in Section V.

## II. Principal-Agent Relationship

1) Filtering system is likened a certified car mechanic who provides independent evaluation on the condition of a used car and ,thereby, helps a buyer and a seller make a bargain.

Principal-agent relationship is said to exist when one person or entity, called an agent, works for the benefits of another, called principal. For example, shareholders(principals) of a company hire managers(agents) and delegate responsibilities to manage the company for the principals' benefits. Agents identify the principals' goals and strive to achieve them. This works well when the agents' interests are aligned with those of the principals, which leads agents not to be tempted to pursue their own interests. But when agents' interests are not in line with those of principals, agents may attempt to expropriate principals' wealth for their own interests. This relationship is based on the premise that both parties work to maximize their own utilities. Principals(shareholders) want higher returns on their investment in the form of dividends or capital appreciation, while agents(managers) seek for extrinsic values, such as compensation, bonuses, or other means of monetary rewards.

Because the principals did not participate in the operation of a company, they had only piecemeal information about the company, usually in the form of financial reports. Consequently huge information gap between principals and agents exists, which is called information asymmetry(Jenson and Meckling, 1976). The information asymmetry may give rise to adverse selection and management's moral hazards. Akerlof(1970) noted that a seller of a used car knew more about the car's value than a potential buyer. The buyer might be ripped off to pay more than its intrinsic value because the seller would turn down the offer anything less than his expected price. Realizing the seller's attitude, the buyer would offer low-ball bids for the used car. Repetitious occurrences of such bargaining would force sellers who want to sell high quality cars to withdraw from the market because they might feel penalized by low-ball bargaining. As a result, only low quality cars ,called lemons, would remain in and dominate the market, which is called adverse selection. Akerlof(1970) asserted that certified independent mechanics would solve this problem by providing the buyers with reliable information about the condition and value of the used cars. In other words, independent mechanics working as intermediaries can boost bargaining between a seller and a buyer. Same reasoning applies to the capital market. Fearing that entrepreneurs with good ideas might be penalized by investors in information deficiency, they may exit from the market because of high cost of capital financing. As a consequence, those with bad ideas will eventually dominate the market, which cause the ineffective functioning of the capital market. This is called the market failure caused by adverse selection.

To overcome the blockage of funds channelling to the capital market, what if those who need capital, such as entrepreneurs, disclose all information to investors? But investors(principals) tend to believe that information conveyed by the entrepreneurs or managements(agents) are not

trustworthy because of their biases to inflate the value of their business ideas to attract capital or to distort financial information for selfish gains. Unless this problem is solved, the capital supplier will not participate in the market. Information intermediaries, who act like certified independent car mechanics, may come to rescue the market by providing objective and credible financial information to investors. Healy and Palepu(2001) noted that three approaches in broad sense would alleviate information asymmetry. First, the optimal contract between principals and agents, such as compensation or bonus agreements, would have the agents' interests aligned with those of the principals. The contract includes the provision for incentives for full disclosure of private information. The second approach is to mobilize the board of directors as a monitoring mechanism for management. The third one is to utilize information intermediaries to enhance the credibility of the financial report and financial intermediaries to analyze and evaluate financial information to differentiate good companies from bad ones. For intermediaries to help smooth channelling of funds to the capital market, they must be provided with credible financial information to base their decisions.

It might be too much naive assumption that agents only act for their own sakes and their interests are not in line with those of principals. Some agents strive hard to work for the best interests of principals, take prides in strong bonding between them and principals, and share vicariously in the success of the firm. In this type of environment, monitoring and controlling agents may not be necessary, but eliminating them completely would also be naive. What matters the most is the degree of monitoring to generate reliable financial reports. Business frauds which devastate the credibility of the financial reports are discussed in the next section

### III. Business Frauds

Black's Law dictionary defines the term 'fiduciary' as "a person holding the character of a trustee, or a character analogous to that of a trustee, in respect to the trust and confidence involved in it and the scrupulous good faith and candor which it requires. A person is said to act in a fiduciary capacity when the business he transacts, or the money or property he handles, is not for his own benefit, but for another person, as to whom he stands in a relation implying and necessitating great confidence and trust on the one part and a high degree of good faith on the other par(Black, 1984).

In short, a fiduciary is the one who acts for the benefit of another and who is required to do

due diligence care for the best interests of the person whom he represents. An agent has fiduciary duties to his principal, but often breaches the duties and commits fraud. Fraud is defined as intentional deception that allows the perpetrator to realize a gain at the expense of victims who suffer economic losses(Albrecht, 2004). Fraud is differentiated from error in that fraud is an intentional misstatement, whereas error is not.

The Association of Certified Fraud Examiners(ACFE) reports in the “2012 Report to the Nations on Occupational Fraud and Abuse” that an organization loses 5% of its revenues to fraud each year(ACFE, 2013).<sup>2)</sup> When applied to the 2011 Gross World Product, the value evaporated due to fraud amounts to more than \$3.5 trillion. Occupational fraud varies from simple asset misappropriation, such as employees’ stealing inventory or pocketing cash in over-the-counter sale(called employee fraud or misappropriation of assets) to manipulating financial information, such as recording fictitious revenue near the year end or understating expenses to increase reported earnings(called management fraud or fraudulent financial reporting). Management fraud causes more detrimental effects than employee fraud because it entails bigger dollar magnitude and more pervasive effects on information users. Two most common types of management fraud include improper revenue recognition and overstatements(understatements) of assets(liabilities). Management fraud harms information users by providing incorrect financial information on which they base their investment decisions.

The Committee of Sponsoring Organizations of the Treadway Commission(COSO) reported that 50 percent U. S. companies committing management fraud during 1987 and 1997 recorded revenues prematurely or created fictitious revenue recognition(COSO, 1999)<sup>3)</sup>. In addition, 50 percent of the fraud companies overstated assets by overvaluing existing assets, recording fictitious assets not owned, or capitalizing items that should have been expensed. Eighty-three percent of fraud cases were committed by the top management. The reasons that management perpetrated fraud are to avoid difficulties that he or his company faces, such as to maintain loan covenant requirement, to meet stock analysts’ expectation, or to increase stock prices(COSO, 1999; 2010). More than 50 percent of the fraud companies were eventually ended up with bankruptcy or different form of ownership.

2) This estimate is based on data compiled from 1388 cases of occupational fraud between Jan. 2010 and Dec. 2011.

3) COSO is an organization of five private-sector organizations including American Accounting Association(AAA), American Institute of Certified Public Accountants(AICPA), Financial Executives International(FEI), Institute of Management Accountants(IMA), and the Institute of Internal Auditors(IIA), participating in a collaborative effort to provide guidance on risk management, internal control, and fraud deterrence.

Financial statements fraud is an intentional and deliberate misstatement of material amounts that would mislead the judgements of rational decision makers. Management who perpetrated fraud broke fiduciary duties not only to shareholders and other stakeholders, but to the public by shaking public trust in the integrity of financial reports which is the cornerstone for the security market's effective functioning. ACFE(2012) also reported that perpetrators with high level of authority caused much larger losses than those at low levels. It was about 3 times more than those by low levels. Financial reports are prepared inside the organization under management's responsibility. Information intermediaries provide investors with credible financial reports that were audited or analyzed. Investors make either direct investments to the organization or indirect investments through financial intermediaries, such as mutual funds, hedge funds, investment banks, and insurance companies.

Several cases of renowned management and intermediaries frauds need to be mentioned because of their devastating effect on the security market. Dennis Kozlowski, the former CEO of conglomerate Tyco, was convicted of misappropriating more than \$400 million of the company's assets to fund his own exorbitant life style. Bernie Ebbers, the WorldCom co-founder and former CEO, was convicted of accounting fraud in the one of the largest scandals in U.S. history. Investors lost \$11 billion due to the management fraud. Kenneth Lay, CEO at Enron, was at the center of the fraud, corruption, and 'cooked books' scandal which blew away hundreds of billion dollars of investors' monies, even though he earned a staggering \$40 million a year. This scandal led to the collapse of the 6th-ranked giant energy trading company out of Fortune 500 companies, and the downfall of accounting firm, Arthur Andersen. In 2009, Bernard Madoff was sentenced to 150 years in prison for defrauding more than 1300 investors in one of the biggest frauds in U. S. history. He concocted \$65 billion Ponzi scheme in his hedge funds firm, Bernard L. Madoff Securities, LLC(SEC, 2012). In a typical Ponzi scheme, the investment managers use funds received from new investors to pay a return to existing investors, rather than from the earnings of the funds' performance. Although Ponzi scheme comes to end when no more new investors join, Madoff's well-known reputation lured a steady stream of investors into the fund for decades.

In April, 2013, Scott London, an audit partner in charge for the accounting firm, KPMG, got fired and interrogated for revealing insider information on its audit clients, Herbalife Ltd., Sketchers USA Inc. and other companies, to his friend, Bryan Shaw. Bryan Shaw paid \$50,000 in cash and gave him a nice jewelry in return for the insider information. Shaw pocketed more than \$1.27 million by using those non-public information in the stock trading. Federal Bureau of Investigation(FBI), Securities and Exchange Commission(SEC) and the U. S. Department of Justice

filed criminal and civil charges against S. London(Byrt, 2013; FBI, 2012; Mintz, 2013). Even though auditors are obligated not to disclose any confidential information without clients' specific consents, S. London breached confidentiality for his selfish interests.

In 2010, Thomas Flanagan, the former partner and vice chairman at Deloitte and Touche, was interrogated by the SEC for profiting more than \$430,000 from securities trading using insider information that he learned during the audit process. He also passed the information to his son who grabbed more than \$57,000 profit from securities trading(Krantz and McCoy, 2013; Mintz, 2013). The moral blindness of accounting firms and other intermediaries shake the public confidence in the integrity of financial reporting and hamper the efficient allocation of scarce resources to those who needed.

A number of executives involved in corporate frauds in Korea were also indicted. In 2013, prosecutors charged SK Global executives for accounting fraud more than \$15 billion over 20 year period. The company reported bogus accounts receivable more than \$1 billion and understated liability more than \$10 billion. The outcome was resulted in the replacement of the corporate management team. Naming a few more companies committed frauds, Hanbo Steel Co., KIA Motors, and Asia Motors were all charged of inflating assets more than \$650 million, \$2.8 billion, and \$1.3 billion, respectively. In 2000, Daewoo Conglomerates including its 12 subsidiaries manipulated asset values more than \$20 billion and hid liabilities more than \$15 billion. Recently, CEO of SK Group and his brother were sentenced to prison for 4 and 3.5 year, respectively, for embezzling more than \$42 million. CEO of Hanwha Conglomerates was also charged with malfeasance in embezzling more than \$250 million. The Korea Herald reported that National Tax Service(NTS) investigated 377 cases in 2013 for tax evasions by founding offshore paper companies(The Korea Herald, 2013). The suspects in those investigations include executives, chaebol owners and their families of big companies. Prosecutors' office indicted CJ Chairman for embezzling more than \$200 million and raising a slush fund more than \$ 600 million(Newsway, 2013). He also established 7 paper companies including 4 in Virgin Island and evaded taxes more than \$50 million.

As ACFE(2013) and COSO(2010) reported, fraud companies in Korea also overstated assets, recorded fictitious assets not owned, understated liabilities, and reported fake revenues. This suggests that schemes endeavored in fraud perpetration are the same regardless of a nation's characteristics. The loss of public confidence increases the cost of capital to even those companies not involved in frauds. Frauds are rooted from conflicts of interest among those participated in the capital market. The current paper looks for ways to reconcile conflicts of interest, especially

between corporate management and shareholders because of its serious impact on the transparency of financial information and effective functioning of the financial market.

#### IV. Reshaping Corporate Environment For Transparent Financial Reporting

Numerous fraud occurrences led to the stock market crash in October 1929. The market continued to plummet for the following 3 years after the crash, evaporating more than \$15 billion market value. The market participants lost their confidence in the market. Frauds were major culprits to the Great Depression. Recognizing the need to restore investors' confidence, the U. S. Congress passed the Securities Act of 1933 and the Securities Exchange Act of 1934. Those Acts aimed at restoring the public's confidence in the credibility of the financial information given to them. As a result, the Securities and Exchange Commission(SEC) was created to reenforce those Acts. As investors' confidence was gradually restored under the SEC supervision, investment funds were slowly funneled to the capital market. But occasional corporate frauds since then , especially those due to management's greed, shattered the public's confidence again. In early 1990's, Enron's collapse ignited government's investigation to identify the nature and extent of accounting improprieties and frauds perpetrated by management. Following the Enron scandal, other frauds committed by management(e.g., Tyco, WorldCom, Xerox, etc.), financial intermediaries(Merrill Lynch), public accounting firms(e.g., Arthur Andersen, Deloitte, Ernst & Young, etc.), and mutual funds' managers were perpetrated. All these scandals prompted the market participants to wonder the integrity of the financial reports and effective functioning of the capital market. As a consequence of those incidents, the U. S. Congress passed the Sarbanes-Oxley Act to protect investors and other stakeholders from the misleading financial information. The Sarbanes-Oxley Act necessitated to reform the governance system of a corporation. Corporate governance was evolved over times to lesson risks associated with frauds and aimed at oversight of management's activities, including financial reporting process(DeZoort and Salterio, 2001; Colley, *et. al.*, 2005). Corporate governance means the way that a corporation is governed. In other words, it is the system by which a company is directed and controlled to achieve its business goals. It may be likened to as a system in which agents(management or directors of the board) discharge their fiduciary duties to principals(shareholders)(Skousen, *et. al.*, 2005). At the helm of the corporate governance are board of directors, audit committee, internal and external auditors.

Shareholders elect directors of the board as their representatives to preserve their investments by monitoring the affairs of the business. But the board delegates responsibilities for running the company to management. However, the board retains authorities to supervise management's operational and financial reporting activities. Because most frauds are perpetrated by management(COSO, 2010), the board's vigilant monitoring over management activities sends clear signals to the stakeholders and the public about its attitude toward fraud risks and reliability of financial reports. Fraud prevention and deterrence are more important than to detect. Because fraudsters often collude with the third parties, manipulate, or alter documents to conceal wrongdoing, fraud detection is hard even to the auditors. Fraud prevention and deterrence refers to creating an environment in which possibility to commit fraud is minimized. Although fraud prevention and deterrence do not guarantee nonoccurrence of fraud, they are the first line of defense to minimize the risks.

To create the effective environment, the tone at the top, such as board of directors' and top management's philosophy and operating style, sets the direction toward the organizations tolerance level for fraud and deviation from control policies and procedures. One of the strong fraud deterrents is to let employees aware that effective detection controls are in place. Thoughts they would be apprehended once they commit frauds would induce them not to be tempted.

## 1. Board of Directors and Audit Committee

Since directors of the board were elected from the shareholders to oversee management on their behalves, ideally the board must be composed of outsiders to maintain independence while performing their duties. The outside directors tend to become more active in pushing management to act for the best interests of shareholders(Beasley, 1996; Defond and Hu, 2005; Green, 2005). Some of the board's duties include to elect management, to approve major investments, and to determine the way to compensate management(Green, 2005). The board also sets up overall tone to assess risk that the organization faces, to devise and implement control policies and procedures to reduce the fraud risk, to establish accountability to those who provided resources to the organization, and to oversee the financial reporting process. On the other hand, management is responsible for developing strategic plans for the prosperity of the organization and operating to reach the business goals. But the board wants to assure that management takes actions in line with the owners' best interests.

The boards' responsibilities for fraud risk management include the following:

- i) Understand fraud risks and maintain oversight of the fraud risk assessment
- ii) Monitor management's report on fraud risks and establish an environment to receive timely and relevant information from management, employees and other whistle blowers.
- iii) Oversee the internal control environment, control policies and procedures
- iv) Communicate with internal and external auditors regarding their findings on frauds(AICPA, 2009).

But due to the fact that outsiders directors lack information about the organization's operating activities, they face difficulties in fulfilling their monitoring duties.

The audit committee, which is a subcommittee of the board, monitors management's financial reporting process and must be composed of at least 3 outside members. The committee is briefed on audit plans from both internal and external auditors. It also communicates continuously with them regarding their findings during audits or any conflicts between auditors and management(Carcello and Neal, 2000; Carcello, *et. al.*, 2002; DeZoort and Salterio, 2001; DeZoort, *et. al.*, 2002). By handing out information that the committee has learned from internal and external auditors to the board of directors, it helps the board fulfill its duties satisfactorily. Because of the committees' duties to foster reliability of the financial information, the member must possess financial expertise and independence.

The audit committee acts as an intermediary between management and the board, and management and auditors. The Treadway Commission notes that "an informed and vigilant audit committee represents one of the most effective influence for minimizing fraudulent financial reporting(COSO, 1999). In the report entitled "Management Override of Internal Controls: The Achilles' Heel of Fraud Prevention", the AICPA notes that management may be tempted to override internal control and engage in fraudulent activities by recording fictitious revenues, manipulating or altering accounting records, and collusion with the third parties(AICPA, 2010). Hence the audit committee must review the effectiveness of internal control procedures and monitor vigilantly whether the control procedures are executed as structured.

## 2. Internal Controls

The Committee of Sponsoring Organizations of the Treadway Commission(COSO) released the updated version of Internal Control-Integrated Framework" in May, 2013 and defines internal control as "a process, effected by an entity's board of directors, management, and other personnel, designed to provide reasonable assurance regarding the achievement of objectives relating to

operations, reporting, and compliance. Objectives relating to operations pertain to efficiency and effectiveness of the entity's operation, including safeguarding assets against theft, fraud, misplacement, and others. Those relating to reporting pertain reliability, timeliness, and transparency of financial reports. Last, objectives relating to compliance pertain to observing applicable laws and regulations.

Internal control consists of five elements: control environment, risk assessment, control activities, information and communication, and monitoring activities(COSO, 2013). The control environment is the set of standards, processes, and structures that provide the bases for carrying out internal control across the entity. In other words, the control environment is the overall attitudes of the board of directors and management about the importance of controls. It also includes management's philosophy and operating style, and personnel policies. Management's emphasis on internal control and adherence to the control policies creates the effective control environment. The personnel policies involve the hiring, training, evaluation, advancement, and compensation. The control environment has a pervasive impact on the success of the internal control.

As for the risk assessment, every entity faces risks coming from internal and external sources, such as changes in customer behavior, competitive threats, regulatory changes, and changes in overall economic circumstances. Management must identify and analyze those risks hindering the achievement of the business goals.

Control activities must provide reasonable assurance that the objectives of internal control will be achieved, including prevention and deterrence of the fraud. The activities include separating responsibilities among two or more persons or departments for related operations to decrease the possibility of fraud occurrence. For example if the same person orders supplies, verifies the receipt, and pay the vendor, numerous abuses may occur. To prevent those abuses, the responsibilities for purchasing, receiving, and paying should be assigned to different persons or departments. By the same token, responsibilities for operations, custody of assets, and accounting must be separated. By doing so, the accounting records serve as an independent check on operation and custody of assets.

It should be kept in mind that internal control systems provide only reasonable, not absolute, assurance that the business objectives will be achieved. Human factors, such as carelessness, confusion or misjudgement, may nullify the effectiveness of the control system. In addition, cost of internal control should not exceed the benefits derived from those cost.

### 3. Internal Auditors

The Institute of Internal Auditors(IIA) defines internal audit as “an independent, objective assurance and consulting activity designed to add value and improve an organization’s operations. It helps organization accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control, and governance processes”(IIA, 2009). Internal auditors are an important part of corporate governance and responsible for monitoring the effectiveness and efficiency of operations and the reliability of financial reporting. They are also responsible for day-to-day monitoring of internal control to locate any weakness and improve the procedures thereon. To discharge their duties properly, internal auditors must be independent from the organization’s line of command function and have direct access to the audit committee for reporting.

This section discussed the board of directors with audit committee, internal control systems and internal auditors as mechanisms for reconciling conflicts of interest between corporate management and shareholders. When these three elements are coordinated each other and functioned to work in harmony, risk management for fraud occurrence will succeed.

### V. Conclusion

An important milestone for a nation’s economy depends on how well savings are funnelled to entrepreneurs. A country that does this distribution well helps entrepreneurs capitalize their innovative ideas and create jobs. In contrast, a country that manages this allocation poorly fails to support innovative ideas and lag down its economy. The channelling of savings to investment is recognized as one of the main problems for those countries undergoing the process of industrialization.

For investors to channel their savings to entrepreneurs, they must be able to base their decisions on the financial information that is reliable and objective, but that is not often the case. As mentioned before, public’s confidence in the transparency of financial reports is one of the crucial ingredients for the capital market to function appropriately. But due to various selfish motives of information providers, investors are provided with biased information which causes distrust to the financial reporting. This distrust, in turn, may induce investors to avoid getting involved in the capital market or even to walk away from the market in the worst case. A single

incident in corporate fraud may stir the public's assurance in the integrity of financial reports, resulting in crumbling the market and devastating the nation's economy eventually.

Information provider knows more about the company's business activities than information users, which leads to information asymmetry. Knowing that information provider may take advantage of the information asymmetry for their own goods, the information users make to offer the low-balling, which will eventually expel entrepreneurs with good ideas from the market. As a result, products with low qualities or entrepreneurs with bad ideas will dominate the market, resulting in adverse selection. Adverse selection arises from the situation when a buyer cannot distinguish good alternatives from bad ones. A buyer may ask questions like: "Is this used car reliable? Can I(recruiter) believe the information on the job seeker's credentials? Are the financial reports reliable? Adverse selection in the financial reporting context occurs when investors(buyers of the information) cannot have credible information to base their decisions on differentiating good investments from bad ones.

The second problem caused by information asymmetry is moral hazard. In terms of financial reporting context, moral hazard is related to how management behaves when his activities cannot be observed or he is not held accountable for his operating activities. The less likely the management is observed or accounted for what he has done, the more likely the management is going to behave inappropriately. Hence reducing information asymmetry between information provider(management) and information users(investors) and providing the users with reliable financial information will help the market discern good companies from bad ones and facilitate smooth funnelling of capital to those who needed.

Aside from the potential investor viewpoint, shareholders need watchdogs to protect their investment in the company, because they do not directly participate in the operation. Shareholders elect directors of the board as their representatives to oversee the management. The board delegates responsibilities for running the entity to management, but retains ultimate authority to monitor whether management acts for the best interests of shareholders. For directors to perform the duties as prescribed, the board must be composed of outside directors who possess financial expertise. But outside directors' lack of business information hinders them to fulfill their responsibilities.

Audit committee, a subcommittee of the board of directors, is in charge of supervising financial reporting process. For that purpose, the committee continuously communicates with internal and external auditors regarding their audit plans, findings during the audits, and any conflicts with management. Audit committee acts like intermediary between auditors and management. By

handing out the information that the committee has obtained during the financial report monitoring process, including internal and external auditors' findings, to the board members, it helps the board discharge its prescribed duties satisfactorily.

To safeguard a company's asset and generate reliable financial reports, the importance of internal control cannot be overemphasized. Internal controls are policies and procedures that are designed to protect assets (from thefts, misuse, misplacement, and fraud), to produce objective and reliable financial information, and to comply with laws and regulations. But the tone at the top, such as the board and management's overall attitudes toward the importance of internal control, helps create an effective control environment. Internal auditors monitor and evaluate the effectiveness of internal control to locate any weaknesses and implement them. They must be out of the organizations' command line to ensure independence in performing their duties.

Tasks of the board of directors, audit committee, and internal auditors must be coordinated to ensure prevention or deterrence of fraud and reliability of the financial reports. When the board, audit committee, and internal auditors, which are the core part of the corporate governance system, work in unity as a reconciling mechanism for conflicts of interest between corporate management and shareholders, financial reports produced under that governance would be trustworthy and help the participants in the capital market make their rational decisions.

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**李麒烈**: 현재 단국대학교 경상대학 경영학부(회계학 전공) 교수로 재직중 이다. 미국 Univ. of Georgia에서 경영학 박사학위를 취득하였으며, 주요논문으로는 “The Effects of Formation On the Firm Performance of the Board of Directors(2010)(이사회 구성이 경영성과에 미치는 영향)” 등 다수가 있으며, 주요관심 분야는 회계감사이며, 특히 경영자 및 종업원 부정 방지를 위한 기업지배구조(corporate governance)의 개선방향에 있다 (gylee@dankook.ac.kr).

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## Directions for Reshaping Corporate Environment to Avert Financial Crisis Caused by Frauds: A Theoretical Framework

Gi Youl Lee

Success of a nation's economy depends on how well savings are funnelled to entrepreneurs. A country that does this distribution well helps the entrepreneurs capitalize their innovative ideas and create jobs. For investors to channel their savings to entrepreneurs, they must be able to base their investment decisions on the financial information which is prepared under management's responsibility. Motivated by personal gains, management often attempts to report financial statements fraudulently, which shakes the public's confidence in the integrity of financial reporting. To provide reliable financial information to the capital market participants for their decision making, monitoring on the financial reporting process is inevitable. Because shareholders do not directly participate in the operation of a business, they need a mechanism to protect their investments. To that end, they elect directors of the board as their representatives to watch for their interests. For directors to perform their prescribed duties, they must be independent of management and possess financial expertise. But outside directors' lack of information on the business activities restricts their abilities. Audit committee helps the board discharge their responsibilities by handing out the information that it has learned from internal and external auditors. In addition, good internal control system enhances the quality of the financial information. Internal auditors monitor and evaluate the effectiveness of internal control to locate any weaknesses and implement them. This study is aimed to help participants in the capital market make their rational decisions basing on trustworthy financial reports they were provided. To that end, tasks of the board of directors, audit committee, and internal auditors must be coordinated to ensure prevention of frauds, or detection if they occur. When they collaborate in unity, financial information provided under that governance would be reliable and help the various market participants achieve their goals.

**Key words:** moral hazard, fraud, board of directors, audit committee