

# The Effectiveness of Internal Control Systems in Preventing Financial Fraud: A Case Study of Multinational Corporations

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**Abstract:** This case study examines the effectiveness of internal control systems (ICS) in preventing financial fraud, with a focus on the Volkswagen (VW) emissions scandal known as ‘Dieselgate’. This paper discusses the internal control problems reflected in this case, including a series of problems such as insufficient division of labor, insufficient supervision, insufficient communication and imperfect approval. These deficiencies allowed the fraud to continue for nearly a decade, resulting in significant financial penalties and reputational damage, reflecting the role of internal control failures in asserting financial fraud. As a result, the study highlights the importance of cultivating an ethical corporate culture, strengthening risk management and ensuring strong internal controls to prevent similar incidents in multinational companies.

**Keywords:** internal control; financial fraud; case study

## 1. Introduction

In recent years, multinational enterprises are facing more and more scrutiny in terms of their financial and operational practices. The scale characteristics of multinational enterprises and the obstruction of internal information communication make them more exposed to the risk of financial fraud and other factors. The VW emissions scandal stands out as a key example of how failures in internal control systems (ICS) can lead to widespread corporate misconduct, creating large factual gaps in the flow of money. The scandal, known as “Dieselgate,” revealed how VW manipulated emissions tests to make its diesel cars more environmentally friendly than they actually were, leading to serious consumer fraud and financial fallout. In light of this case, which reflects the suppression of financial and business fraud by internal control mechanisms, this case study will examine how VW’s internal control systems were breached, assess the weaknesses that led to the emissions scandal, and explore the lessons that can be learned from this failure.

## 2. Internal Control Systems: Overview

ICS is a fundamental framework that helps organizations manage risk, ensure accurate financial reporting, and comply with laws and regulations. These systems contain a variety of components that work together to protect assets and improve operational efficiency. According to Rashid, effective internal control systems play a key role in fraud prevention and detection, ensuring that organizations are able to protect their resources from

potential misconduct [1].

A fundamental aspect of ICS is that it protects the overall environment of internal control, which sets the ethical tone for the organization. Mendes de Oliveira, *et al* emphasize that a strong control environment is critical to curbing fraud because it influences employee behavior and decision-making [2]. In this regard, moral and ethical standards act on individual employees and thus work synergistically with institutional factors; Faisal *et al* argue that strengthening the ethical framework within an organization significantly affects the effectiveness of internal controls [3]. Another key component is risk assessment, which involves identifying and analyzing risks that could hinder the achievement of an organization's goals. An effective risk assessment process is essential to identify vulnerabilities, especially in fraud-prone sectors such as finance [4]. For example, Ogwiji and Lasisi emphasize the importance of assessing the risks of listed financial services companies to mitigate fraudulent activities [5].

In addition to providing an internal control framework and environment, ICS in turn consists of a series of control activities, that is, actual policies and procedures designed to mitigate risk. Maulidi and Ansell point out that organizations must establish strong control activities for their specific risks in order to effectively combat corruption and occupational fraud, as failure of control activities often results in significant financial losses and reputational damage [6]. At the same time, information and communication are essential to the effectiveness of internal controls. Companies must ensure that relevant information flows throughout the organization so that timely decisions can be made and problems resolved [7]. Without proper communication channels, control weaknesses can be overlooked, allowing fraudulent activity to persist.

On the basis of the above framework and activities, the monitoring component is essential to evaluate the effectiveness of ICS. Regular assessments and audits help organizations identify weaknesses and make necessary adjustments. As noted by Burzinji *et al*, the integration of forensic accounting with internal controls can significantly enhance fraud prevention efforts by providing an additional layer of oversight [8–12].

### 3. VW Emissions Scandal: Overview

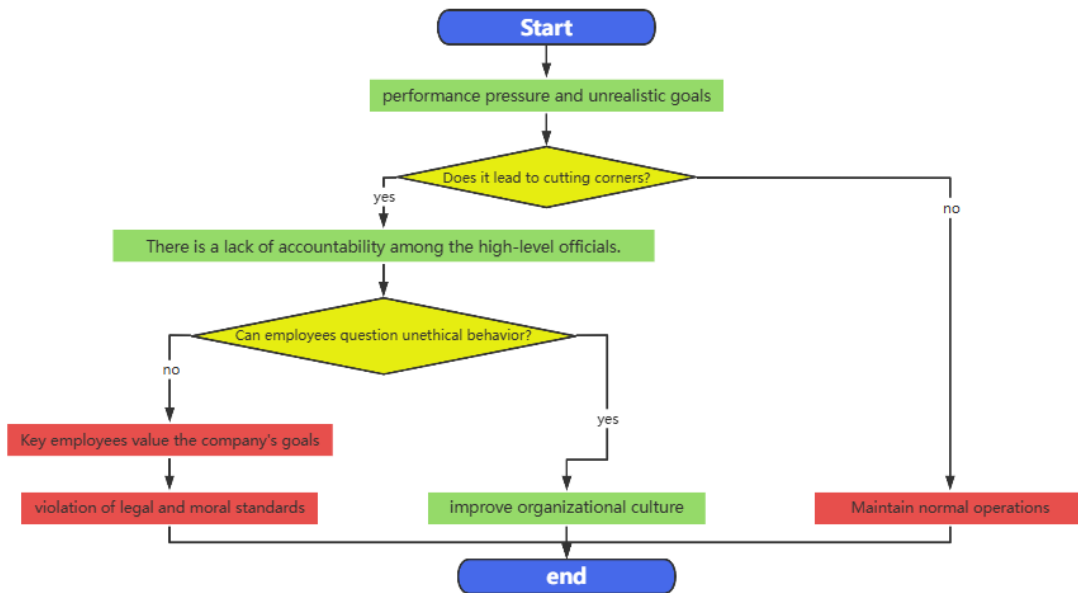
In September 2015, VW was revealed to have installed cheating software in about 11 million diesel vehicles worldwide. These “defeat devices” are detected when the vehicle is undergoing emissions testing and change its performance to produce lower emissions readings. Under normal driving conditions, these vehicles emit nitrogen oxide pollutants up to 40 times the legal limit.

The scandal was so far-reaching that VW faced more than \$30 billion in fines and legal fees, the company's share price plummeted, and its global reputation was severely damaged, which was difficult to recover in the long term. Martin Winterkorn, VW's chief executive, subsequently resigned and criminal charges were brought against several senior executives. From the perspective of internal control, this fraud lasted for nearly ten years, indicating that the company's governance and risk management system has deep flaws, which are analyzed and discussed in this paper.

#### 3.1. Control Environment

The control environment is perhaps the most critical component of an effective internal control system, as it sets the ethical tone and management culture within an organization. At VW, however, the control environment was compromised by an aggressive corporate culture focused on global dominance and profit maximization.

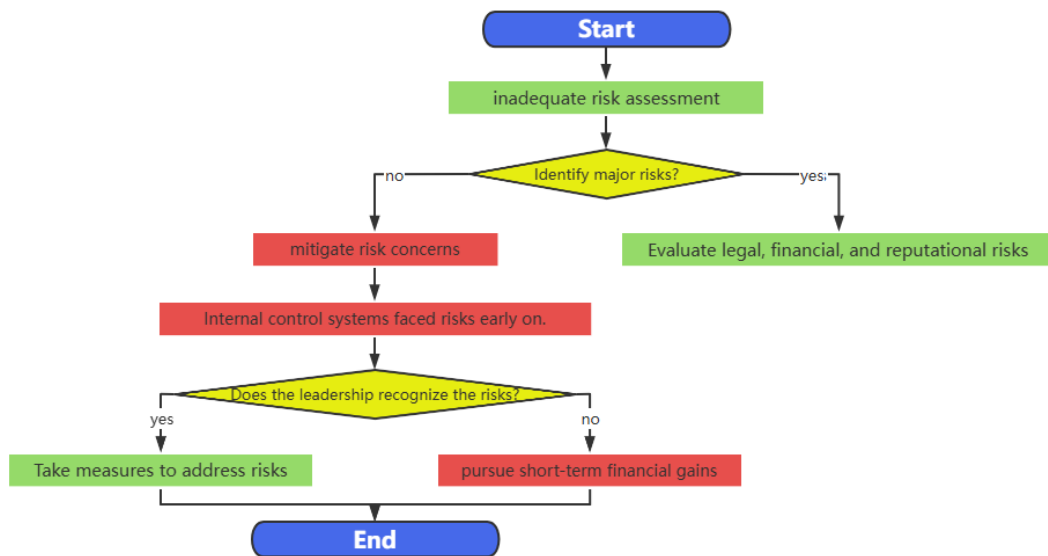
VW's internal structure fostered an environment where performance pressures and unrealistic goals drove employees and management to cut corners. The company's ambitious plan to become the world's largest automaker created intense pressure to meet diesel emissions standards while maintaining profitability, particularly in the U.S. market. This culture likely contributed to a lack of accountability at the top levels of the organization. Additionally, senior management, including CEO Martin Winterkorn, created a highly centralized decision-making environment where employees may have felt unable to question unethical practices. As a result, key employees and engineers responsible for developing the defeat devices operated under the assumption that meeting corporate targets outweighed adherence to legal and ethical standards (as shown in Figure 1).



**Figure 1.** Control Environment.

### 3.2. Risk Assessment

VW's risk assessment procedures are not sufficient to identify significant risks related to compliance with regulations, in particular those related to emissions standards. A well-functioning internal control system should recognize the potential legal, financial and reputational risks associated with the use of illegal software to manipulate emissions data. However, the company's risk assessment process appears to have downplayed these concerns, lacking effective risk assessment measures and thus facing significant risks in the early stages of the internal control system, failing to identify the risks of non-compliance with emissions regulations in different markets, failing to assess the potential legal and financial penalties for non-compliance, and failing to recognize the reputational damage that a major scandal could bring. As a result, VW's leadership either failed to recognize the severity of the risks or deliberately chose to ignore them in pursuit of short-term financial gains, ultimately contributing to a long-term fraud (as shown in Figure 2).



**Figure 2.** Risk Assessment.

### 3.3. Control Activities

Based on the risk assessment, the next step is the risk control activity, which is also the main content of the internal control system. At a theoretical level, risk control activities are specific procedures and policies

implemented to prevent or detect fraud and ensure compliance with regulations. In the case of Volkswagen, the engineers involved in the development of the defeat device were not adequately supervised, and the lack of segregation of duties allowed the same people responsible for product development to achieve this fraud without detection, resulting in an internal modification of software functions. At the same time, although the company had procedures for emission testing, these controls were focused on passing regulatory checks rather than ensuring compliance with emission standards under realistic conditions, and thus failed to guarantee the reliability of business activities at a practical level. The decision to install the defeat device was likely made by a small group of engineers and middle managers without proper review or authorization from senior management, which not only contributed to the fraud, but also to the lack of subsequent improvement measures. Volkswagen's internal controls failed to detect these frauds, partly because of weak oversight and partly because the employees concerned may have believed that they were acting in the best interests of the company given the performance targets set by management and more reflective of the absence of the relevant control environment and control activities.

### *3.4. Information and Communication*

For internal control systems to function effectively, communication of risks, policies and procedures must flow freely throughout the organization. At Volkswagen, its formal code of conduct and compliance policies were replaced by a private psychological organizational structure, so that employees in key positions either did not know the ethical standards they were expected to adhere to or felt empowered to bypass them. At the same time, the lack of transparency made the development process of the device in this case further lack of information communication, and its development activities were kept secret from the internal, so its predicament and fraud were difficult to attract the attention of upper management, and could not be known by external supervisors such as auditors.

### *3.5. Monitoring*

The monitoring component of VW's internal control system was also severely lacking. Monitoring involves ongoing evaluations of internal controls to ensure they are functioning as intended and that any weaknesses are addressed promptly. VW's internal audit functions either failed to detect the emissions fraud or were not given the resources or independence necessary to raise alarms.

Monitoring includes an ongoing assessment of internal controls to ensure they are functioning as intended and that any weaknesses are addressed in a timely manner. But in each case, VW's internal audit department either failed to detect the emissions fraud or was not given the necessary resources or independence to raise the alarm. This reflects that the internal audit and compliance functions were not robust enough to identify fraudulent activity occurring during the development of emissions software, to the extent that they failed to identify financial fraud as a result of business fraud. The fact that the devices involved in the case project went unnoticed for nearly a decade suggests that the monitoring process was ineffective or deliberately suppressed, highlighting the failure of the internal control system.

## **4. Conclusion**

The Volkswagen emissions scandal highlights the need for strong internal controls, emphasizing ethical behavior, risk assessment, transparent processes, and independent audits to prevent fraud and foster accountability.

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**Conflicts of Interest**

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