

The Role Of Internal Auditing And Internal Control System On The Financial Performance Quality In Banking Sector

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Abstract

The objective of the empirical study is to examine and analyze the influence of internal audit and internal control systems on the prevention of accounting fraud in banking sector. This study obtained data from primary data. The sample of this empirical study is an employee who works in the three largest banks in Indonesia and has working experience at least two years. This research uses multiple linear regression analysis as hypothesis testing. The results of the empirical study are (1) internal audit had a positive significant influence on the prevention of accounting fraud in banking sector, (2) internal control system had a positive significant influence on the prevention of accounting fraud in banking sector.

Keywords: internal audit, internal control system, prevention of fraud

El Papel Del Sistema De Auditoría Interna Y Control Interno Sobre La Calidad De Desempeño Financiero En El Sector Bancario.

Resumen

El objetivo del estudio empírico es examinar y analizar la influencia de los sistemas de auditoría interna y control interno en la prevención del fraude contable en el sector bancario. Este estudio obtuvo datos de datos primarios. La muestra de este estudio empírico es un empleado que trabaja en los tres bancos más grandes de Indonesia y tiene experiencia laboral de al menos dos años.

Esta investigación utiliza el análisis de regresión lineal múltiple como prueba de hipótesis. Los resultados del estudio empírico son (1) la auditoría interna tuvo una influencia significativa positiva en la prevención del fraude contable en el sector bancario, (2) el sistema de control interno tuvo una influencia significativa positiva en la prevención del fraude contable en el sector bancario.

Palabras clave: auditoría interna, sistema de control interno, prevención de fraudes.

INTRODUCTION

In recent years, companies in the world face very different challenges, such as globalization, rapid development of technology, industry and business, as well as the risk and complexity of information and data management. With these changes, the risks, including the fraud risks faced by the organization or the company are increasing substantially (KMPG, 2006). In response, the company is now more aware of the need for a proactive method of fraud prevention and detection to minimize potential fraud risks (Falcon Fraud Manager 2008, Entrust, 2008; Stream Base, 2008, in Edge and Sampaio, 2009).

There have been several cases of Financial Statement Fraud in the last decade (eg Enron and WorldCom in the United States; Lippo Bank, Kimia Farma and Indofarma in Indonesia). FSF generates huge losses for market participants, including investors, creditors and employees. Rezaee (2002) states that this cost has reached more than US \$ 500 billion over the past few years. The FSF poses a serious threat to market participants' confidence in audited financial statements.

What is fraud? According to Keller and Owens (2015), there are two categories of fraud, internal and external. Internal fraud is done by insiders, such as employees and directors. External fraud is done by people outside the company, like vendors. Internal fraud can be divided into two categories, such as:

- a. Misappropriation of assets
- b. Fraud on the financial statements

Fraud on financial statements involves cheating on journal entries and authorization managers who can take advantage of journal entries in accounting information systems (Debreceeny and Gray, 2010).

Rezaee (2005) defines fraud financial statements as a deliberate attempt by companies to deceive or mislead users of published financial statements,

especially investors and creditors, by preparing and disseminating financial statements of material misstatements. Examples include improper revenue recognition, unnatural cost of capitalization and a variety of inappropriate accruals.

Internal and external auditors also have an important role. Internal auditors are the first line of defense against fraud because of their knowledge and understanding of the business environment and internal control. Internal auditors may play various roles to prevent and detect fraud within the entity, depending on the direction of the management, the board or the audit committee. Although the responsibility of the external auditor is to provide their opinion on the fairness of the financial statements, users of the audited financial statements generally expect external auditors to detect fraud in the financial statements.

In order to examine the effect of internal audit and internal control system on accounting fraud, the survey was conducted in Tangerang and Jakarta on the three largest banks in Indonesia through writing and online format. Collected quantitative data will be analyzed using statistical tools with multiple regression analysis method.

The purpose of this study is to examine whether internal auditing and good internal control systems can reduce the likelihood of accounting fraud. The findings of this study will provide further insight into the role of internal audit and a good internal control system in order to reduce the likelihood of accounting fraud. The findings of this research have significance for the company's management to continue to develop its internal control system and also the development of internal audit process so that accounting fraud in the banking sector can be reduced.

LITERATURE REVIEW AND HYPOTHESES DEVELOPMENT

Agency Theory

Agency theory is an assumption that explains the relationship between actors and business people. The agency theory is concerned with solving the problems contained in the agency relationship due to improper objectives or different levels of avoidance against risk. The most common financial relationships occur between the principal and the corporate executive (agent).

The agency relationship is a contract whereby one or more people (principals) instruct another person (agent) to perform a service on behalf of the principal and authorize the agent to make the best decision for the principal. (Jensen and Meckling, 1976)

The agency theory addresses issues arising from differences in goals or desires between principals and agents. This situation may occur because the principal does not know the agent's actions or is prohibited by the source to obtain the information. For example, a company executive might have a desire to grow a business to another market. This will make the company's short-term profitability decline, but will lead to prospective growth and higher incomes in the future. However, shareholders who want higher capital growth are currently unaware of the business development plan.

Accounting Fraud

Badan Pengawas Keuangan dan Pembangunan (BPKP) (2003) defines fraud as a misstatement of a material fact that is known to be false or committed intentionally, with the intention of deceiving others which has resulted in other parties being harmed.

Keller and Owens (2015), states that there are two categories of fraud, internal and external. Internal fraud is done by insiders, such as employees and directors.

Fraud Triangle Theory

The concept of "Fraud Triangle" is introduced in the professional literature of SAS. 99, Consideration of Fraud in a Financial Statement Audit. Fraud Triangle consists of three conditions that generally exist when there is fraud: Incentives / Pressure, Opportunity, and Attitudes / Rationalization.

Pressure

The perceived pressure refers to the factors that lead to unethical behavior. Every perpetrator of fraud faces pressure to engage in unethical behavior (Abdullahi and Mansor, 2015). This pressure can be financial and non-financial. Albrecht et al. (2006), stated that because the pressure in the experiments of fraud may not be apparent, it is important to use the word used. If the offender believes that they have a determination, this belief can lead to cheating. Perceived pressure can occur in many forms, especially in financial needs that cannot be matched by income. Financial pressure is recognized as the most common factor that causes an entity to engage in malicious actions. In particular, about 95% of all fraud cases have been committed due to financial pressures (Albrecht et al., 2006). Lister (2007) states that pressure is a major factor in fraud. It determines three types of pressures: personal, work stress, and external pressure. Vona (2008) in his research further states that personal and corporate pressures are the highest motivation for cheating. Examples of perceived pressure include greed, living beyond one's ability, large expenses or personal debt, family or health financial issues, drug addiction and gambling.

Opportunity

Opportunities arise because of ineffective control systems or governance that allow individuals to commit organizational fraud. In the field of accounting, this is called the weakness of internal control. The concept of perceived opportunity indicates that people will take advantage of existing circumstances for their benefit (Kelly and Hartley, 2010). In most cases, the lower the risk of getting caught, the more likely it will happen (Cressey 1953). Several factors lead to opportunities for fraudulent activities within an organization such as negligence of employee policy violations and lack of disciplinary action (Sauser, 2007). Rae and Subramanian (2008) argue that opportunity refers to the ability and strength of an employee to recognize the weaknesses of the organization's system and exploit it by cheating. Furthermore, Srivastava, Mock and Turner (2005) and Hooper et al. (2010) argue that, even when the pressure is extreme, financial fraud cannot occur unless there is a chance. Opportunities have two aspects: (i) organizational vulnerability to manipulation, and (ii) organizational conditions that allow for fraud.

Rationalization

This concept shows that the perpetrators have to formulate some ideas that can be morally acceptable to himself before committing unethical behavior. Rationalization refers to the justification and rationale that immoral behavior is different from criminal activity. If a person cannot justify dishonest, he may not be involved in fraud. Some examples of fraudulent behavior rationalization were, "I just borrowed money", "I am entitled to the money because I have cheated my employer." In addition, some perpetrators to commit fraud because they had the thought, "I must steal to provide for my family." "Some people do it well, why not." (Cressey, 1953). Rationalization difficult to detect, because the person is not possible could read the minds of the perpetrators of fraud. Individuals who commit fraud are committed to justify or condone cheating them (Hooper and Pornelli, 2010). Rationalization is the justification of cheating behavior due to a lack of personal integrity or moral reasoning (Rae and Subramanian, 2008). the tendency to do fraud relies on ethical values and also on the personal attitude of individuals they (Kenyon and Tilton, 2006). Howe and Malgwi (2006) concluded that the bridge of the rationalization of incentives are inadequate and there is a chance when performing actions such fraud.

Internal Control System

The main objectives of internal control systems are summarized in the Auditing Practices Board (APB) and also COSO guidelines. Internal control

system is to ensure, as far as possible:

- a. orderly and efficiently run its business, including adherence to internal policies
- b. securing business assets
- c. prevention and detection of fraud and error
- d. accuracy and completeness of the accounting records, and the
- e. timely preparation of financial information.
- f. The benefits of the internal control system are:
- g. Effectiveness and efficiency of operations.
- h. The reliability of financial reporting.
- i. Compliance with laws and regulations that apply.

Alvin A. Arens (2008: 370) defines the internal control system as policies and procedures designed to provide adequate assurance that the management company has achieved its goals and objectives. These policies and procedures are often referred to collectively control and establish the entity's internal control.

An internal control should consist of five components, among others:

- a. control environment: It is an attitude of the management and employees regarding the need for internal controls. If the control is considered important by the company, then the resistance of the internal control system will increase.
- b. Determination of risk management: It is the process of reviewing the business to see where the most critical risks are, and then design controls to address these risks. This assessment should be done periodically, to account for any new risks that arise due to changes in the business.
- c. control activity: It is the use of accounting systems, information technology, and other resources to ensure that the appropriate controls have been implemented and operating properly
- d. accounting information and communication about the information to be communicated to management control in a timely manner, so that deficiencies can be addressed. The amount of information conveyed must be in accordance with the needs of the recipient.
- e. Monitoring : It is the set of processes used by management to examine and assess whether internal controls are functioning properly. Ideally, management should be able to cope with a failure to control and make adjustments to improve the control environment.

Internal Audit

Internal Auditor is the first line of defense against fraud for their knowledge and understanding of the business environment and internal control. Internal auditors deal with issues that are fundamentally important for the survival and prosperity of any organization. Unlike external auditors, they look beyond the risks and the financial statements to consider issues such broader reputation, growth, impact on the environment and the way it treats its employees.

In short, internal auditors help organizations to succeed. This is done through a combination of certainty and consulting. The guarantee part of the internal auditor job involves managers and governors who know how well the systems and processes that are designed to keep the organization running. Then, the internal auditor offers advisory services to improve systems and processes required

Association Internal Auditor (Institute of Internal Auditors - IIA) cited by Messier (2005: 514), defines internal audit as an independent activity, beliefs objectively, and consulting designed to add value and improve an organization's operations. The internal audit helps an organization accomplish its objectives by conducting a systematic and disciplined approach to evaluate and improve the effectiveness of risk management, control and governance processes.

Internal Audit aims to help members of the organization in order to carry out their responsibilities effectively. In order to achieve these objectives, internal audit staff is expected to be hits with the analysis, assessment, recommendation, consultation and information on the activities that can be studied. Performance of internal audits may be measured using the balanced scorecard to include the following aspects in accordance with what has been suggested by Kaplan and Norton:

- a. Innovation and Learning
- b. Process internal audits
- c. Management /auditees
- d. Board/ Audit Committee

The authors conclude that there are several factors that affect the prevention of fraud accounting. Two of them are the internal audit and internal control. Thus, the authors formulated the following hypotheses.

H1: Internal Audit has positive significant effect on the prevention of accounting fraud in banking sector.

H2: Internal control has positive significant effect on the prevention of accounting fraud in banking sector.

METHODS

This study was done by distributing an online questionnaire where respondents are employees working in the three largest banks in Indonesia and have work experience of at least two years. The method used in this research to analyze data is using multiple linear regression, which will test the validity, reliability, and classical assumption beforehand.

RESULTS AND DISCUSSION

Dependent Variable: Cheating Accounting	Dependent Variable: Cheating Accounting for	
Variable	Coefficient t	Prob
Constant	3.898	0.046
Internal Audit	0.183	0.001
Internal Control	0,523	0,000
R ²		0.689
Adjusted R ²		.686
F-Stat		229.111
Prob		0,000

Accounting Fraud = 3,898+0,183 internal audit+0,523 Internal control system +e

1. Goodness of Fit Model

Adj. R-Squared = 0.686 = 68.6%

Goodness of fit model shown with Adj. R-squared coefficient of 0.686, which means a variation of the independent variables (internal audit and internal control) were able to explain the variation of Cheating Accounting for 68.6%.

2. Test F

Hypothesis:

H₀: There is no significant independent variable

H_a: At least one significant independent variables

Decision-making:

If sig of fstat > 0.05 then H₀ accepted

If sig of fstat < 0.05 then H₀ rejected

Results of treatment showed that the value of 229.111 and fstat fstat sig of 0.000 < 0.05 H₀ is rejected (H_a accepted) so that it can be concluded

that together proved that the Internal Audit and Internal Control tested positive for significantly to prevention of inclination accounting fraud.

3. Test T

a. Relationship between Internal Audit on the prevention of the tendency of Cheating Accounting

Hypothesis:

H₀: There is no significant effect of the Internal Audit on the prevention of the tendency of Cheating Accounting

H_a: There is a significant effect of the Internal Audit on the prevention of the tendency of Cheating Accounting

Decision:

If sig of $t > t$ table then H₀ is rejected

if sig of $t < t$ table then H₀ accepted

internal audit has a value of 0.183 with a regression coefficient t value $3,317 > 1.97190$ (t table) so that H_a accepted (H₀ is rejected) or a positive influence between internal audits of accounting fraud prevention tendency significantly.

b. The relationship between the internal control on the prevention of the tendency of Cheating Accounting

Hypothesis:

H₀: There is no significant influence on Internal Control on the prevention of the tendency of Cheating Accounting

H_a: There is a significant influence on Internal Control on the prevention of the tendency of Cheating Accounting

Decision:

If sig of $t > t$ table then H₀ disapproved

If sig of $t < t$ table then H₀ accepted

internal control has a value of 0.523 with a regression coefficient t value table $9302 > 1.97190$ so that H_a accepted (H₀ is rejected) or a positive influence between internal control over tendency prevention accounting fraud significantly.

CONCLUSION

Based on the test results of this study, the authors can draw the conclusion that (1) The internal audit has a positive significant effect on the prevention of accounting fraud, (2) Internal controls have a positive significant effect on the prevention of accounting fraud, which means, the better the internal audit and control an enterprise's internal, then the accounting fraud prevention, the better.

LIMITATIONS

This study only take samples of employees working in the three largest banks in Indonesia are located in Jakarta dna Tangerang within three weeks pengumpulam samples. Additionally, other limitations are only mmapu researchers gather the 210 respondents in this study.

SUGGESTIONS FOR FURTHER RESEARCH

This study was conducted only on the independent variable internal audit and internal control. So for future studies, the researchers suggest adding more independent variables such as organizational culture, adherence to the rule of law, and compensation.

In addition, this study also took samples only to the three largest banks in Indonesia are located in Jakarta and Tangerang, further research can add additional samples from both bank and additional study sites.

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