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# **The significance of the internal control system implementation on village government performance**

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## **Abstract**

This study aims to examine the effectiveness of an internal control system on village governance performance based on frauds found in village fund management. Primary data were collected by surveying 270 village governments. The data analysis was performed using the Structural Equation Model (SEM). The results found that when the internal control system was weakly implemented, the fraud in village fund management would increase, which led to the declined performance of the village government. In conclusion, effective internal control can reduce fraud levels in village funds. Besides, such

control will bring a positive impact on improving the village government's performance.

**Keyword:** Internal control system, Fraud, Performance.

## La importancia de la implementación del sistema de control interno en el desempeño del gobierno de la aldea

### Resumen

Este estudio tiene como objetivo examinar la efectividad de un sistema de control interno sobre el desempeño de la gobernanza de la aldea basado en los fraudes encontrados en la gestión de fondos de la aldea. Los datos primarios fueron recolectados encuestando a 270 gobiernos de las aldeas. El análisis de datos se realizó utilizando el Modelo de ecuación estructural (SEM). Los resultados encontraron que cuando el sistema de control interno se implementó débilmente, el fraude en la gestión de fondos de la aldea aumentaría, lo que condujo a la disminución del desempeño del gobierno de la aldea. En conclusión, el control interno efectivo puede reducir los niveles de fraude en los fondos de las aldeas. Además, dicho control tendrá un impacto positivo en la mejora del desempeño del gobierno de la aldea.

**Palabra clave:** Sistema de control interno, Fraude, Desempeño.

### 1. INTRODUCTION

Indonesian government policy to alleviate poverty and implement equitable development in rural areas requires a long process. The phenomenon in the field revealed that numerous problems related to the use of village funds still occur. The results of the village funds audit conducted by BPK RI showed that village heads controlled many village funds. Furthermore, if the funds were spent on buying assets, those assets were unknown. The indications of village

fund management fraud deviate from the objective of Law Number 6 of 2014 concerning villages. It aims to advance the economy of rural communities and overcome national development gaps by strengthening village communities as the subject of development.

Fraud is a deliberate act to deceive, a trick, or a dishonest way to take or remove money, property, legitimate property rights of others due to any action or fatal impact from such action (ARENS, RANDAL, ELDER, BEASLEY, 2014). Furthermore, ABBAS & IQBAL (2012) stated that frauds could be analyzed from a variety of phenomena, such as lifestyle changes, suspicious documentation, complaints from customers, or the public. Also, the results of research by LANE (2010) revealed that frauds constitute a significant factor in the low performance of cities. Meanwhile, ABBAS & IQBAL (2012) stated that one of the causes of fraud and accounting scandals is weak internal control.

Additionally, ABBAS & IQBAL (2012) researched 87 companies listed on the Indonesia Stock Exchange found that adequate internal control could decrease frauds so that the company was able to produce high-quality accounting information. Internal control is a process strongly influenced by the board of directors, management, and other personnel. It is designed to provide adequate confidence in goals related to operations, reports, and compliance (ALBRECHT, ALBRECHT & ALBRECHT, 2011). Based on the fraud phenomena, a high number of irregularities and frauds related to village funds were found. This research is crucial because it brings a positive

contribution to succeed in one of the programs developed by the government of the Republic of Indonesia.

## **2. RESEARCH HYPOTHESES**

ABBAS & IQBAL (2012) found that internal control can effectively lower the level of fraud. Also, ABBAS & IQBAL (2012) posited that fraud prevention and detection are carried out by internal auditors who play a role in assessing the effectiveness of an organization, providing input on continuous performance improvement, and monitoring the quality, integrity, and reliability of financial statements. It is in line with the results by LANE (2010), which found that the practice of internal control and the effectiveness of internal auditors can decrease the possibility of a false financial report. Furthermore, LANE (2010), also found that the use of internal control evaluation by internal auditors will be able to prevent fraud. Based on this fact, the first hypothesis was formulated:

H1: The implementation of the internal control system has a negative effect on frauds in village funds

AGRAWAL & CHADHA (1999) found that companies committed fraud generally have a high rate of senior manager's turnover. By doing so, the company can exit from its crisis immediately due to its deteriorating performance. This finding is in line with the results by LANE (2010), revealing that the lack of

competence and effectiveness of internal control by the company's internal audit indicates a variety of fraud in which leads to a decrease in performance. Based on this fact, the second hypothesis was established:

H2: The level of frauds in village funds has a negative effect on the village administration performance

LANE (2010) stated that fraud prevention and detection are carried out by internal auditors playing a role in assessing organizational effectiveness, providing input on continuous improvement in performance, and supervising the quality, integrity, and reliability of financial statements. Furthermore, HAYES, DASSEN, SCHILDER & WALLAGE (2005) revealed that there is a strong influence between internal control and the company's economic performance. It is in line with the findings by LANE (2010), revealing that the practice of internal control and the effectiveness of internal auditors can reduce the possibility of fraudulent in a financial report. Also, LANE (2010) argued that internal control is a process implemented by management. It is designed to provide adequate confidence for financial statements and operational information reliability, unfolding the company's performance. Based on this fact, the third hypothesis was developed:

H3: The implementation of the internal control system will improve the village government performance by reducing frauds in village fund management

CARTON & HOFER, CHARLES (2006) stated that one of the internal control functions is to ensure that a company can run well to reach its high performance. Similarly, LANE (2010) also mentioned that, based on COSO, internal control is designed and carried out by the board of directors, management, and other personnel. It is to provide adequate confidence to attain the company's goals in the form of high performances by (1) the reliability of the financial report, (2) the effectiveness and efficiency of operations, and (3) compliance with applicable rules and regulations. Likewise, ALTAMURO & BEATTY (2010) found that internal control in the form of monitoring and reporting will improve the financial performance of banking companies in the U.S. Furthermore, ABBAS & IQBAL (2012) found that an active internal control system assists organizations in reducing operational risks and improving their performance. The same results were found by LANE (2010), there was a strong influence between internal control and the company's financial performance.

H4: The implementation of the internal control system will improve the village government performance

### **3. METHODOLOGY**

The method used in this study was analytical research. The sample was 270 saturated ones from the analysis unit. The data were collected through a survey by distributing questionnaires to 1,080

respondents at the managerial level. Structural Equation Model-Lisrel then analyzed the data (SMITH & POLITOWSKI, 2008).

#### 4. RESULTS

It is necessary to test the validity and reliability of the questionnaire as an indicator proxy to ensure its efficacy as a measurement tool, assessing each variable accurately. Validity was measured using a loading factor with a standard of  $> 0.5$ , while reliability was assessed by constructing reliability with a CR standard of  $> 0$ . The results are presented in Table 1, as follows:

**Table 1: Summary of Validity and Reliability Tests**

Latent Variable	Indicator	Loading factors	CR	VE	Description	
Internal Control (IC)	IC1	0,992	0,975	0,885	Valid	Reliable
	IC2	0,929			Valid	
	IC3	0,954			Valid	
	IC4	0,867			Valid	
	IC5	0,957			Valid	
Fraud (FR)	FR1	0,991	0,991	0,974	Valid	Reliable
	FR2	0,991			Valid	
	FR3	0,978			Valid	
Performance (PR)	PR1	0,924	0,973	0,924	Valid	Reliable
	PR2	0,972			Valid	
	PR3	0,987			Valid	

Based on the test results, all indicators had a value loading factor (LF) > 0:50 and CR> 0.70; thus, it can be concluded that all signs are valid and reliable. Hence, it can proceed to the next testing stage by checking the matching model. Structural model testing was conducted to confirm that the developed research model passed the statistic model to prove the grand theory in the study. The structural model test was assessed by the Goodness of Fit Index (GOFI). Based on the test results in Table 2, the GOFI scores consisting of GFI, NNFI, NFI, AGFI, RFI, IFI, CFI were > 0.90, indicating that the model was in good condition. Thus, the research model was accepted and could be continued to the hypotheses testing stage.

Table 2: The Goodness of Fit Index (GOFI)-Full Model

No	Goodness of Fit	Target Value	Result	Model Evaluation
1	Chi-square (P-value)	$p\text{-value} \geq 0.05$	77,581 (0,000)	Poor fit
2	RMSEA	$RMSEA \leq 0.08$	0,062	Good fit
3	NFI	$NFI \geq 0.90$	0,990	Good fit
4	CFI	$CFI \geq 0.90$	0,994	Good fit
5	IFI	$IFI \geq 0.90$	0,994	Good fit
6	RFI	$RFI \geq 0.90$	0,985	Good fit
7	SRMR	$SRMR \leq 0.05$	0,022	Good fit
8	GFI	$GFI \geq 0.90$	0,950	Good fit
9	AGFI	$AGFI \geq 0.90$	0,913	Good fit

Hypotheses testing was assessed by Structural Equation Model analysis with a 95% level of significance (typically  $\alpha = 0.05$ ). The

results of hypotheses testing and the path coefficient can be seen in Figure 1 and Table 3, as follows:

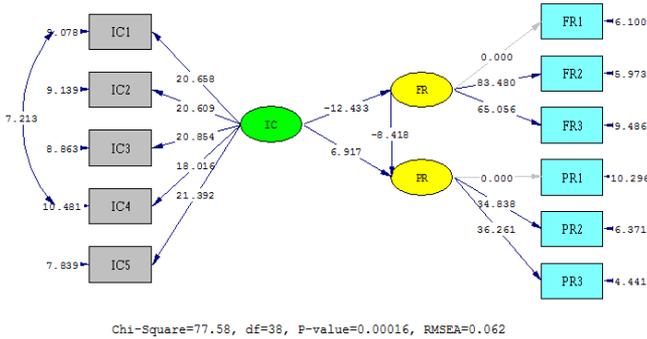


Figure 1: Full Model Diagram Path

Table 3: Hypothesis Test Results

Hypothesis	Path Coefficient	t-Statistic	Significant	Conclusion
IC → FR	-0,677	-12,433 ≤ -1,65	Negative	Hypothesis is Accepted
FR → PR	-0,460	-8,418 ≤ -1,65	Negative	Hypothesis is Accepted
IC → FR → PR	0,710	12,546 ≥ 1,65	Positive	Hypothesis is Accepted
IC → PR	0,399	6,917 ≥ 1,65	Positive	Hypothesis is Accepted

The results of hypothesis testing found that the low effectiveness of the internal control system (IC) affected fraudulent practices (FR) in village fund management. The results in Table 3 show that the hypothesis was accepted. The path coefficient value of 0.677 indicates that IC had a 67.7% influence on FR while other

factors influenced the rest. The practice of fraud (FR) in the village fund management negatively influenced the village government's performance (PR). The results in Table 3 display the accepted hypothesis. A path coefficient of 0.460 depicts that FR had affected PR by 46%, whereas the rest was influenced by other factors.

The low effectiveness of the internal control system (IC) resulted in fraudulent practices (FR) in village fund management in the village administration. Hence, it will reduce its performance (PR). The test results in Table 4 find that the hypothesis was accepted. The path coefficient value of 0.710 indicates the IC had a 71% effect on FR through fraud (PR) whereas other factors influenced the rest. The high level of effectiveness of the internal system control (IC) would improve the village government's performance (PR). The results in Table 4 reveal that the hypothesis was accepted. The path coefficient value of 0.399 indicates that the IC had a 39.9% effect on the PR while other factors influenced the rest. The results of direct and indirect effect to prove that FR was as an intervening variable are presented in Table 5, as follows:

Table 5: Results of Intervening Variable Test

Relations	Direct		Indirect		Total	
	Path	T-value	Path	T-value	Path	T-value
IC ---> FR	-0,677	-12,433	-	-	-0,677	-12,433
IC ---> PR	0,399	6,917	0,311	7,023	0,710	12,546
FR ---> PR	-0,460	-8,418	-	-	-0,460	-8,418

The path coefficient (direct effect) of the PRIC was 0.399, while an indirect effect through FR was 0.311 to obtain the total impact of IC to PR through FR 0.710 higher than the direct effect of 0.399. It indicates that the FR variable had a positive contribution in mediating the IC relationship. Hence, the FR variable was proven to be an intervening variable. The effectiveness of the internal control system as an early warning system should be able to detect any suspicious events or activities, which can lower the village government's performance. This research proves that adequate internal control can reduce the fraud level in village funds. Also, such control will bring a positive impact on improving the village government's performance.

## **5. CONCLUSION**

Prevention and detection of fraud by internal auditors have the role in assessing the effectiveness of an organization, provide input on continuous improvement in performance, and conduct quality control, integrity, and reliability of financial statements LANE (2010). The effectiveness of the internal control system as an early warning system should be able to detect any suspicious events or activities, which can lower the village government's performance. Through a controlling environment, leaders should set moral and ethical values to create a conducive working culture. The risk assessment should always be executed particularly when a decision will be taken to ensure that it has benefits to the organization. Also, the control activities carried out should also be able to assure that any actions are conducted based on

the planning and do not violate provisions and regulations. Information systems and ongoing monitoring as a means to provide relevant information for top management are also tools to measure the success of a conducted program or activity.

If each one of these dimensions is carried out in every aspect of village governance, various efforts can improve the village government's performance. The conditions in an analysis unit found that the internal control process had been implemented. However, low working culture and ineffective time management were still identified. Also, essential positions (such as village treasurer) were taken by incompetent people; thus affecting the village accountability. The government, a supervisor to control the environment, should pay more considerable attention to these issues. Another problem is the lack of information technology facilities, such as the internet network. Hence, so that only a few villages can have access to the internet.

If this condition is not immediately amended, then the level of fraud will increase. If the village government can suppress or eliminate fraud in village funds, it will enable them to improve their performance to be more productive, efficient, and economical in managing its resources. The implementation of the internal control is an early warning system that serves to ensure that all activities carried out by the village government at each level are compliant with the prevailing regulations. Thus, they can be used to signal the entire village government operations.

Furthermore, it is a control tool to detect fraud. Although the control process has been conducted from budgeting to accountability, at the time of its implementation, scams might still occur. It is similar to what happened in the field. During village income budget preparation, the village head could determine a third party who would work on the infrastructure project. This third party then gets paid from the infrastructure project. If the internal control can be implemented well, these practices can be reduced. The influence of the internal control implementation on the village government performance is in line with the research by (ABBAS & IQBAL, 2012). They found that an effective internal control system helps organizations reduce operational risks and improve their performance. Meanwhile, ABBAS & IQBAL (2012) also revealed that companies with weak internal control will produce low performance and can also affect the quality of corporate financial reporting.

This research achieved its aim to confirm the contingency theory (LAWRENCE & LORSCH, 1967). It is when situational factors to improve village government performance could be carried out by ensuring that no financial statement irregularities, no asset management irregularities, and no financial management irregularities occur. The effectiveness of the internal control system as an early warning system should be able to detect any suspicious events or activities, which can lower the village government's performance. This research proves that effective internal control can reduce fraud levels in village funds. Also, such control will bring a positive impact on improving the village government's performance.

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