

# THE EFFECT OF INTERNAL CONTROL PROCEDURES AND GOOD GOVERNANCE ON FRAUD INCIDENTS IN GOVERNMENT AGENCIES

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## ABSTRACT

Fraud is a major economic crime affecting businesses around the world each year and received tremendous public attention. Not only concentrating on the private sector, fraud in the public sector has and always will continue to be a thorn in the inside of any government throughout the world. In Malaysia, fraudulent activities were also found to be occurred in its government. The main objective of the study is to identify the elements of monitoring mechanisms that might be influenced to reduce the level of fraud incidents in Malaysian government. The monitoring mechanisms provided in this study are good governance, internal control procedures and fraud prevention programs. A survey was conducted to various government officers and 91 usable responses were received. Results showed that generally, misappropriation of assets was ranked to be the most fraud case which frequently occurred in the Malaysian government agencies. Based on a regression analysis The results of the study indicated that only one element of the internal control procedures namely the policies was significant in reducing the fraud incidents. Besides, both of the good governance and fraud prevention programs were also proven to have the significant negative relationship with the occurrences of fraud within the Malaysian government agencies. Implications of these findings are discussed.

Keywords: Fraud Incidents, Good Governance, Internal Control Procedures, Fraud Prevention Programs, Malaysia.

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## 1.0 INTRODUCTION

Widely known, fraud is a major economic crime affecting businesses around the world each year and it is believed that fraud is among the most serious corporate problems and challenges in today's business environment (Smith et al. 2005). Nevertheless, the occurrence of fraud in the public sector domain is not a new scenario. In fact, fraud in the public sector has and will always continue to be a thorn in the inside of any government throughout the world. According to Association of Certified Fraud Examiners (ACFE) 2012 Report to the Nations on Occupational Fraud and Abuse, 16.8% of the fraud cases occurred at government agencies or in other words, the public sector of the government. In addition, according to the National Fraud Authority in the United Kingdom, 55.2% of the fraud losses reported is attributed to the public sector (NFA, 2011).

As with any other nation, Malaysia has not been spared of its own cases of the public sectors unethical practices, financial frauds and scandals. Such cases were said to be one of the primary causes of the 1997 Asian financial crisis (Haron, 2010). Furthermore, in the latest Corruption Perception Index 2011 issued by Transparency International, Malaysia is ranked 60th out of 183 countries surveyed with a score of 4.3 out 10. The scandal cases of the National Youth Skills Institute, Royal Malaysian Customs, Federal Territory Islamic Affairs Department and Port Klang Free Zone (PKFZ) are some of the suspected public sector fraud and waste of a great magnitude. As citizens pay taxes in exchange for services rendered by the government entities, constituent may lose faith in the ability of the government's leadership to govern if fraud occurs in the entities and the fallout from fraud goes beyond economic cost (Ziegenfuss, 1996). The collateral damage suffered by the

organization may have a significant impact on the reputation, employee morale, business relation as well as the public relations (PwC, 2011).

Empirically, there have been a number of studies that examined the occurrences of fraud. Many prior researches have addressed the effectiveness of monitoring mechanism such as having good governance, sound internal control procedures and fraud prevention programs. These factors were regarded as the influential factors in mitigating the fraud incidences, but they have mainly focused on the private sectors. Although statistics indicated that the public sector is trailing the private sector in the number of fraud detected by internal audit or risk management (PwC, 2011), yet less attention has been paid to this problem. Therefore, not much research results could be used to fully understand of how these factors might contribute to the fraud incidences within the government's agencies. In addition, the private sector incentives to reduce or prevent fraud do not read across to the public sector. The private sector works on an upstream method, meanwhile the public sector is more downstream and will only deal with fraudulent behaviour after it has occurred.

Therefore, further empirical investigation on the effect of good governance, internal control procedures and fraud prevention programs towards fraud incidents within the public sectors is needed. The output of such study would add significantly to our understanding in preventing the fraud incidences that occurs in the public sectors, specifically in Malaysia as previous studies have been conducted in the western countries. Particularly, the objective of this study is to (1) identify types of fraud occurred that occurred in Malaysian government; (2) identify the relationship between good governance and fraud incidents; (3) investigate the relationship between internal control procedures in term of practices and

policies towards fraud incidents; and (4) examine the effectiveness of fraud prevention program in preventing fraud incidents.

## **2.0 LITERATURE REVIEW AND HYPOTHESES DEVELOPMENT**

### **2.1 FRAUD INCIDENTS IN MALAYSIAN GOVERNMENT**

Fraud is defined as “deliberate deception, trickery or cheating in order to gain an advantage; an act or instance of such deception” (Collins English Dictionary, 2010) or “an intentional act by one or more individuals among management, employees, or third parties, which results in a misrepresentation of financial statements” (Malaysian Approved Standards on Auditing 2001, AI No. 240). The occurrence of fraud is a serious problem that not only causes direct financial losses, but also jeopardizes a nation’s reputation, international linkages and relationships with external stakeholders. Since there is no performance indicator of profit in the public sector, much of the focus has been on the cost of the delivery of the goods and services and the value for money that it represents (Doig, 2007).

The true extent of fraud is unknown but reported incidents show an ever-increasing trend in the number and size of frauds (ACFE Report, 2012). Based on the statistic reported by the Malaysian Anti-Corruption Commission in 2011, 35% of the fraudster arrested emerged from the public sector. There is an increase of 5% compared to the fraud incidents that occurred in year 2010. Recent statistic in the Global Economic Crime Survey 2011 by PricewaterhouseCoopers finds that the economic crime in Malaysia continues to increase. The report highlights that 44% of Malaysian organizations reported being victims of economic crime in the last 12 months; a 57% increase from the 28% reported in the fifth instalment of the survey in 2009. In Malaysia, theft or asset misappropriation (83%) was

the most common type of economic crime reported, followed by bribery and corruption (34%) and accounting fraud (27%).

According to fraud theory, there are three factors that contribute to an individual's committing fraud; pressure or an incentive to engage in fraud; a perceived opportunity; and the ability to rationalize fraudulent behaviour (Cressey, 1953; Albrecht et al., 2006a).

Pressure may be anything from unrealistic deadlines and performance goals to personal vices such as gambling or drugs. Besides, opportunity is an open door for solving a non-shareable problem in secret by violating a trust. The opportunity is generally provided through weaknesses in the internal controls including inadequate supervisions and review, no segregation of duties and lack of system controls. Meanwhile, rationalization is a crucial component of most frauds because most people need to reconcile their behaviour with the commonly accepted notions of decency and trust.

In addition to the identified factors in the fraud theory that motivate a person to commit fraud, poor internal control (KPMG, 2009) and weaknesses in corporate governance practices (Beasley, 1996; ACFE, 2008) were also claimed as another factors that could contribute to frauds incidents. Therefore, limiting an individual's opportunity to commit fraud is where fraud prevention measures such as good governance, anti-fraud programs and internal controls are vital to a jurisdiction's efforts to prevent fraud incidents.

## **2.2 GOOD GOVERNANCE**

Apparently, corporate governance has emerged as a high profile issues and one of the critical interest for managers, regulators of various countries, investors and the academicians (Parker, Peters & Turetsky, 2002). All parties to corporate governance have an interest, whether direct or indirect, in the effective performance of the organization. The

Sarbanex-Oxley Act contain mechanisms that are designed to reduce the occurrence of fraud by strengthening potential sanctions through increased sentencing guidelines and improving corporate governance. Therefore, the effort to promote good governance must be broader not only in the private sector but to the public sector as well.

Prior researches on the effectiveness of corporate governance are highly focuses in the private sector (Law, 2011; Che Haat, Abdul Rahman and Mahenthiran, 2008). Since good governance is crucial in order to reduce the likelihood of fraud occurrence and accomplished better performance in terms of delivery system to the public, therefore, it is expected that by implementing good public governance in public organization, the fraud incidents will be decreased. Thus, this study proposes the following hypothesis:

H1: There is a significant relationship between good governance and fraud incidents in Malaysian public sector.

### **2.3 INTERNAL CONTROL**

Internal control is a major part of managing an organization. It comprises the plans, methods, and procedures used to meet missions, goals, and objectives. Internal control also serves as the first line of defense in safeguarding assets and preventing and detecting errors and fraud. In short, internal control, which is synonymous with management control, helps government program managers achieve desired results through effective stewardship of public resources. Internal control is defined as the control done by the top management to meet organizational goal, which includes, risk management, internal audit, staff training and budgeting.

Research has shown that an effective internal control can provide advance notice of fraud risk, thereby helping to detect and prevent fraud (Gramling and Myers, 2003). In previous literature, lack of effective controls can lead to various issues including security breaches, subversion of employees and fraudulent activities (Warkentin et al. 2006). In view of the demonstrated significance of the internal control procedures, the following hypothesis is proposed:

H2: There is a significant relationship between internal control procedures and fraud incidents in terms of its practices and policies.

## **2.4 FRAUD PREVENTION PROGRAMS**

According to the study conducted by Bierstaker, Brody and Pacini (2006), as an effort to combat fraud in organization, each entity should create and sustain a fraud policy that are separate and distinct from a corporate code of conduct or ethics policy as a guideline for the employees. For instance, a model or sample fraud policy is available from the ACFE. The fraud policy should be clearly communicated to employees through orientations, trainings and annual performance evaluations. In addition, to ensure that the policy has been read and understood, written acknowledgment by each employee should be necessary. This action may helps to confirm their awareness and understanding about such policy.

An anti-fraud policy such as whistle-blowing policy, ethics policy and fraud prevention programs is an important document in every organization (Hite, Bellizzi and Cynthia, 1988). Previous studies indicate that fraud prevention program is effective in detecting and preventing fraud in organizations (Adams et. al 2006, Carpenter and Mahoney, 2001;

Coderre, 1999; Albrecht et al., 2002). However, most of the studies were heavily focus on the private organizations. Although there is a lack of research on the correlation between fraud prevention program and fraud occurrence in the context of public sector, the following hypothesis is put forward:

H3: There is a significant relationship between fraud prevention program and fraud incidents in Malaysian public sector.

### **3.0 METHODOLOGY**

#### **3.1 SAMPLE AND DATA COLLECTION**

The management of the Malaysian government is distributed into three tiers of government namely Federal Government, State Government and Local Government. The Federal Government comprises of ministries, departments and public enterprise such as statutory bodies. The State Government is the second tier of the government, also comprises of ministries (for Sabah and Sarawak only), departments as well as public enterprises. However, the administrative machinery of the State is headed by the State Secretary. Meanwhile, the Local government which is governed by the Local Government Act 1976 comprises of City council, Municipal Council or District Council. The sample of the departments for the study was drawn from all level of the government.

The sample consisted of 233 government agencies which consist of 180 agencies at federal levels, 21 state levels and 32 local levels. Although the sample of this study was randomly selected, purposive sampling was applied to the respondent. The questionnaire was distributed only to those respondents that would yield the information that would meet the purpose of the study. From the 233 samples selected, only 91 responses were received bringing the response rate to 39 percent. Sekaran (2007) stated that a sample



size which was larger than 30 and less than 500 was appropriate for most research. Therefore, the size was considered acceptable for this study. Attached to the booklet were a set of self-addressed, stamped envelope, as well as a cover letter stating that the study aimed to examine the auditors' ethical decision-making and assuring anonymity and confidentiality.

### **3.2 VARIABLE AND MEASUREMENT**

This study outlined one dependent variable and three independent variables to be measured.

#### **3.2.1 Dependent Variable**

As explained in the earlier chapter, the study intended to determine the effectiveness of monitoring mechanism towards fraud incidents in the public sector. Thus, the dependent variable will be measured based on the respondents' feedback gathered in section five of the questionnaire which required the information on number of fraud incidents occurred in the last three consecutive years.

#### **3.2.2 Independent Variables**

The three independent variables which refer to the monitoring mechanisms that influence the fraud incidents in the public sector is determined as (1) good governance; (2) internal control procedures; and (3) fraud prevention program. The elements covered under good governance are leadership, stakeholder relationship, accountability, planning and evaluation. Meanwhile, internal control procedures were divided into two elements namely the policies and practices. Finally, the fraud prevention program which is known as the Organizational Integrity Plan assesses the effectiveness and the awareness of its establishment. Each variable is evaluated based on a seven-point Likert scale (1- strongly

disagree and 7-strongly agree).

## 4.0 RESULTS

Results of this study are divided into two type of analysis. The descriptive analysis is used to achieve the first objective of the study which is to analyze the types of fraud cases exist in the government agencies as based on the respondents' perception. Whereas, the statistical analysis is used to accomplish another three objectives in which to investigate the effect of good governance, internal control procedures and fraud prevention program on fraud incidents.

### 4.1 DESCRIPTIVE ANALYSIS

#### 4.1.1 Fraud Cases According to the Government Agencies

The majority of the respondent is from the federal government (53%), followed by local authorities (21%) and finally the combination of state government and the statutory bodies (26%). Figure 1 presents the percentages of fraud cases based on the different numbers of government agencies.

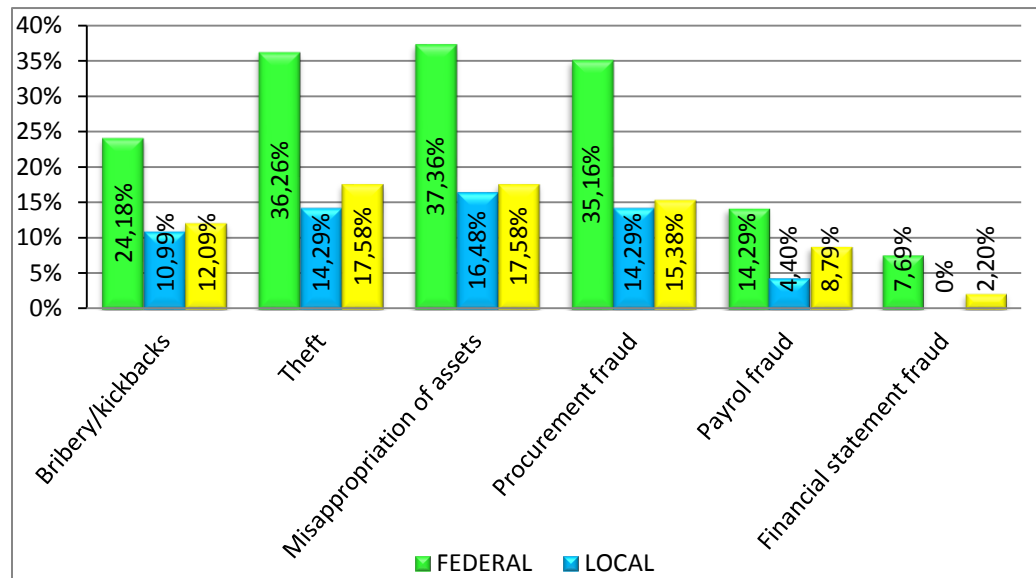


Figure 1: Percentages of fraud cases based on the type of government agencies.

Firstly, in federal government agencies, the highest percentage of fraud case is indicated by misappropriation of assets (37.36%) followed by theft (36.26%), procurement fraud (35.16%), bribes (24.18%) and payroll fraud (14.29%). Meanwhile, the financial statement fraud shows the least percentage of fraud cases (7.69%). Next, the highest percentage of fraud cases in the local government agencies is the misappropriation of assets as well (16.48%). Theft and fraud on procurement indicates the same number of percentages which is 14.29%. The percentage of fraud cases for bribery and payroll fraud are 10.99% and 4.40% respectively. However, from the questionnaire, there is no financial statement fraud indicated in the local government agencies.

On the other hand, other government agencies (i.e. statutory bodies and state government) show that the highest percentage of fraud are theft and misappropriation of asset with the value of 17.58%. This is followed by fraud procurement (15.38%), bribery (12.09%) and payroll fraud (8.79%). The lowest fraud case in these agencies is the financial statement fraud which indicates 2.20% of all the cases. As a result, it can be concluded that, the misappropriation of assets were ranked to be the highest percentage of fraud case in each type of the government agencies. Meanwhile, financial statement frauds were being identified as the lowest percentage of fraud case.

## 4.2 GOODNESS OF DATA

This study utilizes several statistical analyses in order to check for the validity and reliability of the measures and to test the proposed hypotheses. This study performed a factor analysis to examine the validation of the question items which belong to the specific variables. Then, a reliability test as shown was performed to measure the reliability of each of the constructs identified from the factor analysis.

### 4.2.1 Factor Analysis

An exploratory factor analysis, using varimax rotations was performed to understand the structure of correlations of each variable. The Kaiser-Meyer-Olkin coefficient for these dataset is 0.862 for good governance, 0.717 for internal control, .936 for fraud prevention and 0.859 for fraud incidents, indicating that the data could be used to proceed with the exploratory factor analysis (Hair et al., 2010). In addition, the Bartlett test of Sphericity for good governance (Chi-Square = 678.20, d.f. = 55,  $p < 0.01$ ), internal control (Chi-Square = 500.01, d.f. = 78,  $p < 0.01$ ), fraud prevention (Chi-Square = 1427.90, d.f. = 45,  $p < 0.01$ ) and fraud incidents (Chi-Square = 977.44, d.f. = 66,  $p < 0.01$ ) are statistically significant.

The results of the factor analysis indicated that the eleven items used to measure good governance were actually belongs to the two factors with five items and two items, each (all coefficients are above 0.3). As the second factor only has two items, therefore this factor is not being considered for further examination (Hair et al. 2010). Therefore, from the factor analysis, it is indicated that the variable of good governance is measured with one factor that consists of five items. Next, the results of the internal control variable also showed a two factors with five items and four items, each. Another four items were dropped due to the coefficient value less than 0.3. As for the fraud prevention, it was identified that this variable only has one factor construct with 11 items (one item is dropped due to low

coefficient value). Finally, the fraud incidents also have the same pattern of factors as the variable of good governance. Two factors were identified with eight items and two items, each. As a result, the two items factor is dropped due to insufficient items to be used for further analysis. This indicated that the variable of fraud incidents is only measured with a factor that consists of eight items.

#### 4.2.2 Reliability Test

Table 1 shows the statistical test of reliability of the three constructs. The result of the Cronbach's alpha reliability coefficient for good governance is .906 and the standardized item alpha of .913. This result indicates that the internal consistency for the 11 items in the questionnaire is excellent and reliable. As the internal control procedures were divided into two factors which were named as practices and policies, a separate measure were conducted on each factor. The Cronbach's alpha reliability coefficient for practices and policies are .784 and .787, respectively. On the other hand, the fraud prevention program which is the Organizational Integrity Plan had a Cronbach's alpha reliability coefficient of .980 and a standardized item alpha of .980 as well. This indicates that the internal consistency for reliability for all 10 scaled items of the Organizational Integrity Plan is excellent and reliable.

Table 1: Reliability Test

Reliability coefficients	Cronbach's Alpha	Standardized Item Alpha	N of Items
Good Governance	.906	.913	11
Internal Control Procedures			
• Practices	.784	.789	5
• Policies	.787	.777	4
Fraud Prevention Program	.980	.980	10

### 4.3 HYPOTHESES TESTING

#### 4.3.1 Correlation Analysis

Table 2 describes the analysis of Pearson correlation between variables. From the analysis, the results show that the correlation values among the variables ranged between – .028 and 0.677. This indicated that there was no multicollinearity problem among the variables since none of the correlation was more than 0.7. Based on results in Table 2, the perception of fraud incidents (AVE\_FI) is significant and negatively correlated with good governance (AVE\_GG), internal control procedure in terms of policies (AVE\_IC\_POL) and also Organizational Integrity Plan (AVE\_OI). However, the results show that fraud incidents are insignificant with internal control practices (AVE\_IC\_PRAC). Good governance (AVE\_GG) is highly significant with internal control practice (AVE\_IC\_PRAC) and less significant with Organizational Integrity Plan (AVE\_OI).

Table 2: Pearson Correlation Matrix among Variables

	AVE_FI	AVE_GG	AVE_IC_PRAC	AVE_IC_POL	AVE_OI
AVE_FI	1				
AVE_GG	-.298**	1			
AVE_IC_PRAC	-.028	.574**	1		
AVE_IC_POL	-.521**	.183	.010	1	
AVE_OI	-.565**	.213*	.059	.677**	1

Notes:

- 1) \*\* Correlation is significant at the 0.01 level \* Correlation is significant at the 0.05 level
- 2) AVE\_FI: Average Fraud incidents, AVE\_GG: Average good governance, AVE\_IC\_PRAC: Average Internal Control Practice, AVE\_IC\_POL: Average Internal Control Policies, AVE\_OI: Average Organizational Integrity Plan.

On the other hand, good governance (AVE\_GG) is insignificant with internal control policies (AVE\_IC\_POL). However, the result shows that good governance (AVE\_GG) is positively correlated with the other variables. In terms of the correlation between practices (AVE\_IC\_PRAC) and the policies (AVE\_IC\_POL) in the internal control, the results indicate that there is no significant relationship. However, the results show that internal control policies (AVE\_IC\_POL) are highly and positively significant with Organizational Integrity Plan (AVE\_OI).

#### 4.3.2 Regression Analysis

Table 3 presents the result of regression analysis of the independent variables which comprises of good governance, internal control policies, internal control practices and fraud prevention program on the dependent variable, fraud incidents in Malaysian government

**Table 3: Regression Analysis**

Variables	Standardized Coefficients	Std. Error	p-value
Constant		.503	.000**
AVE_GG	-.263	.164	.013**
AVE_IC_PRAC	.147	.179	.167
AVE_IC_POL	-.228	.134	.041**
AVE_OI	-.363	.102	.008**

R<sup>2</sup> = 39.8%

Dependent Variable: Fraud Incidents

\*\* Significant at the 0.01 level

\* Significant at the 0.05 level

Based on the results, the regression was statistically at 5% ( $F = 14.049$ ,  $p = 0.000$ ). The multiple R ( $R = 0.631$ ) showed a high substantial correlation between predictor variables and the dependent variables, thus indicating that the linear regression predicted high respectable results. The  $R^2$  value indicated that about 39.8 percent of the variance in the level of fraud incidents was explained by the four predictor variables. The adjusted  $R^2$  was 0.370 which mean that the regression model explained 37 percent of the various variables in the level fraud incidents in Malaysian government. Therefore, the results hypothesised that good governance, internal control procedures in terms of policies and fraud prevention program that is the Organizational Integrity Plan had a significant relationship with fraud incidents in Malaysian government. However, internal control procedures in terms of practice revealed an insignificant result. The results demonstrated that this study supported H1, H3 and only partially supported H2.

## 5.0 DISCUSSION AND CONCLUSION

The significant negative relationship between good governance and the perception of fraud incidents in Malaysian government explained that an increase in good governance was related to a decrease in the level of fraud incidents. This result is consistent with the studies by Ramaswamy (2005) and Abdolmohammadi, Read and Asare (2004) where they found that fraud is related with corporate governance. Therefore, H1 is supported and good governance is associated with fraud incidents.

On the other hand, internal control procedure in terms of practice is not significant with fraud incidents. In addition, there is a positive relationship between practice and fraud incidents. This means that the internal control procedure in terms of practice does not influence the level of fraud incidents. However, the result for internal control procedure in terms of policies is found to be negatively significant with fraud incidents. Thus, this result



demonstrated that H2 was partially supported. The insignificant result and the positive relationship between internal control practices and fraud incidents may indicate that there is a possibility that the management override of internal controls or collusion between employees or third parties. For instance, even though there is a good practice of internal control, the likelihood of fraud occurrence still exists if there is an involvement from insider and outsider parties such as top management and politicians. This is supported by the study conducted by Riahi-Belkaoui and Picur (2000) and Hurley & Boyd (2007) where the study found that management override of internal controls and collusion between employees and third parties are also seen as factors contributing to fraud.

Meanwhile, there is a significant negative relationship between fraud prevention program and fraud incidents. In this study, the fraud prevention program is indicated by the Organizational Integrity Plan. The result indicates that an increase in the fraud prevention program could lead to a decrease of fraud incidents. Thus, it supports the last hypothesis which is H3. In addition, this result is supported by the survey of Adams et al (2006) where the study demonstrates that fraud prevention program is effective in curbing the fraud problem.

In conclusion, this study contributes to the academia and practitioners in terms of the aspects of theoretical and practical. In the aspect of theoretical, the study contributes to academia by strengthening the evidence for previous findings of how monitoring mechanism affects fraud incidents especially in the public sector organization. On the other hand, in terms of practical aspect, the study provides important information for the public servants on the effect and usefulness of good governance, internal control procedures and fraud prevention program in the public sector.

Although the research has reached its aims, a number of limitations are to be noted. For this and other reasons, the reader is cautioned that this research has several limitations such as this research is not as strongly grounded as usual due to a lack of prior research. Thus, it created a problem to the researcher in finding the guidelines to further review this matter in the context of the public sector especially in Malaysia. Besides, most of the respondents of the questionnaire were received from the federal government. There was a low response received from the state government as well as the local government. The lack of response may result from the limited time available to answer the questionnaire due to work commitment and time constraints. Therefore, a generalization of the conclusion cannot be made on the entire sample.

The limitations of this study have created a room for future research to be undertaken. This study only focused on the three types of the monitoring mechanism, which were good governance, internal control procedures and fraud prevention program. Thus, the future study should look at the other factors that may influence the occurrence of fraud such as the role of auditor and the technology implementation in the government procurement. In addition, this study is conducted basically on the government in Malaysia as a whole. Future research may be conducted specifically focusing on a tier of the government either federal, states or local government. The size of the organization can be take into consideration, thus a more generalization of the results can be made.

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