

## Approaches to Fraudulence Risk Management through Business Control and Culture

Rini Setiawati<sup>1</sup>, Ira Setyawati<sup>2</sup>

<sup>1</sup>Management, Binus University, Jakarta, Indonesia.

<sup>2</sup>Management, Binus University, Jakarta, Indonesia.

<sup>1</sup>rini.setiawati001@binus.ac.id, <sup>2</sup>isetyawati@binus.edu

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**Abstract:** Culture formed in organizations will create individuals with similar values and behaviors that will then form groups. If in an organization a culture is instilled that cheating is an act that is not good and will harm many parties, then employees tend not to commit fraud. This Research want to look at the impact of Business control and organizational culture on fraudulence precaution. Methodology using Partial Least Square (PLS-XLStat). The results obtained R<sup>2</sup> of 0.677 means fraudulence precaution is influenced by 67.7% by business control and organizational culture with coefficients of 0.508 and 0.382 and significant at 5% (t value> t table 1.96). The remaining 32.3% is influenced by other variable that not included in the study. Hypothesis testing shows that business control has a positive and significant impact on fraudulence precaution. Organizational culture has a positive and significant impact.

**Keywords:** Business Control, Organizational Culture, Fraudulence

### 1. Introduction

Notwithstanding good or bad economic conditions, there will always be a possibility for someone to cheat in exchange for obtaining personal benefits at company expense. Fraud is a form of deliberate action and incurs losses as well as induces advantages for the perpetrator. A non-transparent system provides opportunities for the perpetrator to act fraudulently. Hence, a strategy for corporate governance in developing and integrating strategies is needed for the purpose of lowering the risk level of fraud (fraud risk). Preventive efforts that can be carried out by a company by making strategies through good internal controls, forbidding collusion between employees and customers/ vendors, employee monitoring and providing a hotline), creating reward and punishment along with conducting audits proactively.

Business control is “a process, effected by an entity’s board of directors, management, and other personnel, designed to provide reasonable assurance regarding the achievement of objectives in the following categories: effectiveness and efficiency of operations; reliability of financial reporting; and compliance with applicable laws and regulations.” Thus, the definition of Control environment itself is a culture, belief, and organizational values. How follows from the operational style of management, how management assigns authority and responsibility, and how the management set up and develop their employees. Next tendency of environmental control is the level of complicity of the board or its directors. Organizational Culture is combine of psychology and attitudes that is communicated by the leadership team to their employees along with ethics, values, and beliefs which are combined for the work implementation and achieving a business goal. COSO (2011).

The American Institute of Certified Accountants (AICPA) has developed a concept for internal control / business control to coordinate activities within the organization and increase the effectiveness of organizational processes (Lakis & Giriunas 2012). The internal control indicates the rules or standards used so that organizational goals be achieved through adherence to a set of procedures, the organization ensures that employees optimistically apply the standards to achieve business by maximizing organizational competence (Flair 2017).

Hightower (2009) mentioned internal / business control as an operational process and the processes used to determine “the efficiency and effectiveness of operations in an organization” to increase compliance with organizational policies and procedures and compliance with applicable laws. Mihacla and Lulian (2012) state that the control system consists of internal organizational controls and procedures, it is also explained that internal control is not only for accounting purposes, but also a system in which people interact with each other. The emphasis is on the importance of an effective leadership plan for the achievement of effective long-term internal control. When the fraud risk assessment is conducted properly, this could help management identify points of emphasis which can pose some risks related to the integrity of company management and the shareholders (Girgenti & Hendley, 2011).

Aside from internal controls, organizational culture can be used to prevent the occurrence of acts of fraud. The culture formed in the organization will create individuals with the value of traits and behavior which has a similarity who will then form a group. If culture is instilled in an organization that cheating is an act that is not good and will harm many parties, then employees tend not to commit fraud.

Organizational culture is related to a system of sharing values and beliefs between employees which in turn can help understand their respective roles in the organization (Luthans & Doh, 2012). Cameron and Quinn (2005) also defined organizational culture as the organizational representation of values, leadership style, signaling procedures and regularity of tasks, which make an organization successful and unique. Watkins (2013) found that organizational culture is identical to a human immune system; and claims that just like the immune system tries to fight harmful viruses and bacteria, an organizational culture is required to create the role of each person in the organization.

Kinichi et. al (2018) defines organizational culture as a set of views made by groups to determine how they should see, think and react to the environment, including organizational culture that is passed on to employees through a characteristic process. The organizational culture influences the behavior of employees in the workplace and the organizational culture varies at each level. Organizational culture also significantly has a role in fraudulence precaution (Rustandy et. al, 2020), so it also means that the better the culture of the organization is, the more effective it will be in preventing fraud.

Based on this definition of the organizational culture, the organizational culture plays the control role, in which the shaping of the behavior of the employees in the organization is emphasized. Top management is responsible for building trust, values, philosophies and standard informal mindsets in the organization that make the actions of the members in the organization homogeneous.

As quoted by Arens (2014), there are three causes of fraud or the so-called fraud triangle; They are pressure, opportunity and rationalization. In addition, fraud prevention, early fraud detection, fraud investigation and legal follow-up are the most important measures to take to deter fraud.

This research was conducted in a Banana Plantation Company in Indonesia which has a broad land and different locations as well as the various backgrounds of its employees. Naturally, groups of individuals would appear in the company, so that business control and organizational culture might have effects on fraud prevention. The problem formulations discussed in this study are: (1) Does Business control have a positive influence on fraudulence precaution? (2) Does the organizational culture have a positive influence on fraudulence precaution?

## **2. Methods**

This study is quantitative and has implemented PLS XLSTAT test equipment to test the validity and reliability of the data collected. The purpose of the validity check is to confirm whether individual elements of the research instrument are suitable for measuring the variables defined in the study. 2 validity tests were carried out; They are convergent validity and discriminant validity.

The sampling method used was the probability sample with a sample of 70 employees. The business control variable dimensions questionnaire consisted of control environment (5 indicators), risk assessment (5 indicators), control activities (6 indicators), communication and information (3 indicators) and monitoring (1 indicator). Based on the average score of the respondents' answers, the business control is in the "very good" category.

Dimensions of organizational culture used Innovation and Risk Tasking (2 indicators), Attention to Detail (2 indicators), Outcome Orientation (1 indicator), People Orientation (2 indicators), Team Orientation (1 indicator), Aggressiveness (1 indicator), and Stability (2 indicators).

Fraudulence precaution Variable Dimensions consisted of Creating A Healthy Culture, Honest, Open and Help each other (3 indicators), Honest Recruitment Process (5 indicators), Positive Work Environment (3 indicators), Clear Code of Ethics, Easy to Understand and Obey (3 indicators), A Penalty against All Forms of Cheating (3 indicators). Hypothesis test (H1) Business Control has a positive impact on fraudulence precaution. And H2: Organizational Culture has a positive impact on fraudulence precaution.

## **3. Result and Discussion**

The purpose of the validity check is to confirm whether individual elements of the research instrument are suitable for measuring the variables defined in the study. There were 2 validity testing conducted, convergent validity and discriminant validity. Convergent validity of the measurement model with reflective indicator was rated based on the loading factor of each latent construct formation indicator. A latent construct is considered to have good convergent validity of the loading factor is higher than 0,7 and significant. Nevertheless, for early-stage research of developing a measurement scale, then the loading value 0,5 to 0,6 is considered suitable (Chin, 1998 as cited in Ghozali and Kusumadewi, 2016: 37). The discriminant validity with reflective indicator was conducted by comparing the AVE square root of every construct with the correlation value between constructs. The good discriminant validity is if the AVE square root is greater than the correlation between the model constructs.

The objective of reliability testing is to establish instrument accuracy, consistency, and preciseness in measuring constructs. The reflective indicator construct is stated reliable if it has Cronbach’s Alpha and D.G Rho values, and if the value is > 0,60 (Ghozali, 2016). The results of the validity test are presented in Table 1.

**Table 1. Convergent Validity Test Results**

Item	Loading Factor	Item	Loading Factor
CE <sub>4</sub>	0,88	TO1	1,00
CE <sub>5</sub>	0,78	AG1	1,00
RA1	0,55	ST1	0,81
RA2	0,84	HT1	0,85
RA3	0,84	HT2	0,86
CA1	0,63	HT3	0,93
CA2	0,82	RC1	0,75
CA4	0,75	RC2	0,80
CA5	0,73	RC4	0,62
CI1	0,82	RC5	0,68
Item	Loading Factor	Item	Loading Factor
CI2	0,71	WE1	0,88
M1	1,00	WE2	0,72
IN1	0,67	WE3	0,81
IN3	0,82	ET1	0,67
AT1	0,80	ET2	0,74
AT2	0,73	ET3	0,75
OO1	1,00	PE1	0,59
PO1	0,75	PE2	0,93
PO2	0,86	PE3	0,89

The result in Table 1 indicates that the loading factor is higher than 0,5 which means that the variable is valid.

**Table 2. Discriminant Validity Test of Business Control**

	Business Control	CE	RA	CA	CI	AVE
Business Control	<b>1</b>	<b>0,68</b>	<b>0,64</b>	<b>0,67</b>	<b>0,64</b>	0,39
CE	<b>0,68</b>	<b>1</b>	0,30	0,39	0,29	0,63
RA	<b>0,64</b>	0,30	<b>1</b>	0,22	0,27	0,57
CA	<b>0,67</b>	0,39	0,22	<b>1</b>	0,37	0,54
CI	<b>0,64</b>	0,29	0,27	0,37	<b>1</b>	0,59
Mean Communalities (AVE)	0,39	0,63	0,57	0,54	0,59	<b>1</b>

**Table 3. Organizational Culture Discriminant Validity Test**

	Organizational Culture	IN	AT	PO	AVE
Organizational Culture	<b>1</b>	<b>0,75</b>	0,28	<b>0,70</b>	0,35
IN	<b>0,75</b>	<b>1</b>	0,14	0,45	0,55
AT	0,28	0,14	<b>1</b>	0,26	0,59
PO	<b>0,70</b>	0,45	0,26	<b>1</b>	0,65
Mean Communalities (AVE)	0,35	0,55	0,59	0,65	<b>1</b>

**Table 4. Discriminant Validity Test for Fraudulence Precaution**

	Fraudulence precaution	HT	RC	WE	ET	PE	AVE
Fraudulence precaution	<b>1</b>	<b>0,82</b>	<b>0,52</b>	0,61	0,50	0,60	0,38
HT	<b>0,82</b>	<b>1</b>	0,32	0,42	0,43	0,35	0,79
RC	<b>0,52</b>	0,32	<b>1</b>	0,16	0,12	0,25	0,51
WE	0,61	0,42	0,16	<b>1</b>	0,30	0,24	0,65
ET	0,51	0,43	0,11	<b>0,30</b>	<b>1</b>	0,15	0,52
PE	0,60	0,35	0,26	<b>0,24</b>	0,15	<b>1</b>	0,67
Mean Communalities (AVE)	0,38	0,78	0,51	0,65	0,52	0,67	<b>1</b>

Based on Table 2, 3, and 4, it could be identified that the AVE score for each construct is greater than the square value of the correlation between constructs. In other words, it already meets good discriminant validity.

**Table 5. Cronbach's Alpha and Composite Reliability**

Latent Variable	Cronbach's Alpha	D. G Rho (PCA)	AVE
Business Control			0,38
CE	0,71	0,84	0,63
RA	0,62	0,80	0,57
CA	0,72	0,82	0,54
CI	0,32	0,74	0,59
Organizational Culture			0,35
IN	0,19	0,71	0,55
AT	0,29	0,74	0,58
PO	0,46	0,79	0,65
Fraudulence Precaution			0,38
HT	0,86	0,91	0,78
RC	0,69	0,81	0,51
WE	0,74	0,85	0,65
ET	0,54	0,77	0,52

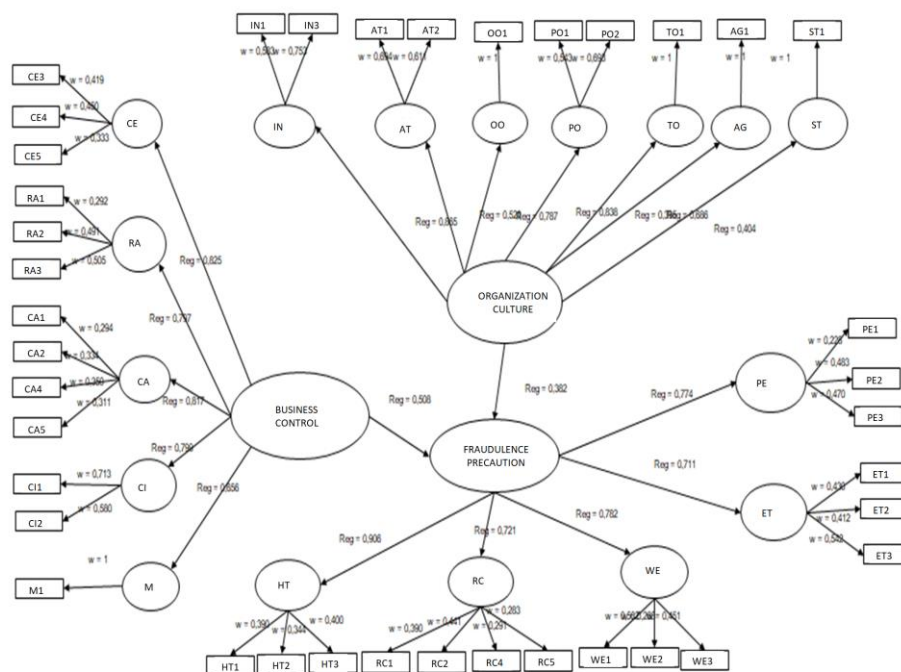
PE	0,74	0,88	0,67
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Table 5 indicates that the D.G Rho value is already > 0,5 which also means that all constructs have good reliability. If AVE is > 0,50 constructs are considered valid and reliable (Ghozali, 2016). Since the AVE value of all constructs is already higher than 0,50 then it already meets reliability and validity.

**Table 6. The Validity and Reliability Test of Formative Indicators**

Latent Variable	Manifest Variable	Outer Weight	Critical Ratio (CR)
M	M1	1,000	1453,226
OO	OO1	1,000	1453,226
TO	TO1	1,000	1453,226
AG	AG1	1,000	1453,226
ST	ST1	1,000	1453,226

In the test of formative indicators validity, the indicator is valid if the critical ratio value is higher than 1,96. From Table 6, it could be concluded that the indicator is valid and reliable.



**Figure 1. PLS-XLStat Model**

**Table 7. R-Squares (R<sup>2</sup>) Table**

R <sup>2</sup>	F	Pr > F	R <sup>2</sup> (Bootstrap)	Standard error	Critical ratio (CR)
0,68	70,15	0,00	0,71	0,07	9,97

Latent Variable	Value	Standard Error	t	Pr. (t)	f <sup>2</sup>	Critical Ration
Business Control	0,51	0,10	5,22	0,000	0,41	3,97
Organizational Culture	0,38	0,10	3,93	0,000	0,23	3,17

Based on Table 7, R2 results were obtained at 0.68, which means that the fraudulence precaution is influenced by the business control variable and organizational culture with each coefficient of 0.51 and 0.38 by

67.7% and is significant at 5% (t-value > t table 1.96)). The remaining 32.3% were effected by other variables that were not included in this research.

**Table 8. Hypothesis Testing Results**

	t-count	t-table	H <sub>0</sub>	H <sub>1</sub>
Business Control → Fraudulence Precaution	5,224	1,96	rejected	accepted
Organizational Culture → Fraudulence Precaution	3,927	1,96	rejected	accepted

The result of this study correlates with Rustandy et. al (2020) and Setyaningsih & Nengzih (2020), in which organizational culture and internal control have an impact on fraudulence precaution. Positive business control and organizational culture in a company have a better impact on fraudulence precaution efforts. Regarding the outcome of this study, the authors claimed that the communication process in the organization is fundamental to building relationships between organizational culture and business control, given that business control framework and social systems theory highlight the need for effective communication channels in changing the Emphasize organizational culture. In addition, clear boundaries are needed to define what constitutes organizational culture and what does not. This will add to management in terms of the ability to control employees' behavior by maintaining organizational values that define their culture and actually affecting their consent to the establishment of business controls.

Pfister (2009) also underlined the influence of the environment on the organizational culture, consisting of what is outside the organization and what is inside the organization. The external environment integrates prevailing social values, practices, laws and regulations, while the internal environment consists of the way employees interact with each other and their personal characteristics. Research has shown that the environment has an impact on organizational culture and how internal control is achieved in the organization.

Business controls represent the management effort to establish the necessary rules and regulations for the successful management of organizations (Mihaela and Lulian, 2012). This view is consistent with the statements made by Cameron and Quinn (2005), in which organizational culture indicates the regularity of procedures and tasks that are responsible for the success and uniqueness of an organization. Ideas on organizational culture and corporate control establish guidelines for the behavior and actions of employees, which are aimed at achieving the development of the company's success.

Schwartz and Davis (1981) argued that organizational culture shapes the background of individuals and groups in an organization and similarly breaks down their beliefs and beliefs. Jaques (2013) also claimed that culture is a collective phenomenon that determines the response of certain members of the same organization to certain stimuli. This proves that employees are starting to trust and share the same and internal mentality.

#### 4. Conclusion

With regard to the study carried out and the proposed hypotheses, it emerged that business control has a positive impact on fraudulence precaution and that the organizational culture also has a positive impact on fraudulence prevention. Corporate culture plays an important role in fraud risk management. In particular, when ethics are firmly anchored in company culture and exemplified by top management, the company is more likely to minimize internal fraud. Management should create and maintain an ethical corporate culture that integrates the core values of the organization and motivates employees to do the right thing. Employees must have the authority to voice their suspicions and recognize their important role in minimizing fraud. A good internal control system, with the right balance between preventative control, deterrence and detective, could significantly reduce the company's vulnerability to fraud.

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