Indonesia Chapter #111

Corporate Governance, Effectiveness of Internal Audit Function and Fraud in Islamic Banking in Indonesia

Naufal Al Baqir & ✉Sulhani

Tazkia University College of Islamic Economics, Bogor, Indonesia

ARTICLE INFORMATION

ABSTRACT

This research explores the correlation between corporate governance and the effectiveness of internal audit functions in preventing fraud within Islamic banking in Indonesia. This study uses 53 observational data sourced from the annual reports of Islamic banking in Indonesia for the period 2010-2019. The data were analyzed using linear regression. The results of this study indicate that corporate governance has no effect on fraud, while the effectiveness of the internal audit function is able to reduce fraud in Islamic banking in Indonesia. The implication of this research is that Islamic banking is expected to consider the effectiveness of the internal audit function in its formation, so that internal audit performance in fraud prevention can be carried out optimally.

Keywords: Fraud, Internal Audit Effectiveness, Corporate Governance.

1. INTRODUCTION

According to the ACFE Indonesia Chapter (2019) all industrial sectors are inseparable from fraud, including those concerning the type, scale of operation, form, and activities, all of which have a risk of fraud. Meanwhile, the industries that are most harmed by the occurrence of fraud are the financial and banking industries, including Islamic banking. This is evidenced by the many cases of fraud that occurred in several Islamic banks, such as the fraud case at Bank Syariah Mandiri (BSM) in 2013 which involved internal bank parties regarding fictitious lending at the Bogor branch of BSM. Bank Syariah Jawa Barat and Banten (BJB) also experienced fictitious credit cases and four internal frauds. A comparable incident took place at the Islamic Bank of South Africa, which suffered from insolvency in 1997 as a result of inadequate accounting and management systems (Rini, 2014).

As an effort to prevent fraud, corporate governance is needed which is reflected in the existence of corporate governance (CG). CG is a system that reflects a systematic monitoring system from the top management level to staff to ensure that the company is well managed (Suzana

✉Corresponding author :
Email: sulhani@tazkia.ac.id

& Lestari, 2019). CG has a very important role. Based on the ACFE survey (2019), fraud is committed not only at certain levels in an organization, but also at the staff and top management levels. Saputra (2017) conclude that CG can reduce the level of fraud at Bank Syariah Mandiri Medan branch. In line with these findings, Halbouni et al., (2016) states that corporate governance has a significant influence in preventing fraud.

The results of a survey conducted by ACFE (2019) showed that internal audit had a very significant role in disclosing fraud that occurred in the company. The existence of internal audit in the company aims to ensure that internal control can run effectively. Research by Drogalas et al., (2017) found that the effectiveness of the internal audit function (IAF) was able to effectively prevent fraud through effective internal control. Research conducted by Yusriwarti (2017) in conventional banking in Pekanbaru concluded that the IAF was able to reduce the incidence of fraud through the recommendations of findings given to top management.

The novelty of this research was conducted at Islamic Commercial Banks in Indonesia with a fairly long period of time from 2010 to 2019. Meanwhile, previous research only focused on a relatively small sample and was carried out in conventional banks with a survey approach as done by Rochmawati et al., (2020) at Rural Banks / BPR X, Rowa & Arthana, (2019) at BPR in NTT; Saputra, (2017) at Islamic bank in Medan; and Fitratul Jannah, (2016) at BPR in Surabaya. In addition, the measurement of the effectiveness of the IAFin this study is measured by comparing the number of branches owned by the Islamic Commercial Bank with the number of internal audits owned by the company. In addition to simplifying the analysis, this formula is also used to see the importance of a good comparison between the number of branches and the number of internal audits owned by the Islamic Commercial Bank, because fraud can occur in any area within the company. Meanwhile,

previous research was conducted using a questionnaire as conducted by Drogalas et al., (2017). Fraud in this study is limited to fraud committed by employees (employee fraud), because this type of fraud is most common in companies.

2. LITERATURE REVIEW AND HYPO-THESIS

Corporate Governance in Islamic Banking
Financial business entities such as banks are very vulnerable or at high risk of fraud so that the principle of prudence is needed to manage them. Corporate governance as reflected by the implementation of CG is designed to protect the interests of stakeholders, improve bank performance, and as an effort to comply with banking regulations so that Islamic banks are expected to develop healthily (Ngumar et al., 2019).

The implementation of CG in Islamic banking is known as Islamic Corporate Governance (ICG) which has the same goal but is distinguished by the obligation to comply with sharia principles. Sharia principles in banking activities are based on a fatwa issued by the National Sharia Council (DSN) formed by the Indonesian Ulema Council (MUI). In addition, the implementation of ICG in Islamic banking also aims to make Islamic banks more syar'i, both in the direction of development and regulation (Trisasmita, 2018). The idea of CG arises due to a situation where there is a clash of interests between the principal and the agent. This situation can lead the agent to provide inaccurate information to the principal, particularly when it comes to the evaluation of the agent's performance. Improper presentation of information will have an impact on the truth of the information needed by the principal (Soleman, 2013).

Internal Audit Function
Currently, internal audit prioritizes the consulting role rather than the watchdog role due to the old paradigm that has shifted, where the role of internal audit prioritizes prevention. Therefore,

management openness is needed so that internal audit can detect and provide advice to management on existing operations (Yusriwarti, 2017). According to Anderson et al. (2017) internal auditing is a valuable and objective activity that is designed to improve the operations of an organization. It uses a systematic and disciplined approach to evaluate risk management, control, and governance processes, helping the organization achieve its objectives. In other words, internal auditing is an independent assessment function that exists within the organization to evaluate the organization's activities as a service provider to the company.

Internal audit has a very important role in an organization. According to Petrescu & Tieanu (2014), all entities require internal audit to conduct business efficiency and reduce costs. The existence of the IAF should not be viewed as an activity that causes a burden on the company's expenses, but rather on the perspective that internal audit is able to increase business benefits by preventing fraud that can harm the business itself in the future.

Fraud
According to the Institute of Internal Auditors (IIA) quoted from Anderson et al., (2017), fraud is any illegal act characterized by deceit, concealment, or breach of trust and does not require the use of violence or physical force. It is committed by individuals or organizations to obtain money, property, or services, to avoid payment or loss of services, or to gain personal or business advantage. From this definition, it can be concluded that fraud is basically an act that violates the law and can harm various parties. Next, ACFE Indonesia Chapter (2019) categorizes fraud into several classifications known as the fraud tree as follows: (1) Asset misappropriation includes the misuse of company assets or property to take advantage. In addition, this fraud is among the easiest to find because the assets are tangible. (2) Corruption is fraud that includes conflict of interest, bribery, illegal gratuity, and economic extortion. Such fraudulent activities pose a considerable challenge in terms of detection as they typically involve collusion with other parties. (3) Fraudulent Statement is fraud by covering up the actual condition of the financial statements through engineering or manipulation in the presentation of financial statements to gain profits.

Hypothesis Development
Internal Auditor Effectiveness and Fraud in Islamic Banking
The existence of Internal Audit in a company can function to prevent and overcome fraud. This is supported by the results of research conducted by Drogalas et al., (2017) and Saputra (2017) that the effectiveness of the IAF is able to prevent fraud within an entity. The ACFE 2019 survey concluded that 23.4% of fraud that occurred in the company was able to be revealed by the IAF. This shows that the IAF in the company has a very important role in preventing and detecting fraud either through disclosure of the fraud or through continuous improvement of the internal control system. Based on this explanation, the first hypothesis in this study is as follows:

H_1: The effectiveness of the internal auditor has a negative effect on fraud in Islamic banking.

Corporate Governance and Fraud in Islamic Banking
In Islamic banking, CG is a mechanism that aims to ensure Islamic banking governance with the principles of openness, accountability, responsibility, professionalism and fairness. With the realization of CG, it is hoped that Islamic banking will be able to decrease conflicts of interest and ensure good supervision of Islamic banking operations. One of the main objectives of CG is to reduce operational irregularities through internal fraud. The previous study show that the better the banking CG, the better fraud prevention that can be done in the

banking sector (Rochmawati et al., 2020; Rowa & Arthana, 2019; Saputra, 2017; Jannah, 2016). Research by Rohmatin et al., (2021) show that CG is able to reduce the possibility of fraud caused by opportunity and rationalization factors. Based on this explanation, the second hypothesis in this study is formulated as follows:

H_2: Corporate governance has a negative effect on fraud in Islamic banking.

3.   METHODS

Population and Sample

The population in this study is all Islamic commercial banks in Indonesia. The sample criteria used are as follows:

a. Islamic commercial banks registered by Financial Services Authority for the period 2010-2019.
b. Islamic Commercial Banks that disclosed annual reports and CG reports during the research period.
c. Having the data needed in research.

Operational Definition of Variable

The dependent variable is fraud as measured by the number of frauds reported in the annual report of Islamic banking. Independent Variable (X):

a. Corporate governance variable: This variable is measured using the composite value presented in the annual report of Islamic banking.
b. Internal Audit Effectiveness Variable: This variable is measured using the following formula:
    Number of branches of Islamic commercial banks i / Number of IAFs of Islamic commercial banks i

Research Model

Fraud it= ait+ β1CGit+ β2EIAit+εit

Note:
Fraud = fraud that occurs in Islamic banking
CG   = Corporate governance
EIA   = Effectiveness of Internal Audit

Data Analysis Technique

In this study, data analysis is carried out using a panel data regression model which is processed with statistical software Stata 14. Panel data regression has three models that can be used such as the common effect model (CEM), fixed effects model (FEM), and random effect model (REM). To get the best model selection, Chow test, Hausman test, and Lagrange Multiplier test can be used. It is important to ensure that the data is relevant to the hypothesis being tested and that it was collected using appropriate methods.

Normality test

Normality test is using the Shapiro-Wilk method with the condition that the data is considered normally distributed if the significance level is more than alpha value of 5%.

Multicollinearity test

To assess whether multicollinearity is present in a set of independent variables, one can utilize measures such as the Variance Inflation Factor (VIF) and Tolerance. Tolerance gauges the degree of variation in a chosen independent variable that is not accounted for by other independent variables. A low tolerance value is equivalent to a high VIF value, as VIF is calculated as the reciprocal of tolerance (VIF = 1/Tolerance). Multicollinearity is absent if Tolerance is greater than or equal to 0.10 or if VIF is less than or equal to 10. Conversely, multicollinearity is present if Tolerance is less than or equal to 0.10 or if VIF is greater than or equal to 10.

Heteroscedasticity Test

Heteroscedasticity test is carried out using the White test. The criteria used in the White test are as follows:

a. If the value of Prob. Chi Square <0.05, meaning there is an indication of heteroscedasticity problems.
b. If the value of Prob. Chi Square > 0.05, meaning there is no indication of heteroscedasticity problems.

3.   RESULTS AND DISCUSSION

In this study, there are 53 data obtained from 2010-2019 of the annual reports of Islamic commercial banks. The table of collection procedures in Table 1.

Descriptive Statistics

From the Table 2, it can be seen that the average fraud that occurred during the last ten years in Islamic banking is 8.2 with the highest score of 83. The average value of internal audit effectiveness is 35% and the average value of corporate governance composite is 1.86, or in the very good category.

Results of data quality test and model selection

The results of data quality test in this study can be seen in tables 3, 4 and 5. From Table 3, it can be concluded that the data is not normally distributed. However, according to Ghasemi & Zahediasl (2012) normality of the data will not cause serious problems if the data used is more than 30. Because the data used in this study is 53 data, it can be concluded that the normality of the data does not interfere with drawing conclusions from the results of data testing. From table 4, the data used in this study is free from heteroscedasticity problems with a p-value of 0.2170. And the results of the multicollinearity test show that the VIF value of 1 and the value of 1/VIF is less than 1 it mean the data is free from multicollinearity problems.

Table 1. **Data Collection Procedure**

Criteria	Year			
	2010-2013	2014-2015	2016-2017	2018-2019
Islamic Commercial Banks registered with OJK	11	12	13	14
Number of banks that meet the criteria	8	9	10	11
The number of data obtained	9	8	16	20
Total data		53		

Source: Data Processed

Table 2. **Descriptive Statistics**

Item	Fraud	Internal Audit Effectiveness	CG
Mean	8.207547	0.356204	1.867925
Median	3	0.238806	2
Maximum	83	0.9615385	3
Minimum	0	0.0641892	1
Std. Deviation	14.07037	0.25896	0.6515584
Observations	53	53	53

Source: Data Processed

Table 3. **Results of Data Normality Test**

Variable	Obs	W	V	Z	Prob>z
Fraud	53	0.59902	19.746	6.383	0.00000
Internal Audit	53	0.88712	5.559	3.671	0.00012
ICG	53	0.98993	0.496	-1.501	0.93339

Source : Data Processed

Table 4. **Heteroscedasticity Test**

Source	Chi2	df	p-value
Heteroscedasticity	7.05	5	0.2170

Source: Data Processed

Table 5. **Multicollinearity Test**

Variable	VIF	1/VIF
Internal Audit	1.00	0.998787
CG	1.00	0.998787

Source: Data Processed

Table 6. **Chow Test Results**

F (10, 40)	Prob> F
0.83	0.6004

Source: Data Processed

Table 7. **Lagrange Multiplier Test Results**

Chibar2 (01)	Prob > Chi bar 2
0.03	0.4362

Source: Data Processed

The first model selection test performed is the chow test. The Chow test aims to choose between the CEM and FEM models. From the test results, the probability value is 0.604 or greater than 0.05, so the CEM model is chosen. Furthermore, the LM test is conducted to choose between the CEM and FEM models. From the test results, the probability value is more than 0.05, so the CEM model is chosen. From the two tests, it can be concluded that the model chosen in this study is the CEM model. The results of the Chow test and LM Test can be seen in the Table 6 and 7.

Hypothesis testing results
The result of testing the research hypothesis can be see in Table 8.

Internal audit effectiveness and fraud
Statistical tests in Table 2 shows that there is a significant negative effect between the effectiveness of internal audit and fraud in Islamic banking in Indonesia. The results of this study are in line with the results of research conducted by Yusriwarti (2017) and Drogalas et al., (2017) that the existence of an internal audit can reduce the level of fraud in Indonesian banks. The statement implies that having a effective IAF plays a crucial role in mitigating fraudulent activities within the Islamic banking system. Internal audit is able to improve operational efficiency through the implementation of internal controls that can prevent fraud (Petrescu & Tieanu, 2014). On the other hand, the results of this study also prove that OJK regulation No. 1/POJK/0.3/2019 related to the implementation of the IAF can reduce the risk of bank losses due to inefficient business processes and the occurrence of fraud in the company.

Corporate governance and fraud
Based on Table 2, it shows that CG has no effect on fraud in Indonesian Islamic banking. The results of this study are in line with the results of research conducted by Najib & Rini (2019) and Astuti et al., (2019) that corporate governance has no effect on fraud. This is presumably because: 1) corporate governance carried out by Islamic banking does not touch the aspect of fraud prevention; 2) corporate governance implemented is more aimed at reducing conflicts of interest; and 3) monitoring and supervision at the top management level does not touch the operational level and daily activities of the

Table 8. **Statistical Test Results**

Variable	Coef.	p-value
Independent Variable		
Internal Audit Effectiveness	-25.85999	0.000
CG	2.009224	0.457
Const	13.6659	0.021
N	53	
F-stat	0.0014	
R^2	0.2321	
Adjusted R Squared	0.2014	

Source: Data Processed

company. Research conducted by Ngumar et al., (2019) concludes that although the board of directors and top management have an important role at the operational and institutional levels, their existence is not fully capable of controlling fraud that occurs, because fraud can occur at every level of the organization. In addition, the measurement of corporate governance used in the study is suspected to be less focused on elements of corporate governance related to fraud, such as the audit committee function or the risk monitoring function. This causes the resulting effect to be insignificant because the measurements used are too broad.

5. CONCLUSION

This study aims to analyze the effect of internal audit effectiveness and corporate governance on fraud in Islamic banks in Indonesia. Based on the results of the research discussed in this section, it can be concluded that internal audit effectiveness influences fraud in Islamic banking, while corporate governance has no effect on fraud in Islamic banking. Because fraud often occurs not only in central Islamic banking but also in certain branches in the regions, Islamic banking is expected to be able to meet the adequacy of the IAF by considering the number of branches owned so that the IAF that is carried out can play an effective role in preventing fraud because Internal audit resources are sufficient both in terms of quantity and quality.

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