

# THE INFLUENCE OF GOOD GOVERNANCE, INTERNAL AUDIT FUNCTION AND ETHICAL WORK CLIMATE ON THE FRAUD LEVEL

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***Abstract:** This study shows the determinant factors which influence the fraud level in local government of Indonesia. The objective of this research was to examine the influence of good governance, the effectiveness of internal audit function, and ethical work climate on the fraud level. The study was conducted on 108 head offices and auditors in the 36 local governments of Central Java, Indonesia. The data used are primary data through questionnaires, and secondary data used the results reports of supreme audit of Republic Indonesia. This research was carried out in 2016. The data was processed using SEM Partial Least Square. The results show that: good governance, the effectiveness of the internal audit function and ethical work climate, have negative significant influence to the fraud level.*

***Keywords:** good governance, the effectiveness of internal audit function, ethical work climate, the fraud level.*

## 1. INTRODUCTION

Frauds and corruptions are cancers that eat away at society's productivity and reduce the effectiveness and efficiency of economies (Albrecht *et al*, 2011). ACFE (2014) mentions three types of fraud, fraudulent financial statements, missappropriation assets and corruption. From the findings, the highest was found in terms of quantity in the asset missappropriation with 85% of the total amount and the loss of \$ 130,000. But otherwise, fraudulent statement occupies the largest share of 9%, with a total loss of \$ 1,000,000. The magnitude of the findings has made the institution suffered losses, with the possibility that misstatements due to fraud or error.

Cohen *et al*, (2004) stated the weak corporate governance has been the cause of fraud and scandal of accounting. When top management played a role in fraud and collusion, it become increasingly complicated and more difficult to detect (Alleyne and Howard, 2005). Other causes, ethical behavior remains questionable both in society

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and within organizations (Callahan, 2004). Murphy (2012) also stated that the ethical climate plays a role when fraud is perpetrated within organization..

In Indonesia, fraud phenomenon also occurs in government agencies, seen from the findings until June 2014, there are 223 examination report (LHP) supreme audit Republic Indonesia/ BPK which indicates criminal act turned over to law enforcement. From the examination report reveals 437 findings which were indicated causing to the state losses. These findings are based on the BPK calculation which costs the state IDR 33,392,803,321,893 and US \$ 840,991,291. (Nizam Burhanuddin, 2014).

The survey results of Transparency International Indonesia (TII, 2010) reported that from the data surveyed distribution across Indonesia is to determine the factors that trigger the fraud occurrence of corruption as it is seen from the bureaucratic process parameter pace (public service). Booz Allen and Hamilton in TII (2010) states that the higher corruption level shows that good governance is still far from expectations. The measurement of Corruption Perception Index (CPI) which was conducted by Transparency International (TI, 2015) produces that Indonesia ranks to 88 of 168 with a score of 36.

This research investigates the willingness and actions of local government in the Middle Java of Indonesia to report peer misconduct. In other words, their propensity to implement preventive actions and mechanisms to avoid and reduce the possibility of fraud occurrence (Albrecht *et al.*, 2011; Bar-Gill and Bebchuck, 2003; Hemray, 2004; Rezaee, 2012).

It also presents the results of a study that predicts local government employees from the perspective of ethical climate theory (Victor and Cullen, 1988) and several contextual predictors common to previous fraudulent research. It specifically investigates the caring, rule, code of law, independence, instrumental climates to predict fraud. Previous research focused on the study of the fraud, whereas in this study the researchers also use good government, internal audit function, and ethical work climate as factors that affect fraud in the local government. Furthermore, there are only a few previous researches regarding this matters motivating authors to investigate and accommodate new developments in the application of local government accounting in Indonesia.

Based on the description, the authors considered it is important to do some research as it was outlined by good governance research, internal audit function, ethics and fraudulent context. The purpose of this study was to determine and obtain empirical evidence and to get an answer how much the influence of good governance, internal audit function and ethical work climate on the fraud level.

This paper will be organized into some explanations as follows: literature review, theoretical framework, study model and hypothesis, conclusion, include references.

## **2. LITERATURE REVIEW**

### **2.1. Implementing Good Governance**

Cadbury Committee in 1992 was the first institution that introduced and the term of corporate governance and defined as the system by which organisations are directed and controlled. The United Nations Development Programme (1997) argue that governance as the exercise of political, economic and administrative authority to manage a nation's affairs at all levels. World Bank (1999) states governance as the way state power is used in managing economic and social resource for development and society. Asian Development Bank (1999) defines governance as the manner in which power is exercised in the management of a country's economic and social resources for development.

International Federation of Accountants (2014) in their research revealed that governance comprises the arrangements which is put in place to ensure that the intended outcomes for stakeholders are defined and achieved. Good governance is characterized by strong oversight, which put significant pressures on the improvement of public sector performance and corruption handling. Good governance can enhance organizational leadership, management, and supervision, can result more effective interventions, and ultimately lead to better outcomes with the improvements of people's lives. (IFAC, 2014). Based on the above explanation, good governance is the application of principles and rules of government policy to ensure the decision-making result of government governance which is solid and responsible, it is suitable to the public interest. (IFAC (2014); UNDP (1997); WORLD BANK (1999); ADB (2011), OECD (2004), LAN (2000), BPKP (2002), KNKG (2006), LAN& BPKP (2000)).

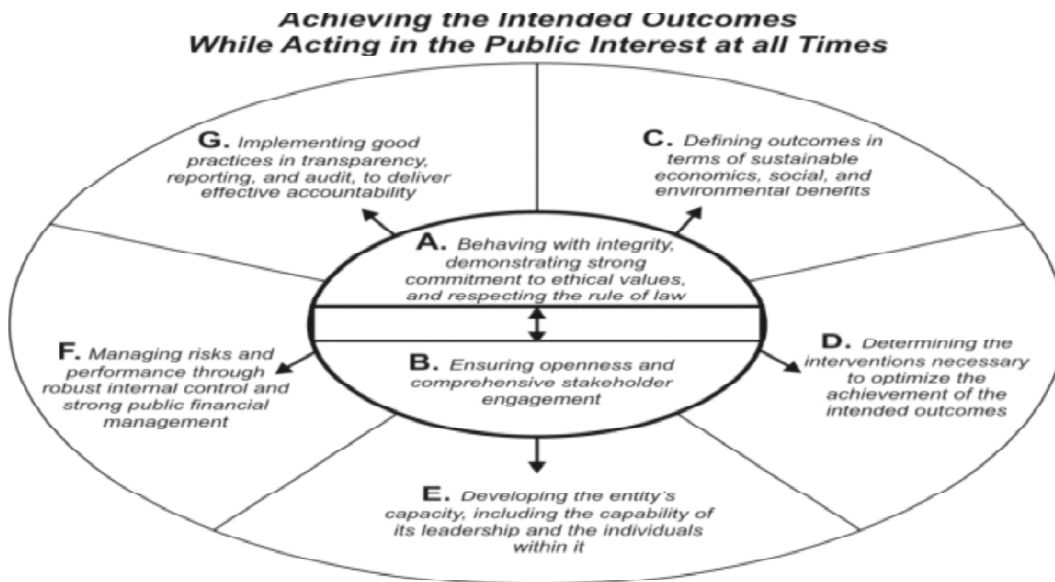
#### **2.1.1. Characteristics of Good Governance**

According to United Nations, good governance promotes equity, participation, pluralism, transparency, accountability and the rule of law, in a manner that is effective, efficient and enduring. Otherwise, UNDP (LAN & BPKP, 2000), the principles of good governance are: participation, rule of law, transparency, responsiveness. ADB explained that good corporate governance contains four core values namely, accountability, transparency, predictability and participation. Good governance improves organizational leadership, management, and supervision of, the intervention more effective and better output. (IFAC, 2011).

### **2.2. Effectiveness of Internal Audit Function**

Internal audit function according to International Standard on Auditing (ISA) 610 (2009) and The International Standards of Supreme Audit Institutions (ISSAI) 1003 (2010) as an appraisal activity established or provided as a service to an entity. Its functions are examining, evaluating and monitoring the adequacy and effectiveness of internal control. The internal audit function will be effective if it can provide additional value to organization (IIA, 2004; Hiro Tugiman, 1997; Nagy and Chenker,

Figure 1: Principles of Good Governance in the public sector



Source: International Federation of Accountants, 2014

2002; Allegrini *et al*, 2006) and achieve the desired goals (Cohen dan Sayag, 2010). The purpose of internal audit is to improve efficiency and effectiveness of organization (Eden and Moriah, 1996). Furthermore, Cangemy and Singleton (2003) states that an effective internal audit function is to achieve its objectives, and the main purpose of internal audit department is to help improving and enhancing internal controls.

### 2.3. Ethical Work Climate

Over the past several decades, increasing attention has been given to ethics within organizations (Kaptein, 2010). Ethical work climate or often abbreviated to ethical climate is one of the most influential conceptual basis in the field of business ethics (Martin and Cullen, 2006:175). Since it was introduced by Victor and Cullen in 1987 and 1988, ethical work climate is more growing in the literature of business and ethics and famous with Climate Ethical Theory (Martin and Cullen, 2006: 175). Ethical Work Climate according to Victor and Cullen (1988: 101) is as the policies and procedures of organization that provides ethical values. The research on ethical climate which was conducted in non governmental organizations and non public sector is done by Malloy and Agarwal (2010) which states ethical work climate as the perception of policies, procedures, myths, reward and punishment systems, and behaviors that are manifested in actual ethical conduct of the members. (Hodgkinson, 1996; Sims, 1992; Trevino, 1992 in Malloy and Agrawal, 2010).

Victor and Cullen (1988) crossed classification of three classes from ethics theories (egoism, utilitarian and deontological) with three reference groups or locus analysis dimensions (individual, local and cosmopolitan) formed nine theoretical dimensions of ethical climate. From the previous statement we can conclude that ethical work climate is specific organization policies and procedures that provides ethical values. [Victor and Cullen, 1988; Martin and Cullen (1987, 1988), Denison (1996). Trevino *et al* (1988), Malloy and Agrawal (2010) Sims (1992)]. Dimensions in the measurement of ethical work climate is caring (caring), rules (rules), laws and code of ethics (law and code), independent (independence) and instrumental (Victor and Cullen, 1988).

**Table 1**  
**Five Dimensions of Ethical Work Climate**

Ethical Criteria	Locus of Analysis		
	Individual	Local	Cosmopolitan
Egoism	Instrumental		
Benevolence	Caring		
Principle	Independence	Rules	Law and Code

Source: Vardaman *et al*, 2012.

**2.4. Fraud Level**

Fraud is specific factors of deception, breach of trust by misstatements that is characterized in the form of fraudulent financial statement, missappropriation assets, and corruption that led to the financial risk in company (Arens 2014; IIA, 2013: ACFE 2014: Belkaoui, 2012, Beasley *et al*, 1996; Dorminey, 2012; Ricchiute, 2006; Singleton and Singleton, 2010).

The existence of fraud may be seen by looking at the symptoms as the evidence which is circumstantial, along with the emergence of such change in lifestyle or behavior, suspicious to documentation, customer complaints or suspicions to co-workers; and the incidence of irregularities (fraud) can be reflected through the emergence of certain characteristics that are situated, such as the condition/state of environment, and the behavior of someone which is an indicator of fraud that are referred to as red flags (Moeller, 2010).

Based on the Standards of Auditing Standard (SAS) No. 99, Concideration of Fraud in Financial Statement Audit and Arens *et al* (2014) introduced the concept of fraud triangle as the cause of fraud occurrence. The act of fraud occurs because there is a set of conducive conditions to the occurrence of such acts. A set of the conditions is known as the condition that causes fraud.. This study was measured using a type of fraud by ACFE (2014), where in combination with fraud triangle as a tool to detect and predict the occurrence of such fraud committed by Skousen *et al*, 2008; Lou and Wang, 2011; Ramamoorti, 2008; Dellaportas, 2013; Dorminey, 2012; Choo and Tan, 2008; Morales, 2014.

### 3. THEORETICAL FRAMEWORK AND HYPOTHESIS

#### 3.1. The Influence of Good Governance Application to Fraud Level

Fraudulent on financial statements is one of the centers of auditors attention from time to time. In order to determine whether there is possibility of fraud in financial statements, then the one that matters is governance. (Rezaee and Rilley, 2010). Entities that have weak corporate governance, it tends to be found fraud in financial statements. This weakness is based on a failure to apply the principles of governance and governance mechanisms which are less effective to open the opportunities for fraud.

Dechow *et al* (1996), and Beasley *et al*, (2000), Ponduri *et al* (2014) focuses on the influence of governance against fraud, fraud proposal, the person who is responsible for a variety of fraud and the role of regulatory bodies in tackling fraud. Ponduri stated that good governance involves honesty, transparency, and accountability in organization. One of social control to prevent all forms of unethical practices including bribery and corruption is governance by building an ethical culture. Fraud prevention mechanisms such as codes of employees conduct, strict enforcement, the mechanism of whistle-blowers, and regular monitoring mechanisms to overcome fraud. Philip Laws (2011) found in the United States, good governance mechanism, such as the effectiveness of internal audit, tone of the top, the effectiveness of audit committee, ethical guidelines and policies which are positively associated with the reduced fraud in organization. The success of the previous auditor in fraud detection and the auditor type who work is an influential factor in reducing fraud.

Agrawal and Chada (2005) states that governance mechanism is associated with the entity probability that conducts restatement in calculating its earnings. Statistically, this relationship is very closed and strong with the idea that an independent director with financial expertise can provide supervision on the company's financial reporting practices. Similar opinion was expressed by Magnanelli (2010) who states that by using blockholder, a model system of corporate governance can reduce the presence of fraud and its mark. Good management became a major influence and is closely related to corporate governance in preventing fraud.

Based on the research problem and a framework that has been stated previously, the research hypothesis can be formulated as follows:

Hypothesis 1: There is a negative influence between good governance to fraud level in local government

#### 3.2. The Influence of Internal Audit Function Effectiveness to Fraud Level

Internal auditors play a role in the prevention and detection of fraud by assessing the effectiveness of the organization, to give input on sustainable performance improvement and monitoring of quality, integrity and reliability of financial reporting (Rezaee and Riley, 2010: 206). Meanwhile, Emanuel *et al*, (2013) reported internal audit in Kogi state can effectively reduce fraud and irregularities in the public sector. Internal

control systems in the state were very weak; auditing and financial reporting procedures are not accountable because of political interference and the skills of some of the staff audit weak. By understanding about the various types of fraud, the auditor may reduce the possibility of fraudulent financial reporting (Beasley *et al*, 2000). While Church *et al* (2001) suggest an internal auditor to identify significant variations in the trend of fraudulent financial reporting. There is a positive relationship between the findings of the internal auditor's experience and client trust of fraud detection.

Tak Isa *et al* (2012) stated that there are several ways to prevent financial fraud. Basic main problem is the detection of inadequate financial and ignorance of the importance of the internal audit function in the internal control system in a single entity. In Romania, with the same perception of the internal auditor and the structure of internal controls were adequate, the prevention of financial fraud can be overcome.

Burnaby *et al* (1998) conducted a survey of internal auditors to fulfill professional responsibilities and skills to find fraud. Of all industries, fraud in the field of IT has the potential and the greatest degree of possible losses. On the other hand, Thompson (1999) argues even though most of the internal auditor concerns about financial fraud, they need to prevent and detect about it. Internal auditors should be able to see the occurrence of fraudulent financial reporting. KPMG conducted the survey results in 2010 also explains that the factors which led to an increase in fraud is weak internal audit, declining ethical values and a failure to act to prevent and detect fraud.

Based on the research problem and a framework that has been stated previously, the research hypothesis can be formulated as follows:

Hypothesis 2: There is a negative influence between internal audit function effectiveness to fraud level in local government.

### **3.3. Ethical Work Climate Influence to Fraud Level**

Ethical Work Climate plays an important role when fraud presents in an organization, and is correlated with specific motives and rationalization for cheating. The study results showed that ethical work climate is explicitly considered for the prevention and detection of fraud. Murphy and Dacin (2011) considered that ethical work climate will bring up the fraud in company at egoistical level/local climate, which lead employees tend to commit fraud. Employees are expected to do what is the best for increasing the company's profits regardless of the consequences from such actions. Soltani (2014) in his literature study examines the factors that affect corporate failure, ethical climate, tone at the top, bubble economy and market pressure; fraudulent financial reporting; accountability, control, inspection, governance; and compensation.

Shafer and Wang (2011) states that serving public interest (benevolent/cosmopolitan climate) which is owned by professional accountants are significantly more tolerate earnings management that is conducted by company. Adnan, *et al* (2013) measure the dysfunctional behavior of managers in budgeting, reporting manipulation by measuring the ethical antecedents, such as ethical attitude, ethical ideology, code

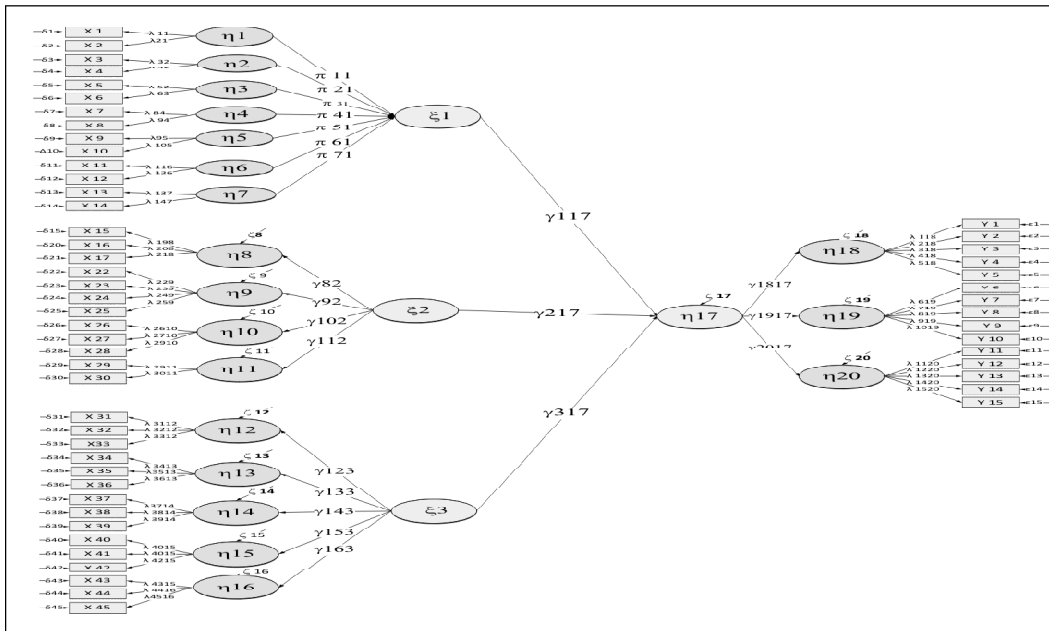
of ethics and ethical work climate and perceived ethical leadership. Through the code of ethics, employees will know what to do's and not to do from ethical practices which are expected from them, while ethical work climate/Climate Ethical Work is in line with the organization's culture but it is strong enough to influence ethical conduct to manipulate financial statements.

Based on the research problem and a framework that has been stated previously, the research hypothesis can be formulated as follows:

Hypothesis 3: There is a negative influence between ethical work climatetofraud level in local government.

Based on the theoretical framework and hypothesis , then the model of the research is as below:

Figure 2: Theoretical Framework Study



#### 4. METHODOLOGY

The method that is used is verificative research and explanatory research or causality, that this research aims to determine that one variable causes changes to another variable (Sekaran and Bougie, 2013: 98). This study is included in the overtime study group (cross-sectional studies). Because the study is cross-sectional studies/research study which is conducted by only at once collecting data, it could be daily, weekly, or monthly, in order to answer the research statement (Sekaran and Bougie, 2013: 106).



### **Methods of Data Analysis**

This study uses both primary and secondary data. Primary data was collected using a questionnaire as a research instrument and secondary was derived from audit agency/BPK RI. After tabulation of data, then the data is analyzed using the method of Structural Equation Modeling (SEM) with the aids of Partial Least Square (PLS).

### **Operationalization of Variables**

1. Implementation of good government (X1), with the dimensions include integrity, openness, outcomes, interventions, entity capacity, risk and performance, and accountability (IFAC (2014), UNDP (1997); WORLD BANK (1999); ADB (2011), OECD (2004), LAN (2000), United Nations (2014), BPKP (2002), NCG (2008), LAN (2000))
2. Effectiveness of internal audit function (X2), dimensions are internal audit quality, auditor professional capability, organizational settings, and contribution of value-added internal audit. Cohen (2010); Moeller (2010); Hiro (1997); IIA (2010)
3. Ethical work climate (X3), with dimensions, such as concern, rules, laws and codes of conduct, independent and instrumental. Victor and Cullen, (1988), Martin and Cullen (1987, 1988), Victor and Cullen (1988), Denison (1996), Trevino *et al* (1988), Malloy and Agrawal (2010), Sims (1992),
4. Fraud Level (Y), dimensions are fraudulent financial statement, missappropriation assets, and corruption that led to the company's financial risk (Arens 2014; IIA, 2013; ACFE 2014; Belkaoui 2004, Beasley *et al*, 1996; Dorminey, 2012; Ricchiute, 2006; Singleton and Singleton, 2010).

### **Description of Study Results**

The questionnaire items that were used have been thought on the standards of validity and reliability (Hair *et al*, 2014). The measurement device to analyze validity and reliability is Partial Least Square - Structural Equation Modelling (PLS-SEM) with an alternative method of partial least square model approach measurement on second stage (second order). The study was conducted on 108 responden as inspectors, audit team leader and Unit Leader, and Treasurer in DPKKAD section in 36 local governments of Central Java, Indonesia. This research was carried out in early 2016.

## **5. FINDING AND DISCUSSION**

### **Data analysis**

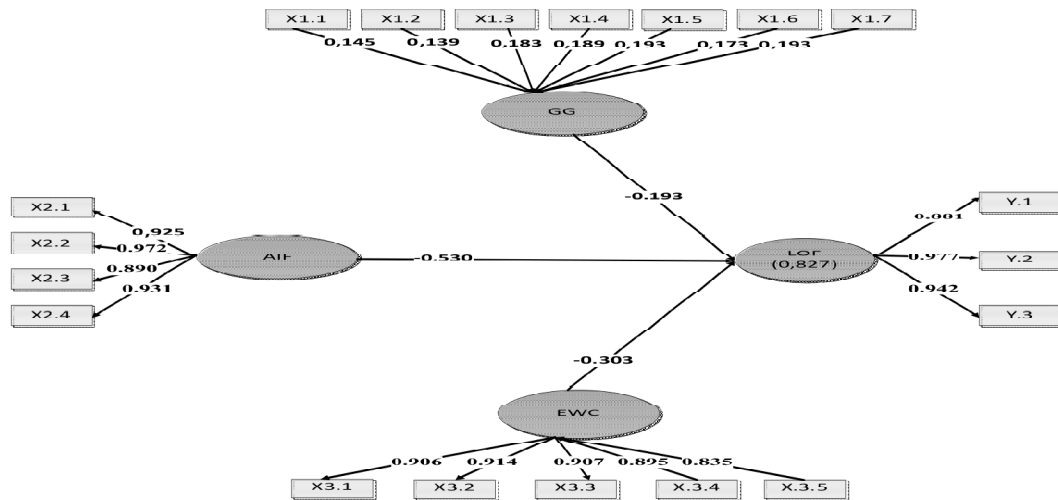
Testing the effect of good government implementation, effectivity of internal audit, and ethical work climate on the level of fraud is done by using structural equation modeling (SEM). In structural equation modeling, there are two types of models which are formed, the measurement model and the structural model. Measurement model

describes the proportion of variance of each manifest variables (indicators) that can be explained in latent variable. Through the measurement model, it will be known which indicators are more dominant in the formation of latent variables. After each measurement model, latent variables will be elaborated further it will be elaborated structural model that will assess the effect of each independent latent variables (latent exogenous variables) to the latent dependent variable (endogenous latent variable).

**Model Measurement (Outer) Model**

Measurement is a model that links between latent variables to manifest variables. There are two latent variables to manifest variables. Implementation of good governance consists of seven manifest variables, effectiveness of internal audit function consists of four manifest variables, ethical work climate consists of five manifest variables and fraud level consists of three manifest variables. This study uses partial least square method of estimation which obtained full path diagram.

**Figure 3: Full Model**  
**The Influence of Governance Implementation, Internal Audit Function Effectiveness, Ethical Work Climate to Fraud Level**



Source: Data Processed (2016)

**(a) Variable Measurement Model of Good Government Implementation**

Good government consists of seven manifest variables. Measurement governance uses formative measurement models. There are three things that must be evaluated from formative indicators such as collinearity, significance and relevance.

**Table 2**  
**Weight Factors Variable Implementation of Good Governance**

No	Const- ruct	Dimension	Coeffecient Component		Relevance	Vali- dity	VIF	Collinearity	
			Esti- mate	Error Standard (STDEV)					
(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	
1	TKP	X1	Integrity	0.145	0.03	Relevant	t.t.	1.767	Non Col
2		X2	Openness	0.139	0.02	Relevant	t.t.	3.636	Non Col
3		X3	Outcomes	0.183	0.02	Relevant	t.t.	4.232	Non Col
4		X4	Interventions	0.189	0.02	Relevant	t.t.	2,994	Non Col
5		X5	Entity's Capacity	0.193	0.02	Relevant	t.t.	2.350	Non Col
6		X6	Risks & Performance	0.173	0.02	Relevant	t.t.	3.479	Non Col
7		X7	Accountability	0.193	0.02	Relevant	t.t.	3.943	Non Col

Source: Primary Data Processed (2016)

**Table 3**  
**Measurement Model of Internal Audit Function Effectiveness, Ethical Work  
Climate and Fraud Level**

No	Var	Dimension	Loading Factor		R <sup>2</sup> (O <sup>2</sup> )	Dimension				Construct		
			Esti- mate (O)	Error Stan- dard (STDEV)		Vali- dity	Relia- bility	AVE	CR	Vali- dity	Reliabi- lity	
(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)	(11)	(12)	
1	FAI	X8	KA	0.925	0.067	0.86	Valid	Reliable	0.866	0.962	Valid	Reliable
2		X9	KPAI	0.972	0.019	0.95	Valid	Reliable				
3		X10	PO	0.890	0.038	0.79	Valid	Reliable				
4	IKE	X11	KNT	0.931	0.038	0.87	Valid	Reliable				
7		X14	KEP	0.906	0.039	0.82	Valid	Reliable	0.796	0.950	Valid	Reliable
8		X15	ATR	0.914	0.031	0.83	Valid	Reliable				
9		X16	HUK	0.907	0.030	0.82	Valid	Reliable				
10		X19	INDP	0.895	0.028	0.80	Valid	Reliable				
11		X20	INST	0.835	0.060	0.70	Valid	Reliable				
12		TK	Y1	FFR	0.881	0.067	0.78	Valid	Reliable	0.874	0.953	Valid
13	Y2		MA	0.977	0.008	0.96	Valid	Reliable				
14	Y3		CO	0.942	0.028	0.89	Valid	Reliable				

Source: Primary data processed (2016)

These three variables are using reflective measurement models, so that what is concerned are:

- 1) Dimension Validity, the dimension limits of a construct which has good validity convergence is the AVE-value of 0.5 and above. Dimensions of each construct in this study had a good level of convergence validity.

- 2) Dimension Reliability, the dimension of reliability which is seen from  $R^2$ -value of each dimension. According to Hair *et al.*, (2014: 103) dimensions with  $R^2 > 0.5$  are considered to have good reliability, between 0.3 and 0.5 are poor reliability, and below 0.3 are considered unreliable.
- 3) Convergence Validity Dimensions per Construct. aconstruct has good convergence validity if it has greater AVE value than 0.5 (Hair *et al.*, 2014: 103). Convergence validity test results which are presented in general dimension has AVE value which is greater than 0.5.

### Structural Model (Inner Model)

Structural model is a model that links exogenous latent variables to endogenous latent variables or endogenous variable relationship with the other endogenous variables. Here's a summary of the values that are used in structural model.

**Table 4**  
Statistics Summary Test Results

Path	Coefficient	VIF	T Test		R Square
			t count	p-value	
$X_1 \rightarrow Y$	-0.193	6.104	2.047	0.004	0.827
$X_2 \rightarrow Y$	-0.530	2.710	4.271	0.000	
$X_3 \rightarrow Y$	-0.303	2.465	2.321	0.000	

The implementation of good governance, effectiveness of internal audit function and ethical work climate together give the influence of 82,7% on fraud level, while the remaining 17,3% is the influence of other factors which are not examined.

**Table 5**  
Structural Model Influence Good Governance, Internal Audit Function, and Ethical Work Climate on Fraud Level

Endogenous Constructs	Exogenous Constructs			
	GG	IAF	EWC	Error Variance
Fraud	-0.193 (6.104)	-0.530 (2.710)	-0.303 (2.465)	0,173

**Table 6**  
The Implementation of Good Governance on Fraud Level Test Result

Path Coef	T <sub>count</sub>	P <sub>value</sub>	H <sub>0</sub>	H <sub>a</sub>
-0.193	2.047	0.004	Rejected	Accepted

From the P value can be concluded P value (0.004) < 0,05. With significance level of 5%, it can be concluded that Ho is accepted and Ha is rejected. it can be concluded that the implementation of good governance has negative influence to fraud level.

**Table 7**  
**Internal Audit Function Effectivenesson Fraud Level Test Result**

<i>Path Coef</i>	<i>T<sub>count</sub></i>	<i>P<sub>value</sub></i>	<i>Ho</i>	<i>Ha</i>
-0.530	4.271	0.000	Rejected	Accepted

From the P value can be concluded P value (0.000) < 0,05 With a significance level of 5%, it can be concluded that Ho is rejected and Ha is accepted. It can be concluded that internal audit function effectiveness has negative significant influence to fraud level with a significance level of 5%.

**Table 8**  
**Ethical Work Climate on Fraud Level Test Result**

<i>Path Coef</i>	<i>T<sub>count</sub></i>	<i>P<sub>value</sub></i>	<i>Ho</i>	<i>Ha</i>
-0.303	2.321	0.004	Rejected	Accepted

From the P value can be concluded P value (0.004) < 0,05. With a significance level of 5%, it can be concluded that Ho is rejected and Ha is accepted. It can be concluded that ethical work climate has negative significant influence to fraud level with a significance level of 5%.

## DISCUSSION

### The Influence of Government Governance on Fraud Level

Good governance comes from the paradigm shift from state administration to public administration and the changing demands from government to governance, which requires the need of increased public accountability. This is an effort on the utilization of government apparatus in the hope that it can realize the system of public administration that really can and are able to practice the principles of good governance. In order to do that it required the development and implementation of the system of accountability and transparency which is precise, clear and evident so that the governance and development can take place in effective, efficient, effective, clean, responsible and free from corruption, collusion and nepotism practices.

From the statistics discussion, it can be concluded that the implementation of good governance influence fraud level in the 5% significance level. The fact that happened, despite the repeated changes of government as well as the leadership succession can take place peacefully and democratically, it was that the behavior of those who are in power still color the decision-making process in the name of public interest. On the

other hand, because of the power decentralization, corruption had been decentralized. Not only the highest authority and the central government who corrupt, but it has spread to many new center power, in the Parliament, Region Parliament, local government, and even political parties which since in the beginning they are expected to be the democracy prime mover. This is in which good governance ensures the efforts to eradicate corruption. Having regard to the number of good governance elements, it is expected to, slowly but sure, be the fraud, the abuse of power for the benefit of himself and his group, will be monitored. And, in turn, corrupt government will be regarded as poor governance and does not deserve to be preserved.

This study was also supported by a research made by Ponduri *et al* (2014), Agrawal and Chada (2005), Omar and Katerina (2011), Barbara Sveva Magnanelli, (2010), Kalbers (2009), Kalbers (2009) and Farber (2005).

### **The Influence of Internal Audit Function Effectiveness to Fraud Level**

According to Rezaee and Riley (2010: 133) that internal auditor activity is to prevent and detect fraud in the organization. Similarly in this case a survey that was conducted by KPMG (2010) also explains that, weak internal audit are all factors that lead to an increase in fraud.

From the results of the study states that the effectiveness of internal audit function negatively affects of -0.530. According to the classification of Guilford (1956: 145) shows that the influence of internal audit function moderately affects on fraud level. Inspectorate as the prime mover of good governance is required to address the challenges that the expectations of the public/stakeholders such as the prevention and eradication of corruption, excellent public services, responsive to citizen complaints, the accountable financial statements, as well as imposed targets for local governments achieve unqualified opinion by the effective system supervision.

The weakness of internal audit function in Central Java government is on the resource settings in which there is the lack of auditors who have achieved a kind of functional positions auditor (JFA), the lack of specific training in auditing and fraud, and the number of auditors who are not suitable to the auditee.

### **The Influence of Ethical Work Climate to Fraud Level**

The study results provide strong empirical evidence that ethical work climate will reduce fraud level. In other words, it can be interpreted that fraud level can be reduced if work climate in contained company has the characteristics of concern, rules, legal and ethical code, independent ethical climate and instrumental. The statement was supported by Murphy *et al* (2012) states that ethical work climate plays an important role when fraud presents in an organization, and is correlated with specific motives and rationalization for fraud. Similar thing is disclosed by Shafer and Wang (2011); Adnan, *et al* (2013) ethical work climate is in line with the organizational culture but it is strong enough to influence ethical conduct to manipulate financial statements.

The observations in field also show that fraud which is committed is “congregation” fraud which is committed together for supervisor instructions or conditions that lead to fraud. The lack of pressure from the leadership and supervision which inherent on internal regulatory authorities open the opportunities of fraud happens. This pressure can be implemented with written ethical code that is related to fraud acts and the implementation of facts integrity between the various parties to jointly reduce corruption, collusion and nepotism as one form of fraud/cheating.

## 6. CONCLUSION

Based on the data analysis and discussion of study results, it can be concluded as follows;

- 1) Good governance, internal audit function and ethical work climate have negative significant influence to fraud level.
- 2) The implementation of good governance, the effectiveness of internal audit function and ethical work climate together give the influence of 82,7% on fraud level, while the remaining 17,3 % is the influence of other factors which are not examined.

## 7. IMPLICATIONS

It is recommended for local government to strengthen good governance. The implementation of e-government such as e-budgeting, e-procurement, etc. becomes crucial to be implemented in order to reduce fraud level. In terms of internal audit function setting, the education and training of auditors absolutely must be done. Training and experience as an internal auditor is needed to enrich the quality of internal auditors that will improve the quality of policy and level of responsibility for the impact of decisions on other people’s lives. Elaboration of the integrity pact is the framework of the implementation of good governance with ethical work climate. Strengthening the whistleblower system and their reward and punishment is one way to create clean government and free of corruption.

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