

THE EFFECT OF WHISTLEBLOWING EFFECTIVENESS, INTERNAL AUDITORS COMPETENCE ON FRAUDULENT FINANCIAL REPORTING (SURVEY ON ALL BANKS IN INDONESIA)

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***Abstract:** This study aims to explain how the effect of whistleblowing effectiveness, internal auditors competence on Fraudulent financial reporting. This paper develops a theoretical framework as the basis of a hypothesis to answer the above research questions: (1) how is the effect of whistleblowing effectiveness on the Fraudulent financial reporting, (2) how is the effect internal auditors competence on the quality of financial reporting. This study is scheduled to be conducted in 49 banks. This research was conducted by random sampling. The data is primary data collected through questioner. Data analysis method to test the hypothesis is the analysis of Multiple Regression. This study will use the hypothesis with a significance level of = 0.05.*

***Keywords:** The whistleblowing effectiveness, internal auditors competence, Fraudulent financial reporting.*

1. INTRODUCTION

The companies endure a lot of losses caused by fraud trend to increase every year. (Coram et al., 2008). The survey conducted by the Association of Certified Fraud Examiner (ACFE) 2014 cannot explain the fact the actual fraud. The result of a study conducted by the ACFE (2014) categorizes industry organizations who are the victims of fraud as follows:

There are many fraud cases in Indonesia happen in the banking industry. Bank Indonesia receives reports as many as 1,009 cases of banking crimes. Cases of fraud reports dominance throughout the year and not presence card case (CNP) (Waas, 2012). The same thing was conveyed by the Financial Services Authority (OJK), which handles as many as 619 cases of banking fraud in various regions throughout 2013, a total of 236 cases have been on the verdict of the judges in the courts (Panjaitan, 2013).

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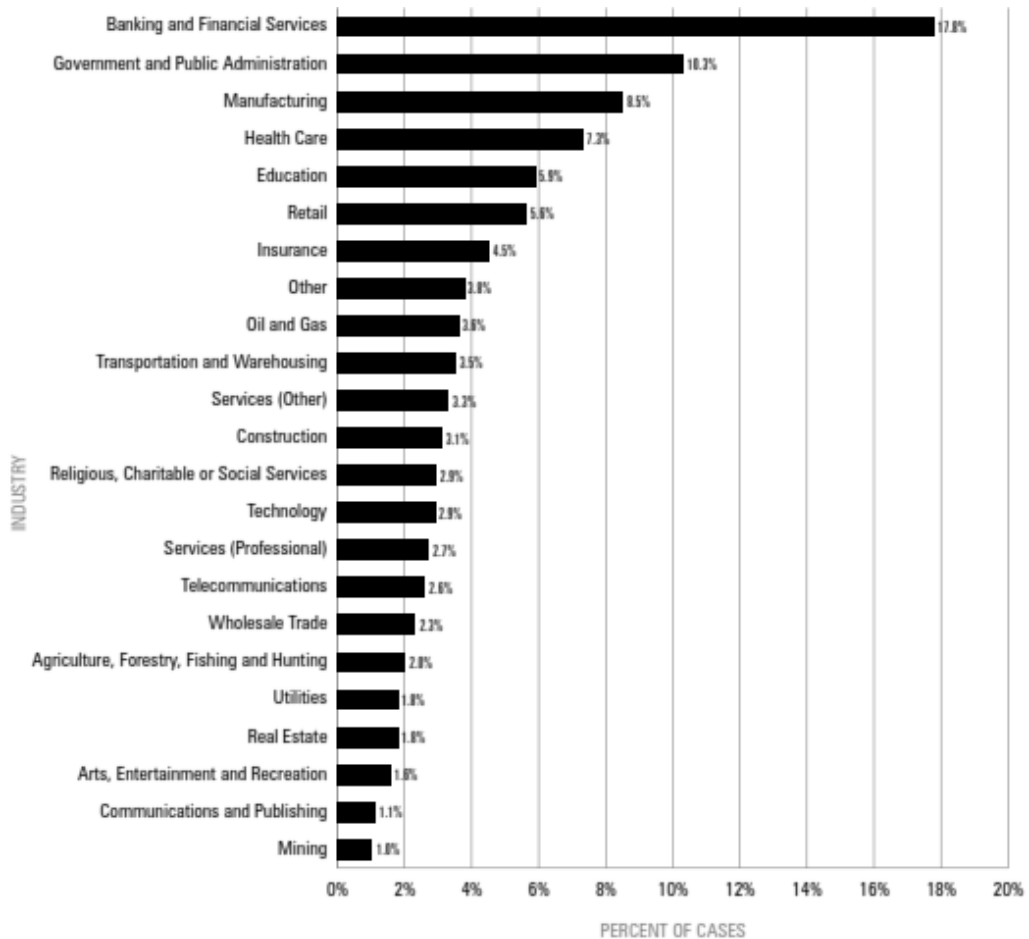


Figure 1: Industry organizations who are the victims of fraud

Fraud is unlawful, fraudulent plans and meaningful dishonesty (Razae, 2010). Financial statement fraud or fraudulent statement is commonly referred by the ACFE as one branch of the three (3) types of fraud. Rezaee and Relay (2010) explained that fraudulent financial reporting is intentional behavior either by act or omission that results in misleading financial statements. Furthermore Albrecht et al., (2012) revealed that fraud is a crime that is rarely seen. Disclosure of fraud is hard to find because the crimes committed cannot be touched and invisible. Only the red flags and symptom fraud or indicators that can be seen.

ACFE in the Report to the Nation (RTTN) starting from 2002, 2004, 2006, 2008, 2010, 2012, 2014 concluded fraud based on the position level of perpetrators. The number increased every year. The average value of loss based on the job level of perpetrators shows that the top level management led to the more loss than the lower level.

ACFE (2014) described occupational fraud in tree forms, namely corruption, asset misappropriation, financial statement fraud. Further explained (ACFE) the fraud tree to explain financial statement fraud is the fraud tree potential to cause the big losses in the company's.

Financial statement fraud is a serious problem worldwide (Dong et al., 2012). Fraudulent financial reporting happen through out all organizations and than perpetrators begin to mid-level until the top management (Arens et al., 2014; Rezae and Relay, 2010). In America a lot of incidents of fraud that occurs in almost all industry and no exception banking industry (Wells, 1997).

ACFE in 2014 found the company lost at least 5% of revenue every year due to fraud, the potential losses in 2013 estimated Gross Domestic Product (Gross World Product) in the United States approached \$ 3.7 trillion due to fraud. ACFE (2014) highlighted the importance of early detection. The longer allow fraud, the greater the losses experienced by the company and will be more difficult to detect. Fraud triangle theory says the fraud was due to pressure, opportunity and rationalization. (Rezaee and Riley, 2010).

ACFE (2014), in the Report to the Nation (RTTN) classifies control fraud efficiently to detect and prevent fraud, detection methods most commonly used in fraud in the workplace is a tip or information, management reviews, internal audit, unintentionally, account reconciliation, document examination, external auditing, monitoring, informed by law enforcement, IT control, recognition, and more.

Furthermore ACFE (2014) shows the employees are valuable sources of information. Employees are more able to find potential fraud in comparison with the customer, the reporting anonymously, vendors, shareholders/owners and competitors. Activities fraud is often discovered first by the employee (Appelbaum et al., 2006; Kaplan et al., 2010; Moberly 2006), but employees tend not to report the error.

One way that is done by the company to detect errors and to minimize the risk of error is to facilitate reporting of violations (whistleblowing), (Lee and Fargher, 2013, Paul and Townsend 1996; Miceli et al., 2009; ACFE, 2014).

Whistleblowing disclosures in Indonesia, not became a liability, it is listed on the Capital Market Supervisory Agency and Financial Statements (Bapepam LK) No. X.K.6 in 2012 on the submission of annual reports of listed companies or public companies. That rule only describes the issuers or public companies are required to disclose its whistleblowing mechanisms. On that basis, of a total of 494 listed companies publicly listed in 2013, only amount 142 (29%) who have and disclose whistleblowing policy. Disclosure whistleblowing system disclosed by the OJK as follows:

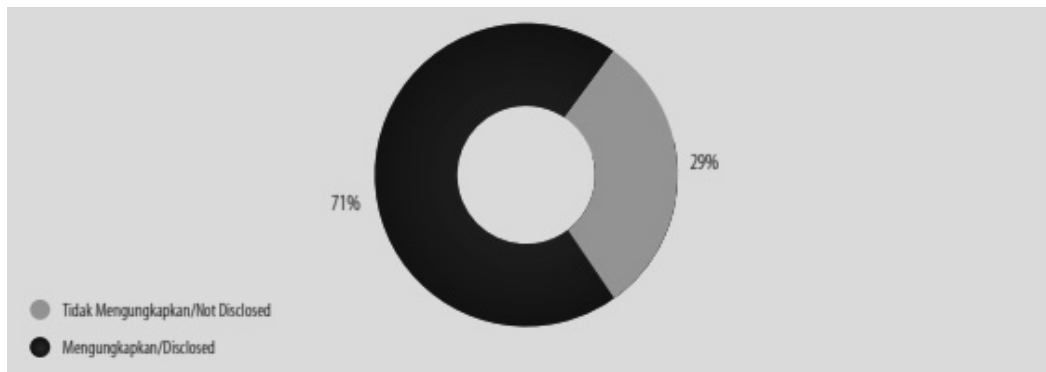


Figure 2: Disclosure Whistleblowing System

Based on Law No. 13 of 2006 on the Protection of Witnesses and Victims, a number of violations can be reported through this whistleblowing channels. Violations can be reported via the Whistleblowing channel among others include: violation of laws and regulations, corporate codes, generally accepted accounting principles, policies and operational procedures of the company, or other fraudulent acts (KNCG 2008).

Besides whistleblowing, variables that effect fraudulent financial reporting is the internal audit competence. According Salameh et al., (2011) Internal audit is considered most effective in the prevention of fraud in the company. But the surprising results in this study an internal audit afraid whistleblower to top management, this can lead to the independence and objectivity of the auditor is becoming weaker. Internal auditors should review the reliability (reliability and integrity of financial information and the implementation of the work or operation, as well as the various means used to identify, measure, classify and report information (Tugiman, 2006).

The Institute of Internal Auditors (IIA), 2012, No. 1210. A2 Internal auditors must propose to have sufficient knowledge to evaluate the risk of fraud. But the internal auditor is not expected to have the expertise, whose main responsibility is to detect fraud. Specifically the standards require the internal auditor to evaluate or assess the risk of fraud and to control the provision of advice to reduce risk and improve control. Risk assessment as the preparation of the audit plan and testing of internal controls. Internal audit is also an act of detection and prevention.

Based on the IIA 2012 1210. A2-2.2 about accountability for detecting fraud, SAS 99 describes the internal auditor and the external auditor uses red flags are: opportunities, incentives and pressures, attitudes and rationalization.

This study describes the probability of fraudulent financial reporting is influenced the whistleblowing effectiveness and internal auditor competence.

2. THEORITICAL FRAMEWORK AND HYPOTHESIS DEVELOPMENT

2.1. Whistleblowing

According to Micelli dan Near (1992), Dandekar (1990), Goldberg (1987), Near and Micelli (1985), James (1984), definition Whistleblowing is the disclosure by organization members (former or current) of illegal, immoral, or illegitimate practices under the control of their employers, to persons or organizations that may be able to effect action. In keeping with previous research, hereinafter terms such as wrongful activity and questionable practice refer to omissions as well as commissions, for example, when an organization fails to warn employees of workplace hazards”.

According to The National Committee on Governance (KNKG) (2008) defines Whistleblowing is the disclosure violations or disclosure act unlawful, unethical or immoral or disclosure of other acts that can harm the organization and stakeholders, conducted by the audit committee and internal audit or the head of the organization to the head of the organization or other institution can take action on such violations. This disclosure is generally done in secret (confidential).KNKG in 2008, the effectiveness is divided into three parts: (1) The condition that makes the employee who witness or know of a violation to be willing to report. (2) The attitude of employees to report any fraud or violation. 3). Have access Whistleblowing to exit if the management does not respond.

Companies use Whistleblowing to detect fraud, Whistleblowing good will detect fraud and minimize the cost of losses (especially at companies that implement policies Whistleblowing (Lee and Neil, 2013; ACFE, 2014, Chung et al; 2004; Paul and Townsend, 1996; Barnett et al: 1993).

Based on the theories and finding several studies, the hypothesis in the study is:

H1: the whistleblowing effectiveness influence on fraudulent financial reporting.

2.2. Internal Auditor Competence

Competence according to Hannon (2000) description that competency a someone ability in exploiting or using skill and also science of exist in its, to be utilized in work execution become responsibility. Competence according to Gilmore (1996:42) description that competency is ability to use the science and skill effectively in reaching best performance in certain duty status. Susanto (2007) stated that competence means employees have the knowledge and expertise to perform their duties. Competence according to The International Federation of Accountants (IFAC) Education Committee (1998) is the ability to perform the task and roles expected of a professional accountant, both newly qualified and experienced, to the standard expected by employers and the general public. Based on IFAC Education Committee

(1998) competence is ability to carry out tasks and roles according to the standards expected by the employers and the general public.

According to the IIA Research Foundation's Common Body of Knowledge (CBOK) study (2012) competence is defined as the ability to adequately perform a task, duty or role. Competence integrates knowledge, skills, personal values and attitudes. Competence builds on knowledge and skills and is acquired through work experience and learning by doing. According Pickett (2010) stated that internal auditor must possess the knowledge, skill, and other competencies needed to perform their individual responsibilities. Furthermore Sinnott, et al., (2002) stated that a competency is a characteristic of an employee that contributes to successful job performance and the achievement of organizational results. These include knowledge, skills, and abilities plus other characteristics such as values, motivation, initiative, and self-control.

According to Cheng et al., (2002), Boutler et al., (1999), Hannon (2000:238), Gilmore (1996), Susanto (2007), Agoes dan Ardana (2009), (IFAC) Education Committee (1998), IIA (2012), Pickett (2010), Sinnott, et al., (2002), Le Boterf (2004), Boyatzis (2008), McIntosh (1999), Flint (1988), Arens et al., (2012), Hiro (1997), Cheng, et al., (2002), Mills (1993), Rai (2011) the dimensions and indicators used in this study for the internal auditor competence variables are knowledge, behavior.

Auditor Internal considered the most effective way to prevent fraud in the company and the Internal Auditor who has sufficient knowledge to evaluate the risk of fraud and internal auditors who have the expertise responsible for detecting fraud (Salameh et al., 2011; The Institute of Internal Auditors (IIA) 2012; SAS 99).

According to Williams, and Schwier, (1937), James, K. L. (2003), Gras-Gil, E., et al., (2012), Caplan, (1999), Cohen et al., (1996), Kranacher (2008), Bloomfield, and Shackman (2008) description that internal auditor competence influence on fraudulent financial reporting.

Based on the theories and finding several studies, the hypothesis in the study is :

H2 : the internal auditor competence influence on fraudulent financial reporting.

2.3. Fraudulent Financial Reporting

According to Arens et al., (2014) fraud is the intentional use of deceit, a trick or some dishonest means to deprive another of his money, property or legal right, either as a cause of action or as fatal element in the action itself.

From definition above, fraud is an act deliberately to defraud or deceive, a deceit or a way dishonest ways to retrieve or eliminate the money, property, rights of legitimate property of others either because of an act or fatal impact of the act own. The various definitions above, there are four (4) important aspects:

1. Deception
2. Dishonestly
3. Intent
4. Concealment

According to the Institute of Internal Auditors (IIA, 2013) fraud is Any illegal act characterized by deceit, concealment, or violation of trust. These acts are not dependent upon the threat of violence or physical force. Frauds are perpetrated by parties and organizations to obtain money, property, or services; to avoid payment or loss of services; or to secure personal or business advantage.

According to Albrecht et al., (2012) proposed that symptoms related fraud: it is very important that fraud fighters exercise care when proactively detecting fraud. First, there are almost always alternative explanations for what looks like fraud symptoms.

According to Rezaee and Relay (2010:5) fraudulent financial reporting is intentional or reckless conduct, acts, or omissions, that result in materially misleading financial statements. Rezaee and relay (2010), the three factors that drive a person commit fraud, better known as the “fraud triangle” is pressure, opportunity, rationalization.

Theoretical Framework of this research is illustrated as follows:

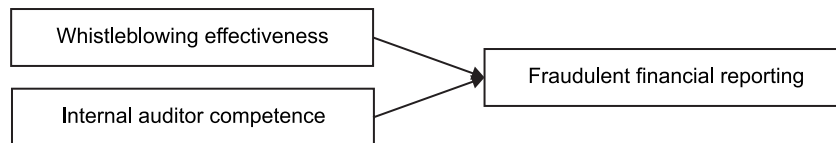


Figure 3: Theoretical Framework

3. METHODOLOGY

The research method is a method or a systematic way used to solve the problem formulation. (Kothari, 2004). this study is descriptive research, descriptive research is a study designed to describe the characteristics of people, events or situations (Sekaran and Bougie, 2013). Namely: (1) The whistleblowing effectiveness, (2) Internal audit competence, (3) Fraudulent financial reporting.

The research is verificative research where research is conducted on a population or a particular sample in order to test the hypothesis that has been set (Sugiyono, 2012). According to Sekaran dan Bougie, (2013) unit of analysis refers to the level of aggregation of the data collected during the subsequent data analysis stage, The unit of analysis in this study are all banks in Indonesia recorded until 2015.

According to Sekaran and Bougie (2013), population is the entire group of people, events, or things of interest that researcher wishes to investigate. According to Sekaran and Bougie(2013), The sample is part of the population that reflects the selected portion of the population, or in other words some elements of the population that make up the sample (Sekaran and Bougie, 2013). In this study, the sampling technique used was probability sampling is simple random sampling is a technique of selecting representative sample of the population was randomly without regard to strata that exist in the population and every member of the population has the same ability to have (Sekaran and Bougie, 2013).

The source of data in this study consisted of (1). Primary data and (2). Secondary data (Sugiyono, 2008). According to Sekaran and Bougie (2013), Primary data is data obtained by researchers directly (first hand), while secondary data is data obtained by researchers from existing sources. In this study, secondary data is data on the results of previous studies (journals) and literature relevant to this study.

3.1. Measurement of Variables

Table 1
Measurement of Variables

<i>Concept</i>	<i>Dimension</i>	<i>Indicator</i>	<i>Scale</i>	<i>No. of questionnaire</i>
Whistleblowing Effectiveness KNKG (2008), Miceli and Near (1985, 1992, 1995), Nam and Lemak (2007), Hook et al., (1994), Barnett et al., (1994)	1. Conditions	1.1 Understanding of ethics.	Ordinal	1, 2, 3, 4, 5
	Employee (Internal Audit) to be willing to report if knowing violation	1.2 Understanding the importance of whistleblowing.		
		1.3 Provide violation reporting line.		
		1.4 Ease in reporting the violation.		
		1.5. Guarantee the confidentiality of the company against the whistleblower.		
	2. Employee behavior (Audit Internal) to report fraud.	2.1 Attitude honest and Wise.	Ordinal	6,7,8,9,10
	KNKG (2008), Miceli and Near (1985, 1992, 1995), Nam and Lemak (2007), Hook et al., (1994), Barnett et al., (1994)	2.2 Objective Attitude.		
		2.3 Attitude Persistence and Tenacious.		
		2.4 Commitment reporting "false financial reporting".		
		2.5 Commitment to the Protection of the complainant Violations "Whistleblower".		

Concept	Dimension	Indicator	Scale	No. of questionnaire
	3. The presence of reporting access for any fraud if the management does not respond appropriately KNKG (2008), Miceli and Near (1985, 1992, 1995), Nam and Lemak (2007), Hook et al., (1994), Barnett et al., (1994)	3.1 Availability reporting procedures. 3.2 Availability of media for reporting violations "Whistleblowing". 3.3 Follow-up reporting violations 3.4 Submission of reporting violations to the media or regulators.	Ordinal	11, 12, 13, 14
Internal Auditor Competence Pickett (2010), The IIA global internal audit competency framework (2013) Cheng, et al., (2002).	1. Knowledge Pickett (2010), The IIA global internal audit competency framework (2013), Cheng, et al., (2002).	1.1 Compliance of formal education. 1.2 Implementation of the content of the Internal Audit Charter. 1.3 Implementation of IAS-IFRS. 1.4 Understanding the legislation. 1.5 Understanding the bank management.	Ordinal	1, 2, 3, 4, 5
	2. Skill Pickett (2010), The IIA global internal audit competency framework (2013), Cheng, et al., (2002).	2.1 Skills to communicate and interact. 2.2 Skills both oral/written for deliver audit issues 2.3 Skills both oral/written by an external auditor. 2.4 Skills both oral/written by the board of directors. 2.5 Continuous training regarding Fraud Examiner. 2.6 Continuous training of the Internal auditing.	Ordinal	6, 7, 8, 9, 10, 11
	3. Attitude Pickett (2010), Cheng, et al., (2002).	3.1 Uphold a professional responsibility as forward any claim honestly and wisely. 3.2 Uphold a professional responsibility as an auditor not to disclose information. 3.3 Do not discuss with outsiders. 3.4 Mutually communicating discuss problems that arise. 3.5 Mutual respect, trust, and support among examiners. 3.6 Apply the precautionary principle.		12, 13, 14, 15, 16, 17

<i>Concept</i>	<i>Dimension</i>	<i>Indicator</i>	<i>Scale</i>	<i>No. of questionnaire</i>
Fraudulent Financial Reporting Rezaee (2010), Moyes et al., (2006)	1. Identify the symptoms and red flags Incentive and Pressure Rezaee (2010), Moyes et al., (2006)	1.1 The pressure of Management.	Ordinal	1, 2, 3, 4, 5, 6, 7, 8, 9, 10, 11, 12, 13
		1.2 Compensation of Management.		
		1.3 The rapid growth company.		
		1.4 Management expectations too high in forecasting.		
		1.5 Cash flow accordingly.		
		1.6 Conditions LK bad, as a negative signal.		
		1.7 Experiencing financial distress		
		1.8 Take over threat if bankruptcy happens.		
		1.9 Significant control of the financial management.		
		1.10 profitability ability to repay debt.		
		1.11. Competition is high.		
		1.12. Financing capital to compete		
		1.13. LK prepared in accordance with SAK		
2. Identify the symptoms and red flags Opportunity Rezaee (2010), Moyes et al., (2006)	2.1 Restrictions information.	Ordinal	14, 15, 16, 17, 18, 19	
				2.2 Family ownership.
				2.3 System accounting ineffective.
				2.4 SPI inadequate.
				2.5. Financial reporting in the dominance of family ownership.
				2.6 Oversight and Audit Committee on Finance and SPI.
				2.7 Presentation by fairvalue.
3. Identify the symptom and red flags Rationalization Rezaee (2010), Moyes et al., (2006)	3.1 Transaction unusual at the end of the period.	Ordinal	20, 21, 22, 23, 24, 25, 26, 27, 28	
				3.2 Restrictions on the scope of the auditor.
				3.3 Violations of the law by the company.
				3.4 Communication is not effective.
				3.5 Restrictions audit the old and new audit.
				3.6 Reasons not deserve to minimize profit.
				3.7 Creative accounting.
				3.8 Failed to fix the SPI.
				3.9 Limitation of audit by management.

3.2. Multiple Regression

After assumption test, multiple linear regression analysis was conducted to know the effect of whistleblowing effectiveness, internal audit competence to fraudulent financial reporting. Model of the regression in this research was as follows:

$$FFR = \alpha + \beta_1 EWB + \beta_2 KAI + \varepsilon$$

α = constant

β = estimated parameters.

4. RESULTS AND DISCUSSION

4.1. Results

Normality test aims to test whether the regression model, or residual confounding variables have a normal distribution. The test results showed normal distributed data as indicated by the rules of diagonal residual (Ghozali) (Figure 4) with a significance of 0.871 or greater than 0.05 (Ghozali, 2012) (Table 2). Multicollinearity test showed no correlation between the independent variables. This is indicated by the VIF is ≤ 10 and no independent variables that have a value tolerance of less than 0.10 (Ghozali, 2012) (Table 3). Heteroskedasticity also not be a problem, in which the dots randomly spread and spread both above and below the number 0 on the Y axis (Figure 5). Having fulfilled classical assumption test, carried out multiple regression analysis results showed R² value of 0.876 which indicates regression meet goodness of fit. The regression equation can be expressed as follows:

Normal P-P Plot of Regression Standardized Residual

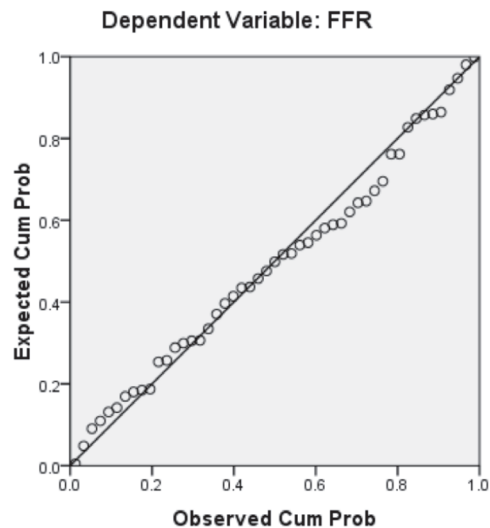


Figure 4: Normality Test

$$\text{FFR} = \alpha + \beta_1 \text{EWB} + \beta_2 \text{KAI} + \varepsilon$$

$$\text{FFR} = 201,899 - 0,566 - 0,412 + \varepsilon$$

Table 2
Normality Test
One-Sample Kolmogorov-Smirnov Test

		<i>Unstandardized Residual</i>
N		49
Normal Parameters	Mean	0,0000
	Std. Deviation	8,9962
Most Extreme Differences	Absolute	0,085
	Positive	0,085
	Negative	-0,045
Kolmogorov-Smirnov Z		0,595
Asymp. Sig. (2-tailed)		0,871

a. Test distribution is Normal.

Table 3
The effect Whistleblowing Effectiveness and the Internal audit competence
on Fraudulent Financial Reporting

<i>Model</i>	<i>Unstandardized Coefficients</i>		<i>Standardized Coefficients</i>	<i>t</i>	<i>Sig.</i>	<i>Collinearity Statistics</i>	
	<i>B</i>	<i>Std. Error</i>	<i>Beta</i>			<i>Tolerance</i>	<i>VIF</i>
1 (Constant)	201.899	12.483		16.174	.000		
EWB	-2.186	.341	-.566	-6.402	.000	.647	1.546
IA	-.638	.137	-.412	-4.658	.000	.647	1.546

a. Dependent Variable: FFR

Table 4
Model Summary

<i>Model</i>	<i>R</i>	<i>R Square</i>	<i>Adjusted R Square</i>	<i>Std. Error of the Estimate</i>	<i>Sig. F Change</i>
1	.876 ^a	.767	.757	9.18973	.000

a. Predictors: (Constant), IA, EWB

b. Dependent Variable: FFR

Results showed partial regression, the whistleblowing effectiveness and internal audit competence affected to fraudulent financial reporting. This is demonstrated by the significant value of the whistleblowing effectiveness and internal audit

competence 0,000 respectively ($p < 0.05$) and 0.00 ($p < 0.05$). Likewise simultaneously, the whistleblowing effectiveness and internal audit competence together affected to fraudulent financial reporting that can be seen from the count F significance of 0.000 ($p < 0.05$).

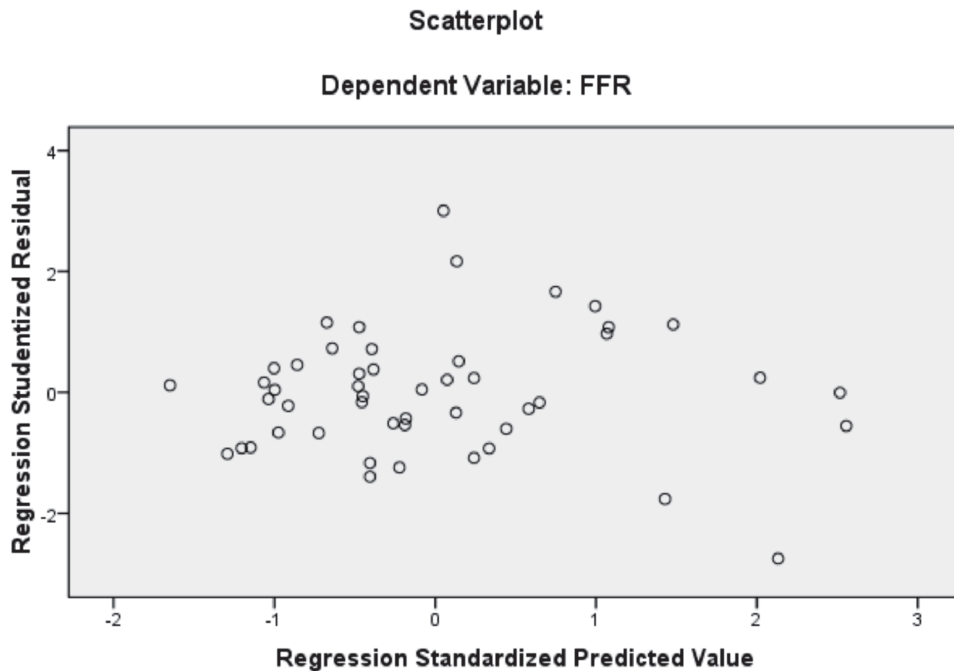


Figure 5: Heteroskedasticity Test

4.2. Discussion

The results showed the whistleblowing effectiveness effected to fraudulent financial reporting. The study provides empirical evidence that the better the whistleblowing effectiveness will reduce fraudulent financial reporting. The results of this study confirm previous research conducted by Lee and Neil, (2013); ACFE, (2014); Chung et al., (2004); Paul and Townsend, (1996); Barnett et al., (1993) which states that the company will implement a whistleblowing well be able to detect fraud and to minimize losses. The same study results indicated by Samuels and Zhang (2009) explained that whistleblowing reduce the intensity to perform fraudulent financial reporting. Miceli et al., (1991) whistleblowing reduce cheating behavior in the company, so it can improve the performance of organization in the long term. Dyck, et al., (2010), shows that the whistleblower for detecting fraud in the company.

Internal auditor Competency also significantly affected to the fraudulent financial reporting. The study provides empirical evidence that the better the competence of internal auditors will have positive impact on tackling the decline Fraudulent

Financial Reporting. The conclusion that the internal auditors competence on Fraudulent Financial Reporting confirm previous research by Williams and Schwier (1937) where the research results of internal auditors affect control of the company, thereby reducing employees to alter records of cash in his book. Further research conducted by James (2003) where the research results of internal audit structures to prevent and detect fraud in the financial statements. Further research conducted by Gras-Gil, E., et al., (2012) where the research results of internal auditor affect transparency, integrity and quality of financial reporting and internal audit is able to report any findings and explain the problem.

5. CONCLUSIONS AND RECOMMENDATIONS

Whistleblowing effectiveness influence on fraudulent financial reporting. Effectiveness can see from dimensions of employee conditions (internal auditor) willing to report violations, attitude of employees (internal auditor) the report, the whistleblowing Access.

Internal Auditor Competency influence on fraudulent financial reporting. Competence is determined the internal auditor either Knowledge, Skills, Behavior.

Increasing the effectiveness of whistleblower can be done by creating mechanisms and procedures clear to the complainant, in order to protect the confidentiality of the complainant in order to protect identity pressure due whistleblower actions.

Improvement in particular organizational structure and role of the internal auditor position. The relationship between the organization and the Internal Audit Board of Directors is the command that allows for conflict of interest if found Fraudulent Financial Reporting in the top management level. We recommend that there should be flexibility where internal audit could be directly related to the Audit Committee more independent to report in case of fraud.

To improve the competence of internal auditors, internal auditors need competence should be enhanced by having such certification: PPL followed consistently and periodically both regarding the detection of fraud. Internal auditors are expected to have good skills in planning the examination, was able to find potential for fraudulent financial reporting, as Pressure, opportunity, rationalization.

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