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How Does the Good Corporate Governance Prevent the Internal Fraud in Banks?

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***Abstract*—The purpose of this study is to examine whether banking governance in Indonesia could have a role in reducing the number of internal fraud in banks. The data in this study used the 2014-2017 banking report with a sample of 211 banks. Hypothesis testing techniques are carried out using multiple regression analysis. The dependent variable in this study is the number of internal fraud in banks, while the independent variables are the banking governance score and the level of complexity. This study also added a control variable that is the type of banking ownership. The results showed that banking governance and type of ownership did not show any effect, whereas the level of complexity showed positive effect results. These shows that the higher the level of banking complexity, the higher the possibility of internal fraud in banks.**

Keywords: internal fraud in banks, banking governance, banking complexity, ownership type

I. Introduction

Corporate governance or called Good Corporate Governance (GCG) is one of the determinants of the crisis that occurred in Southeast Asia [1]. Poor implementation of GCG will have an impact on business scandals and company collapse [2]. Business scandals that often occur can be caused by fraud, both internal and external fraud by the company. Recent fraud often involves employees of the company itself [3].

The ACFE research institute found evidence that more fraud occurred in financial institutions where banking and financial services contributed to a large portion of the fraud scandal with an average loss of $ 200,000 [4]. Furthermore, KPMG found fraud cases involving senior managers in manipulating bad loans [5]. The industry or institution that is most vulnerable to fraud is banking [6]. This happens due to the existence of very strict financial transaction regulations [7].

In the banking sector in Indonesia, fraud is a major factor causing banks to not survive [8]. The findings of the Financial Services Authority in 2015 there were 50 fraud perpetrators, of whom 25 were directors and 18 were executive officers. In 2016, the OJK examination showed that there were 33 banking fraud perpetrators, of whom 14 were directors and 13 were executive officers, and there were 2 commissioners and 4 employees [9]. In 2017, there were 57 banks that indicated fraud [10]. Based on OJK's findings from 2015-2017, it can be concluded that fraud cases in banks have increased from year to year.

Fraud describes any intentional fraudulent attempt intended to take property or rights of another person or party. This fraud effort is driven by various internal and external forces carried out individually or collectively [11]. Based on the theory of fraud triangle, fraud can occur because of pressure, opportunity, and rationalization factors. Frauds that occur in banks based on research can occur due to external pressure [12]. The results of research on banks in China show that the risk of internal fraud is an operational risk for banks in China [13].

The increase in fraud cases in banks is inversely to the results of study and GCG scores held by banks. The development of banking governance in Indonesia until 2018 has shown a good improvement where the results of the GCG score showed a good average [14]. In addition, there are study results that show that the better the GCG of banks, the lower the banking fraud [2]. The existence of GCG results and increasing in fraud cases in banks raises a question whether GCG in banks has no effect in preventing fraud cases in the banking sector mainly related to fraud committed by internal banking parties. This finally encouraged researchers to conduct further research to examine whether GCG in banks has an influence on cases of internal fraud in banks.

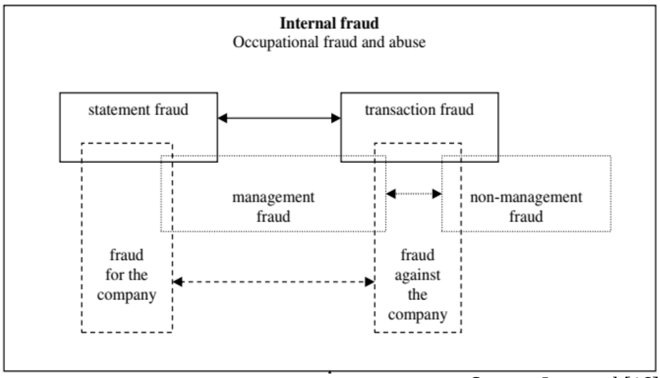
II. Literature Review

A. Good Corporate Governance

Good Corporate Governance (GCG) is closely related to the concept of the company to direct and control every organizational function in a company. GCG implementation can improve company performance. Therefore, the application of GCG is needed by companies, including banks [2]. GCG in banking is closely related to how business or banking activities are directed and managed as well as how goals are set, strategies are implemented and performance is monitored by the board of directors or management [15]. The application of GCG in banks is specifically regulated by the Financial Services Authority (FSA) through the Financial Services Authority Regulation (FSAR) Number 55 of 2016 concerning the Implementation of Governance for commercial banks. The application of GCG in banking is carried out in accordance with the principles consisting of transparency, accountability, responsibility, independence and fairness [16].

B. Internal Fraud

Internal fraud in a company can be done by employees, managers or executives [17]. Internal fraud in banking can significantly affect the financial condition of banks if the amount of fraud is more than one hundred million rupiahs [18]. Internal fraud is related to statement fraud and misuse of position or job and transactions that could be carried out by both management and non management. Fraud committed by management could be in the form of fraudulent of statements and transactions, whereas non management is only transactions fraud [16].



Source: Jans et al [16].

Fig. 1. Internal fraud classification.

III. HYPOTHESIS DEVELOPMENT

A. Good Corporate Governance

GCG is also one of the ways or alternatives in order to prevent fraud [19]. In addition, Indriastuti and Ifada's study shows that the higher the quality of GCG, the lower the possibility of fraud [2]. Research conducted by Mohd-Sanusi on banks in Malaysia also showed results that the GCG mechanism had a negative effect on internal fraud or employee fraud. Governance mechanisms can be in line with business assumptions and proactively help overcome the possibility of business failure [20]. Based on these, the hypothesis in this study is:

H1 = GCG has a negative effect on internal fraud

B. Banking Complexity

Banks in carrying out their operational activities must have core capital that has been regulated by the FSA. The existence of these core capital obligations, FSA divides operational activities based on core capital which is often referred to as the Commercial Bank Business Activities (BUKU) [21]. The greater the core banking capital, the greater the scope of fundraising activities carried out both from distributing and raising funds at home and abroad. In addition, the higher the core capital, the higher the target of lending to Micro Small and Medium Enterprises (MSME) special sectors according to FSAR. The more activities and types of distributing of funds in banks, the higher the complexity of internal control. In addition, the work of the Internal Auditor Work Unit will also become increasingly complex. The existence of this complexity can make fraudulent occur more late to be prevented, minimized and there is an encouragement for fraud. Based on these, the hypothesis in this study is

H2 = Banking Complexity has a positive effect on internal fraud.

IV. RESEARCH METHODOLOGY

A. Population and Sample

The population in this study consisted of banks in Indonesia which published annual reports from 2014-2017. This study uses a purposive sampling technique with research samples obtained by 211 banks. This study is an unbalanced panel with times series and cross section properties with the following sampling criteria:

TABLE I. SAMPLING CRITERIA.

No	Criteria	Total
1	Annual Banking Reports published on the website	460
2	Did not publish the ranking value of governance and the amount of internal fraud	(249)
Total Sample (2014-2017)		**211**

Source: processed data, 2019.

B. Measurement of Variables

This study uses the dependent variable in the form of the amount of internal fraud that occurred in the banking system. The amount of banking internal fraud was obtained from the published annual reports. The dependent variable in this study using GCG variable, the type of banking complexity and the type of the banking industry. The GCG is measured by GCG scores issued by banks based on FSAR. The type of complexity is measured based on core banking capital which are classified as BUKU based on FSAR. Whereas the type of banking industry is measured by a dummy between banks that have been listing and non-listing on the IDX. The following is an explanation of the definition of the variables:

TABLE II. DEFINITION OF OPERATIONAL VARIABLES

No	Variables	Measurements
1	Internal Fraud	Fr_Int = Total internal fraud
2	Good Corporate Governance	GCG = 5 "Very Good"; 4 "Good"; 3 "Good Enough"; 2 "Not Good"; 1 "Bad"
3	Type of Complexity	Cmplx_typ = 1 "core capital <1 trillion; 2 "core capital of 1- 5 trillion; 3 "core capital of 5-30 trillion"; 4 "core capital> 30 trillion".
4	Type of Industry	Ind_typ = 1 "listing"; 0 "non listing"

C. Data Analysis Techniques

The analytical method is multiple regression analysis. The model used in this study is as follows:

$$Fr\_Int = \beta_0 + \beta_1 GCG + \beta_2 Cmplx\ \ typ + \beta_3 Ind\ \ typ + \varepsilon$$

Explanation:

Fr_Int = Internal Fraud

GCG = Good Corporate Governance

Cmplx_typ = Type of Complexity

Ind_typ = Type of Industry

V. Results and Discussion

A. Descriptive Statistics

The descriptive statistics results in table 3 show that the average score of internal fraud is 7,3. This shows that the average number of internal fraud that occurred in the banking system was 7 cases. While the minimum value for the number of internal fraud cases is 0 or no cases at all and the maximum value of internal fraud cases is 189 cases. GCG in banks shows the minimum value is 2 and the maximum value is 5 and the average value is 3,7. The average value of GCG is 3,7, indicating that banks in Indonesia are quite good in implementing GCG.

The banking complexities in table 3 show the minimum value is 1 and maximum is 4 with the average is 2,1. The average value is 2,1, indicating that most banks in Indonesia have core capital 1-5 trillion rupiah. While for the industry type, the minimum value is 0 and the maximum is 1, and the average is 0,4. The average value is 0,4, indicating that many banks in Indonesia are still not listed on the Indonesian stock market.

TABLE III. Descriptive Statistics

Variable	N	Min.	Max.	Mean
Fr_Int	211	0	189	7,322
GCG	211	2	5	3,791
Cmplx_typ	211	1	4	2,180
Ind_typ	211	0	1	0,417

Source: processed data, 2019.

B. Multiple Regression Analysis

The results of the multiple regression analysis test in this study could be seen in table 4. The regression test results in table 4 show that only the banking complexity variable shows a significant value 0,000 or less than 5%, whereas GCG and industry type show insignificant values, above 5 % These shows that the test results is consistent with the hypothesis in this study is banking complexity variable.

The results of regression analysis on GCG showed insignificant results with a significance value above 5% or equal to 46.5% indicating that GCG has no effect on the number of internal fraud in banks. This result is not consistent with several studies that show that GCG affects the fraud of both internal fraud in particular and fraud in general [2,3].

The results of regression analysis on banking complexity show significant results with a significance value below 5% or equal to 0.00% which indicates that banking complexity affects the number of internal fraud that occur in the banking sector. The test results show a positive significance value which means that the higher the banking complexity, the higher the possibility of internal fraud in banks. The test results consistent with the hypothesis and previous study [2].

The results of regression analysis of control variable in this study showed significant results with a significant value above 5% or equal to 91,6%. This result indicates that the type of banking does not affect the number of internal fraud in banks.

TABLE IV. Multiple Regression Analysis

Model		t	Sig.
1	(Constant)	-1,865	0,064
	GCG	0,732	0,465
	Cmplx_typ	7,357	0,000
	Ind_typ	0,105	0,916
F statistik = 0,000; R Square= 24,9%			

Source: proceed data, 2019.

VI. Conclusions

From this study, it can be concluded that the number of internal fraud in banks is quite low, seen from the average number of fraud with 7 cases. However, there are still banks that have a very high number of internal fraud with 189 cases of fraud. The results showed that the greater the type of banking complexity, the higher the possibility of internal fraud.

This study was conducted with several limitations. First, the test sample in this study only uses the number of internal fraud without regard to the nominal value of the rupiah that occurred. Second, the number of internal fraud in this study does not classify internal fraud committed by management, permanent employees and contract employees. Therefore, further study can classify in more detail about internal fraud both from the nominal amount and from the perpetrators of internal fraud.

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