



Analysis the Effect of Internal Control and Whistleblowing System in Fraud Prevention with Ethical Climate as Moderator

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Abstract. The goal of this study is to know how internal control and whistleblowing system influence fraud prevention moderated by an ethical climate. The object of the research is the Local Government Unit (LGU) in Soppeng Municipality. The study included 135 respondents from 27 LGUs. The primary data from the questionnaire were used in this study, which makes use of purposive sampling. Using the moderated regression analysis (MRA), the data were analyzed. The outcomes showed that the internal control and whistleblowing system had a positive and significant effect on fraud prevention. An ethical climate can strengthen the influence of internal control and whistleblowing systems in preventing fraud. The novelty of this research is the existence of ethical climates as a moderator that provides confidence about the right form of behavior in an organization. This research is important because it can help local governments to fight fraud and can increase public trust.

Keywords: internal control · whistleblowing system · ethical climate · fraud prevention

1 Introduction

The regional autonomy system given by the central government to regional governments to manage their regions provides a large enough opportunity for corruption or fraud to occur. Regional autonomy is granted to regions to enable local governments to improve their efficiency, effectiveness, and accountability [20]. However, according to Rinaldi et al. (2007), since 2001, when regional autonomy was implemented under Law No. 22 of 1999, there has been an increasing trend of corruption in local governments [25]. Indonesian Corruption Watch (ICW) stated that local governments are the second most corrupt institution with 95 cases in 2019 and 62 cases in 2020 which cost the state up to Rp 6.1 trillion.

Due to budget management flaws, local government units are a segment of the public sector that is frequently on the focus of attention. This is evidenced by several misuses of the budget. Cases of concern in Soppeng Municipality include the corruption case of the routine road rehabilitation or maintenance project for the 2012 fiscal year by the Head

of Department and Head of the Public Works Department with a state loss of Rp 618 billion [22], the case of embezzlement of salaries committed by the Head of Soppeng Municipality Agriculture Service with a state loss of IDR 215 million [13]. In addition, there are cases of fake Covid-19 suits carried out by the Director of the Latemmalala Soppeng Hospital and cases of the Cabbenge market development project carried out by PT Pelita Griya Asrimuda as a developer who received development funds of Rp. 8 billion more from Soppeng Municipality Government without going through a tender process [8].

The public sector has been criticized for high levels of corruption. Bribery, corruption, “ghost worker” issues, recruitment of unqualified staff, mismanagement of funds, and absenteeism are commonplace in the public sector [30]. The regional autonomy system given by the central government to regional governments to manage their regions provides a large enough opportunity for corruption or fraud to occur.

The impact of the many cases of fraud is a decrease in the level of public trust in the government, therefore the government must make efforts to overcome this, namely by strengthening and tightening supervision through internal control and providing a system that can accommodate reports or public complaints against the use of public funds in local governments or what is known as the whistleblowing system.

Internal control is a fairly important variable considering that various secular financial scandals have created the need for an effective internal control mechanism even though the organizational motive is not for profit [2]. The common symptoms of fraud is due to inadequate internal control [4]. This is consistent with Tuanakotta, (2010) [31], who states that preventing fraud begins with internal controls. Internal controls contribute to operational efficiency and effectiveness [9]. This internal control will produce information and reports that are free from misstatement [6]. Fraud prevention involved a good division of responsibilities, staff supervision, performance monitoring and also establishing measures to ensure that the system is accessed with proper controls (Kimani, 2011), so this internal control becomes interesting to study [17].

To prevent fraud, an anti-fraud environment is needed, one of which is by implementing a whistleblowing policy with several strategies. A strong ethical environment and good corporate governance (GCG) can improve the company’s whistleblowing system (Lee & Fargher, 2013) thus enabling fraud prevention to be carried out better [18]. Taiwo & Polytechnic (2015) in their research recommends that public organizations should promote a whistleblowing culture widely and need to be supported and implemented throughout the organization [30].

Schultz & Harutyunyan (2015) state that whistleblowing is seen as a tool to uncover and eradicate fraud [27]. Whistleblowing can be interpreted as the act of exposing fraud, illegal, immoral, or illegal practices by one member of the organization to another party [12]. Several studies on whistleblowing have also been carried out and proven effective. As in the research of Johansson & Carey (2016), the company can use the existence of a whistleblowing policy to identify and prevent fraud [15].

Principal-agent and ethical climate theory will be utilized in this study. Ethical climate as a moderating variable, the ethical climate has been studied in the organizational behavior and business literature for over two decades [34]. Ethical climate is a belief about things that include good behavior in an organization, so it can provide behavioral

guidelines for the worker [21]. Therefore, in this study, the ethical climate is expected to moderate the whistleblowing system and internal control that can contribute to fraud prevention.

The novelty of this study is the use of ethical climate moderation to describe the values within an organization and how workers should be held accountable for ethical or unethical behavior within an organization, using three philosophical dimensions: egoism, benevolence, and principles [29]. This study aims to determine how an ethical climate, combined with internal control and a whistleblowing system will affect fraud prevention. The main contribution of the research is to assist local governments in analyzing internal controls and whistleblowing systems to determine policies to combat fraud to increase public trust in the government.

2 Literature Review

2.1 Principal Agent Theory

Principal agent theory discusses the relationship between parties who work together. An agent is a party that performs a service or task on behalf of a principal [11]. The originator of agency theory in 1976, namely Jensen and Meckling explained that there is a bond between management (agent) and the owner (principal) that can trigger conflict. These conflicts occur because there are differences in interests.

2.2 Ethical Climate Theory

Victor and Cullen first proposed this theory in 1988 [34]. Ethical climate explains the values within an organization and how workers are responsible for their ethical or unethical behavior [29]. Originally, Victor & Cullen (1988) compose a framework with philosophical dimension of ethics includes three criteria: egoism, benevolence, and principle [34].

2.3 Conceptual Framework and Hypothesis Development

In accordance with the principal-agent theory that the government must be responsible for the management of funds entrusted by the community by showing that the reports produced are of good quality and useful. So, it is appropriate for the government to make efforts to achieve this, one of which is to establish good internal controls in preventing fraud. The internal control in the research of Doig (2014) have a positive impact on the tendency of fraud, while in the research of Alli et al. (2020) and Herawaty & Hernando (2021) found that internal controls have no significant impact on fraud prevention [1, 5, 10, 14]. The following is a possible formulation of the research's hypothesis, which is based on the preceding explanation (Fig. 1):

H1: Internal Control has a positive effect on fraud prevention.

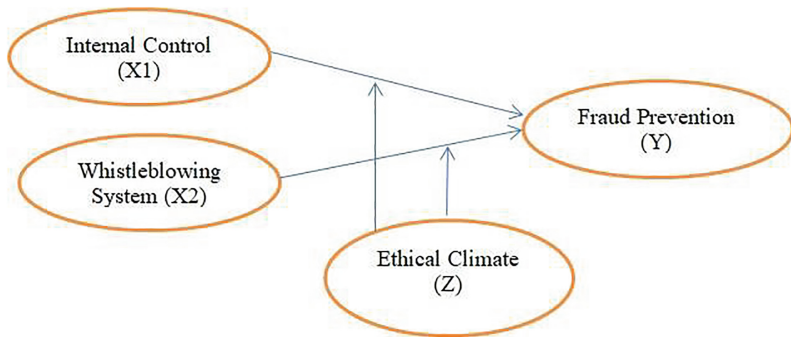


Fig. 1. Conceptual Framework

According to agency theory, good governance can be achieved [33]. Good governance and implementing a system that can be a means of reporting violations or acts of fraud, namely the whistleblowing system. These efforts are aimed at increasing public confidence in the control of funds by local governments. The study conducted by Shonhadji & Maulidi (2021) found that the whistleblowing system can prevent potential fraud [28]. This is supported by the research by Widiyarta et al. (2017) and Atmadja et al. (2019) [7, 35]. However, this study's findings differ from Johansson and Carey's (2016) study [15]. The following is a possible formulation of the research's hypothesis, which is based on the preceding explanation:

H2: Whistleblowing System has a positive effect on fraud prevention.

As a management tool, internal controls have long been recognized as an essential component of GCG for preventing fraud. They argue that additional research is required to develop internal control strategies to detect and prevent fraud and to better comprehend the ethical climate and environment of internal control [26]. In ethical climate theory, in a certain ethical climate, an interaction arises between humans or among its members in a certain way, so that their activities must always be controlled. To successfully manage the risk of unethical and illegal actions by employees, organizations must learn how to build and maintain an ethical climate/environment, one that minimizes the possibility of fraud, corruption and an environment that guides and supports ethical decision making [16]. The following is a possible formulation of the research's hypothesis, which is based on the preceding explanation:

H3: Ethical Climate can moderate the influence of Internal Control on fraud prevention.

In ethical climate theory, the ethical climate can be interpreted as the organizational environmental conditions that result in the perception and response of the members of an organization to an event [19]. Ahmad et al. (2014) stated that ethical climate theory can be used to demonstrate how the reporting intentions can be influenced by organizational climate in relation to whistleblowing behavior [3]. He used ethical climate work theory which is described through his research on whistleblowing behavior, which links that

organizations have different ethical climates that will affect individual intentions to take whistleblowing actions. This research supports the improvement of the rule of law in Malaysia which was carried out at the Malaysian Institute of Internal Auditors (IIA Malaysia). The consequences of his exploration demonstrate that the moral environment rule is huge in anticipating the internal whistleblowing intentions. The ethical climate principle is the belief about what is right and what is wrong based on the application of rules, laws, and standards. Additionally, Raharjo (2015) in his findings revealed that the ethical climate has an impact on whistleblower intentions to stop fraud [23]. The following is a possible formulation of the research's hypothesis based on the preceding explanation:

H4: Ethical Climate can moderate the effect of the Whistleblowing System on fraud prevention.

3 Methodology

The Local Government Unit (LGU) in Soppeng Municipality was the location of this study. The research time is from May to July 2022. The population in this study is LGU in Soppeng Municipality. The total population consisted of 27 LGU samples amounting to approximately 135 people, using questionnaires. The method that used for data analysis is moderated regression analysis (MRA).

The formula for the analysis test is as follows:

$$Y = \alpha + \beta_1 X_1 + \beta_2 X_2 + \varepsilon \quad (1)$$

$$Y = \alpha + \beta_1 X_1 + \beta_2 X_2 + \beta_3 X_1 Z + \beta_4 X_2 Z + \varepsilon \quad (2)$$

Information:

Y = Fraud prevention

α = Constant

β = Regression Coefficient

X1 = Internal Control

X2 = Whistleblowing System

Z = Ethical Climate

ε = Standard Error

4 Results

4.1 Multiple Linear Regression Analysis (Hypothesis Testing)

R square's determinant coefficient has a value of 0.423 or 42.3%. The internal control and whistleblowing system has a 42.3% influence on the fraud prevention variable, according to these findings. Beyond the scope of this study, additional variables have an impact on the remaining 57%. In the meantime, the f count > f table (23.806 > 2.444). This indicates that the both internal control and the whistleblowing system has a significant

Table 1. Multiple Linear Regression Analysis Result (Without Moderating Variable)

Model	Unstd. Coefficients		Std. Coefficients	T	Sig.
	B	Std. Error	Beta		
(Constant)	4,056	3,323		1,221	0,224
X1	0,482	0,079	0,488	6,081	0,000
X2	0,104	0,043	0,201	2,424	0,017
Z	-0,048	0,051	-0,071	-0,938	0,350
Adjusted R Square	0,423				
F table	23,806				

(Processed Data, 2022)

impact on fraud prevention. The following formula can be derived from the results of the aforementioned regression tests:

$$Y = 4.056 + 0.482 X_2 + 0.104 X_3$$

The results are as follows, as shown by the tests in Table 1.

- a. H1: Internal Control (X_1) has a positive effect on Fraud Prevention (Y)
The internal control variable (X_1) has a partially significant effect on the fraud prevention variable (Y) because the probability value is below 5% ($0.000 < 0.050$). The first hypothesis is therefore accepted.
- b. H2: Whistleblowing system (X_2) has a positive effect on fraud prevention (Y)
The probability value of the whistleblowing system variable (X_2) is 0.017 and it less than 5% ($0.017 < 0.050$), the fraud prevention variable (Y) is significantly affected. As a result, the second hypothesis is accepted.

4.2 Moderated Regression Analysis (Hypothesis Testing)

R square's determinant coefficient has a value of 0.458, or 45.80 percent. After interacting with the ethical climate variable (Z), it indicates that the internal control and whistleblowing system has a 45.80% impact on the fraud prevention variable (Y). Other factors outside of this study have an impact on the remaining 54.20 percent. In the meantime, the f count is greater than the f table ($15.348 > 2.444$). It means that internal control and whistleblowing system variable, together will significantly affected the fraud prevention after there is a moderating of ethical climate.

From the regression test results, the following formula can be obtained.

$$Y = 70.523 + 0.015 X_1 \cdot Z + 0.024 X_2 \cdot Z$$

From the tests in Table 2, it can be seen as follows:

- c. H3: Ethical Climate Moderates the Effect of Internal Control (X_1) on Fraud Prevention (Y)

Table 2. Multiple Linear Regression Analysis Result (With Moderating Variable)

Model	Unstd. Coefficients		Std. Coefficients	T	Sig.
	B	Std. Error	Beta		
(Constant)	70,523	28,749		2,453	0,016
X1	0,342	0,113	0,346	3,037	0,003
X2	-0,465	0,387	-0,896	-1,201	0,232
Z	-1,414	0,584	-2,087	-2,419	0,017
X1. Z	0,015	0,005	1,397	2,759	0,018
X2. Z	0,024	0,008	3,511	3,219	0,002
Adjusted R Square	0,458				
F table	15,348				

(Processed Data, 2022)

So, it is known that the internal control variable after interacting with the ethical climate gets a value of 0.018 which is lower than 0.050 significance. And the t-count value is $2.759 > 1.977$ (t table). Thus, the third hypothesis is accepted.

d. H4: Ethical Climate Moderates the Effect of Whistleblowing System (X_2) on Fraud Prevention (Y)

From Table 2, it is known that the whistleblowing system variable interacting with ethical climate has a value of 0.002 below the standard value of 0.050 significance. And the t-value is $3.219 > 1.977$ (t table). Thus, the fourth hypothesis is accepted.

5 Discussion

5.1 Internal Control has a Positive Effect on Fraud Prevention

In the Soppeng Municipality Government, particularly in the Local Government Unit, the hypothesis that internal control has a positive and significant effect on fraud prevention can be empirically demonstrated. It is known that an institution or organization’s ability to prevent fraud improves with improved internal control. Conversely, if the internal control of an institution or organization is not good, fraud prevention will be difficult.

Supported by the principal-agent theory. The principal-agent theory can support internal control in preventing fraud, namely with the formation of good and adequate internal controls. The responsibility given by the principal to the agent can be carried out properly because of the control that can oversee the running of the government so that it can give confidence to the people of Soppeng Municipality as a principle that local government financial management has been effective and produces reliable financial reports in accordance with applicable regulations. The study’s finding are consistent with the opinions of Doig (2014), and Adetiloye et al. (2016) [1, 10]. However, the it is in contrast to the research of Ali et al. (2020) and Herawaty & Hernando (2021) [5, 14].

5.2 Whistleblowing System has a Positive Effect on Fraud Prevention

The hypothesis state that whistleblowing system has a positive and significant effect on fraud prevention can be empirically demonstrated in the Local Government Unit of Soppeng Municipality Government. This means that an organization's ability to stop fraud will improve when it has an effective whistleblowing system.

The whistleblowing system is used by someone to report and disclose the occurrence of fraud in local governments. The principal-agent theory lends credence to the findings of this study. Agency theory is a solution to agency problems in local government financial management, so that financial goals in local governments can be used according to community needs. A system is needed to prevent the personal desires of local governments which lead to fraudulent actions. This system is called the whistleblowing system. The existence of this system will make fellow local government officials and local government officials with the community monitor each other so they are afraid to commit fraud because it will be reported.

The utilization of the whistleblowing system properly will make the responsibilities given by the principal to the agent be carried out properly because there is a system that can accommodate reports of violations that occur in local governments. In this case, the Soppeng Municipality Government uses LAPOR! An application that aims to make government administration able to provide access to public participation, both the community or employees in the Local Government Unit and the community in general in submitting aspirations and complaints online and it will improve the quality of public services. This study agrees with the research by Shonhadji & Maulidi (2021), and Widiyarta et al. (2017) [28, 35]. However, its different with the results from Johansson & Carey (2016) and Atmadja et al. (2019) [7, 15].

5.3 Ethical Climate Strengthens the Influence of Internal Control on Fraud Prevention

The results of the hypothesis test show that Ethical Climate strengthens influence of Internal Control on fraud prevention and can be proven empirically in the Soppeng Municipality Government, especially in the Local Government Unit in Soppeng. Supported by ethical climate theory, which discusses a set of ideas on moral philosophy that shows whether organizations have the ethical awareness to solve problems. The ethical climate that has the most influence on the object of research is the ethical climate- principle. On the ethical climate principle, if you want to make decisions and take action, you must comply with applicable laws, regulations, codes, and procedures.

The next influential ethical climate is the ethical climate-benevolence. Ethical climate-benevolence is based on concern for others. Organizations with strong benevolent characteristics will tend to implement internal control as well as possible. Soppeng Municipality Government applies a climate-benevolent ethic, so it can be said that it has implemented internal control as much as possible. Egoism is the ethical climate that has no significant impact on the subject of research. The ethical climate-egoism is the climate where members of the organization are given the freedom to determine how members of the organization prioritize their personal interests above the interests of the

organization. Soppeng Municipality Government does not prioritize its own interests but prioritizes the public interest, so that internal control can be carried out properly.

Therefore, Soppeng Municipality Government, which has a dominant in ethical climate-principal, will try to make decisions and actions so that applicable regulations or laws can be complied with, namely by establishing internal controls that can oversee the running of an organization so the fraud can be prevented. This study's results are consistent with the research of Ruck & Welch (2012) and Kazemian et al. (2019) [16, 26]. However, it is not in line with the research of Tuti & Mulyani (2021) [32].

5.4 Ethical Climate Strengthens the Influence of the Whistleblowing System on Fraud Prevention

The results of the hypothesis test show that ethical climate strengthens the impact of the Whistleblowing System on fraud prevention which can be empirically demonstrated in the Soppeng Municipality, especially in the Local Government Unit in Soppeng. The findings are supported by an ethical climate theory that focuses on organizational values and how workers are responsible for ethical or unethical behavior within an organization.

The ethical climate that plays the most role in the object of research is the ethical climate-principles. Ethical climate - principles are based on the belief that there are rules, laws, and standards as a universal principle. If members of the organization engage in unethical behavior, other members must have different opinions so that compliance with the law is a factor that must be considered for everyone in deciding, determining, and choosing ethical dilemmas. When an organization develops an ethical climate-principles, members of the organization will tend to do whistleblowing. If members of the organization use the whistleblowing system to report violations, they can prevent fraud by reducing the public's desire to commit fraud because it will be reported through the whistleblowing system. Because the Soppeng Municipality Government adheres to the ethical climate principle more than any other, there will be a greater propensity to use the whistleblowing system in an ethical manner.

The ethical climate existent through an organization will influence organizational members to make ethical decisions in conflict management. The existence of an ethical climate will encourage every individual in an organization/institution to report any violations that can harm the organization on preventing fraud. This result is consistent with the research by Ahmad et al. (2014), Reshie et al. (2020), and Raharjo (2015) [3, 23, 24]. However, it is not in line with the research from Lestari & Yaya (2017) [19].

6 Conclusion

The system for whistleblowing and internal control has a significant impact on fraud prevention. The likelihood of fraud is lower when the government's internal control system is better. The system make government officials and the public monitor each other so they feel reluctant to commit fraud. An Ethical Climate can moderate internal control towards fraud prevention and Ethical Climate can moderate the whistleblowing system for fraud prevention.

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