

The Role of the Government Internal Auditor in Fraud Risk Management:

A Case Study in Local Government of Gunung Kidul and Sleman Yogyakarta Province

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Abstract— The purpose of this paper is to explore the current practices of the internal auditors in the local government of Gunung Kidul and Sleman regency regarding their role in fraud risk management. This research has used qualitative methods through an interview with the highest level of those inspectorates, which are the head of both inspectorates. The role of the government internal auditor in supporting fraud risk management has not reached an optimum level, which can be seen its audit was not based on risk-based audit approach. The government internal auditor has not arranged risk-based audit plan includes objectives identification of the audit objects and the audit procedures in mitigating fraud risk. Several recommendations for the inspectorate of local government Gunung Kidul and Sleman regency are an arrangement of the risk based audit plan, awareness improvement programs, and capability enhancement programs both quantity and quality aspects.

Keywords: *internal auditor; fraud risk; fraud risk management; risk-based audit; risk-based audit plan*

I. INTRODUCTION

The main purpose of risk management was previously to maximize company value by anticipating from the possibility of bankruptcy [1]. Risk management was such a part of hedging activity to shift the company's risks [1]. Finally, the risk approach used in risk management has been continuously evolving and has been adopted in public sector risk management in USA [2] and Scotland [3]. Risk management has also been implemented in Korea when Enterprise Risk Management (ERM) had been introduced in public sector company since 2007 [4]. According to COSO (Committee of Sponsoring Organizations) in [5], risk management is a process, which all levels and components of organization dedicate their commitment to providing a reasonable assurance of its organizations' goals. Therefore, all the organizations' strategies have been set to overcome all risks that destroy organizations' goals.

One of the risks that can thwart the organizations' goal is the fraud risk. Generally, fraud is an illegal act by an internal member of an organization or an external person in order to get individual and collegial which cause financial damage to other parties directly [6]. ACFE (The Association of Certified Fraud Examiner) in [6] has classified fraud into a "fraud tree", which

is known as Uniform Occupational Fraud Classification System. Fraud appears in many types includes corruption of bureaucratic staff that directly caught (OTT) by KPK (Corruption Eradication Commission). Recently based on the official website of KPK, there have been many fraud cases such as OTT in Constitutional Court of Indonesia and legislative of Mojokerto regency, bribery cases of governor of Banten province, Head of Klaten regency, Mayor of Tegal, governor of Bengkulu province, corruption case of E-KTP with the amount of Rp 2 Triliun, bribery case of BPK (Supreme Audit Agency), and other fraud cases.

Based on that phenomenon of fraud, it is a logical view if it appears a question of the role of a government internal auditor in preventing fraud cases. Muehlmann et al. [7] state that the internal auditor should be alert in auditing of fraud high-risk areas. Fraser [8] also states that the internal auditor must focus its audit in areas that have great possibilities of fraud by a risk-based audit approach. Daugherty and Anderson [9] state that based on the three-line defense model, the internal auditor has to assure that fraud risk management has been implemented effectively. The Institute of Internal Auditor in Sadler et al. [10] states that internal auditing is an assurance function of risk management to ensure management obtain a holistic view of risk management strategy implementation. The full definition of internal auditing according to IIA [10] states that internal auditing is

"an independent, objective assurance and consulting activity designed to add value and improve an organization's operations. It helps an organization accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control, and governance processes."

The government internal auditor is an authorized unit of a government institution that has the main function to assure that organizations' goals can be achieved effectively and efficiently as stated in articles 9 verse 2(d) UU number 39/2008 pertaining to the government ministry. The rapid dynamics of the business environment of the government institutions force the increasing roles of the government internal auditor in risk management implementation [11]. Coetzee [12] as well as Boyle and Boyle [13] state that the function of the internal auditor as an

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assurance of risk management should be clearly implemented such as focuses of its audit in fraud high-risk areas, performs a risk-based audit as well as communicates all risk issues of its organizations. Empirically, Danescu et al. [14] state that the risk-based internal audit can increase the effectiveness of risk management.

Based on an emerging of fraud cases in government institutions, therefore research question is "Why the government internal auditor has not supported fraud risk management optimally?" This paper tries to research and disclose the role of the government internal auditor in fraud risk management in two research locations, which are the inspectorate of local government of Gunung Kidul and Sleman regency, the special region of Yogyakarta province. The main purpose of this research is to provide a valuable contribution to the enhancement role of the government internal auditor in fraud risk management.

II. RESEARCH METHOD

This research has used qualitative methods through an interview with the highest level of those inspectorates, which are the head of the *inspectorate* of local government of Gunung Kidul and Sleman regency. The main purpose of the interview is to explore the roles of the government internal auditor in the process of public sector fraud risk management. Although risk management is part of management's responsibility, the government internal auditor has also special roles in assuring the effectiveness of this risk management in fraud prevention. The roles of the government internal auditor will be elaborated through direct interviews methods to those respondents.

The interview is supported by several important questions that relate to the roles of the government internal auditor in all process of fraud risk management through its audit and other supervisory tools. The examples of topics in those questions are specific roles of government internal auditor in providing assurance of fraud risk management, a risk-based audit, an internal auditor improvement program of its capacity building, its level of IACM (Internal Audit Capacity Model), a quality assurance enhancement of its audit process includes hierarchical review, audit procedures and techniques of a risk-based audit and other important questions. The interview was performed in Gunung Kidul and Sleman on July 10 and 18, 2017 respectively.

III. RESULT AND DISCUSSION

Based on the research result through a direct interview with the head of the inspectorate of local government of Gunung Kidul and Sleman regency, it can be concluded that the role of the government internal auditor in fraud risk management has not achieved optimum level. This means that the government internal auditor has not performed all process of fraud risk management effectively. Moreover, the government internal auditor has not executed assurance function of fraud risk management as its audit was not a risk-based audit as required by the internal auditor standard. However, the inspectorate of local government of Gunung Kidul regency has made a list of the high-risk of its audit objects. Meanwhile, the inspectorate of local government of Sleman regency has not had that high-

risk list as mentioned. Based on the standard of Indonesian Government of Internal Auditor (SAIPI) number 3010 verse 03, the priorities of an internal audit must be based on risk assessment/evaluation by the internal auditor [15].

Both the inspectorates of local government Gunung Kidul and Sleman regency have not performed a risk-based audit comprehensively. According to SAIPI number 3120, the internal audit activity has to be able in evaluating the risk management effectiveness and improving the risk management process [15]. Furthermore, the standard also states that the internal audit activity must evaluate and mitigate the fraud risk [15]. Hence, risk management in those two local governments has not achieved an optimum performance because the government internal auditor has not supported fraud risk management optimally. Based on the interview, the respondent said as an example that there had been an audit of fraud high-risk construction project by the internal auditor, but there was not any significant finding in its audit. Unfortunately, the problem audit had been found by the external auditor (BPK) as the internal auditor had not detected the problem. This condition proves that the fraud risk prevention has not been performed effectively.

The first factor why the internal auditor had not achieved an optimum level in supporting fraud risk management is, the internal auditor's awareness of the risk importance in the audit approach was still in low level. Based on the interview, it can be noticed that most auditors did not rely on risk approach in performing their audit tasks. It seems that they had not realized that a risk-based audit is an important tool in preventing fraud cases in their institutions. Simona and Elisabeta [16] state that the activities both of the public sector and private sector are becoming increasingly more complex due to risks they face. Based on this finding, the internal auditor should have greater risk awareness in performing their audit due to the more complex of the risks in the public-sector organizations. Bechara and Kapoor [17] prove that around the world, substantial investments are being sacrificed to strengthening risk management programs. Therefore, the failures in optimizing risk management will cause loss of profitability and loss of financial and asset of the organization. The head of both inspectorates' states that most of the auditor's staff had not emphasized their audit in identifying fraud risk and their risk-based audit approach.

Secondly, lack of the quantity of the internal auditor in both inspectorates was said as the factor that caused the internal auditor had not reached an optimum level in supporting fraud risk management. The broader audit scope forced the two inspectorates to perform more audit tasks in more institutions in other audit objects. Due to the complexity and dynamics of the current situation in public sector, both the inspectorates of local government of Gunung Kidul and Sleman regency need more auditors in performing their annual audit plan. Unfortunately, it not such an easy thing to recruit more auditor as the number of people who can be trained as an auditor is limited. The lack of auditor team caused limitation span of control for the internal auditor, and therefore their role in fraud risk management cannot be achieved effectively. An example

of this situation that proved the lack of auditor people can be seen from many auditors of the two of inspectorates have to cope with several audit tasks in the same period. It means as stated by the head of the inspectorate of the local government of Gunung Kidul and Sleman regency, in several cases, it is possible for an auditor has to finish two or three audit report in the same time. The overload situation for the internal auditor's staff disturbs the effectiveness of the audit objectives. However, it will be a disadvantage for the two inspectorates in performing their role in supporting fraud risk management because too many tasks for the auditors will decrease their focus on fraud risk that they have to cope with.

Thirdly, the quality of the internal auditor was also said as one of the important factors that caused the internal auditor had not achieved an optimum level in supporting fraud risk management. Besides the quantity, the quality of the internal auditor has also become a problem, especially in the risk-based audit competency. This situation is similar to the findings of a research by Abdullatif and Kawuq [18] that many of the internal auditors still deal with tasks related to compliance audit, not risk-based audit. Therefore, lack of competence in performing risk-based audit caused the internal auditor did not support fraud risk management effectively. On the other hand, the audit objects that have greater fraud risk, have also increased significantly. The internal auditor has roles in supporting the fraud risk management of the organization, for examples are evaluating and providing assurance on the risk management processes and the assessing the accuracy of risk estimation [18]. These roles can be achieved only if the two inspectorates of the local government of Gunung Kidul and Sleman regency have proper quality includes knowledge and skills related to fraud risk management as well as risk-based audit.

Fourthly, the business process of the internal auditor in performing their audit task was stated by the head of the two inspectorates as one of the factors that caused the internal auditor had not reached an optimum level in enhancing fraud risk management. Based on the interview result, the business process that needs concern mainly is the quality assurance process includes a hierarchical review. In several audit tasks, it was still found that the auditor had not emphasized the fraud risk. Sometimes, this quality of the hierarchical review from bottom to up, which was the member of the audit team to the audit supervisor, caused the lack of fraud awareness that could happen anytime. Nicolaescu [19] states that the need for compliance of auditors with fraud standards is very important, which includes the audit process review that should be the focus on fraud risk. Both the two inspectorates of local government had not issued a comprehensive audit manual which consists of risk-based audit mechanism standard. Hence, the business process of the audit process caused the fraud risk management can be supported effectively.

However, all the four factors that caused the internal auditor had not achieved an optimum level in supporting fraud risk management is also related to the commitment of the heads of local government and their awareness of fraud risk management. Actually, the heads of local government can execute their commitment and awareness of fraud risk management by building the capability of the inspectorate

include an ample amount of the internal auditors and their quality in performing a risk-based audit. The real actions are by supporting the internal audit with an additional budget to enhance the knowledge and skills of the internal auditor in risk management as well as risk-based audit expertise. The head of the two inspectorates of the local government has to set an enhancement program of the internal auditor capability building using several models such as IACM (Internal Auditor Capacity Model). The quality of the internal auditor especially their knowledge and skills in the risk management areas are the main requirements for their role in supporting fraud risk management. Daugherty and Anderson [9] state that the internal auditor is in the position of the third line defense, which their role is supporting risk management of the organizations includes fraud risk management. According to this concept of the three lines of defense, the internal auditor provides final assurance to make sure that risk management includes fraud risk management works effectively [9]. Hence, the internal auditor capacity in this matter, especially in a risk-based audit, is compulsory.

Moreover, it is recommended that both of the two inspectorates of local government of Gunung Kidul and Sleman regency may start to arrange a risk-based audit plan. The internal auditors have the opportunity to create value by developing a continuous focus on the risk, and arrange the audit plan around the identified risks [17]. The risk-based audit plan is an effective tool for the internal auditors in expanding their role in supporting management, especially in fraud risk management. The effective risk-based audit plan should be completed with the organization's objectives and their organization's risks that are relevant to those objectives [17]. Both of the inspectorates of the local government of Gunung Kidul and Sleman regency can start in creating risk-based audit plan by identifying the objectives and goals of all the audit objects.

One of the audit objects, which is a building construction project of a strategic building of the local government, can be taken as one of the examples. The auditors must identify its audit objectives in order to prevent fraud risk. The identified objectives, for instances are preventing from the improper bidding of this project, a markup of the price as stated in Owner's Estimate (OE), and poor quality of the building. By identifying all the objectives and goals of their audit objects, the inspectorate can focus their procedures audit in achieving those objectives. Based on this objective, the internal auditor automatically will set the proper procedure audit to cope with the possibility of markup price of the Owner's Estimate price. The auditor can use a comparable price audit procedure so it can be stated the fair price that should be used in this construction project. Knowing the fair price is the main tool in determining the price of the contract of the building construction project, whether the contract price has been marked up or not. Shortly, the risk-based audit plan approach will cover the potential problem of the internal auditor in doing their risk-based audit. The role of the internal auditor in supporting fraud risk management can be an advantage for the organization as a whole through their performance in doing a risk-based audit, and therefore fraud risk can be mitigated.

Besides using the risk-based audit plan, another recommendation for the inspectorate of local government Gunung Kidul and Sleman regency is awareness improvement programs through a formal training and education, seminars, in-house training relate to risk management and risk-based audit. The aim of this comprehensive program is to increase all internal auditor staff's awareness in risk-based audit approach, regardless their position in the internal audit organization. By joining all formal and informal education pertaining to risk management and risk-based audit, their mindset will be expanded especially in the importance of risk approach.

Furthermore, the capability enhancement programs both quantity and quality aspects should be increased intensively includes the quality assurance improvement programs and the hierarchical reviews in the audit process. The quality assurance improvement programs can be done by applying a pilot project with one or two audit teams in the implementation of a risk-based audit. The result of all the business process of this pilot project of a risk-based audit, includes the using of risk-based audit procedures, an effective internal review process as well as an audit working papers based on the proposed risk-based audit standards, will enhance the role of the government internal auditor in fraud risk management.

IV. CONCLUSION

The role of the government internal auditor in fraud risk management through the fraud prevention has not reached an optimum level, which can be seen its audit was not based on a risk-based audit approach. The government internal auditor has not arranged a risk-based audit plan includes identification of the objectives and the goals of the audit objects as well as the audit procedures in the risk mitigation especially for fraud high-risk. The reasons that the internal auditor has not performed a risk-based audit are as follows: its awareness of the risk importance in an audit approach is still in low level, the quantity of the internal auditor, the quality of its auditor, as well as its audit business process that has not achieved an optimum level. All the four factors that caused the internal auditor had not achieved an optimum level in supporting fraud risk management is also related to the commitment of the heads of local government and their awareness of fraud risk management.

Several recommendations for the inspectorate of local government Gunung Kidul and Sleman regencies are arrangement of a risk-based audit plan, awareness improvement programs through a formal training and education, seminars, in-house training relate to risk management and risk-based audit. Besides, capability enhancement programs both quantity and quality aspects should be increased intensively includes quality assurance improvement programs and hierarchical reviews in the audit process. It is recommended for both two of the government internal auditors to start a piloting project with one or two audit teams in the implementation of a risk-based audit.

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