

# The Effect of whistleblowing Hotline, Surprise audit, and the independence of Audit Committee on internal Fraud: Facts of Banking Companies in Indonesia

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**Abstract**— Banking and other of finance institutions was one of the sectors that has lots of fraud. Indonesian Financial Services Authority discover the most substantial fraud in the banking involves employ or customers. Therefore, banking needs a mechanism that can limit that actions. This study aims to analyze the effect of whistleblowing hotline on internal Fraud, the effect of surprise audits on internal fraud, and the effect of the independence of the audit committee on internal fraud. Furthermore, this research analyze the effect of whistleblowing hotline, surprise audits, and the independence of the audit committee against internal fraud simultaneously.

Paper is based on the data from annual reports and Good Corporate Governance (GCG) company banks report listed on the Indonesia Stock Exchange in the period of time throughout twelve years 2008-2018. Samples were tested by multivariate regression analysis. The Results showed that the whistleblowing hotline significantly affect negative against internal fraud. Surprise audit has a significant negative effect on internal fraud. The independence of the audit committee hotline has a significant negative effect on internal fraud. In simultaneous whistleblowing hotline, surprise audits, and the independence of the committee audit affect negatively against internal fraud.

**Keywords**— fraud; bank; whistleblowing; surprise audit.

## I. INTRODUCTION

Fraud is a latent danger that threatens every organization. Based on survey results of the Association of Certified Fraud Examiners (ACFE) in 2018, banking and finance institutions was one of the sectors that has lots of fraud. Fraud in the banking industries can be interpreted as an act of intentionally violating of the internal provisions consist of policies, systems, and procedures which could potentially harm the bank both material and moral. The existence of fraud in the world of banking wouldly gave great impact on the trust of the customers level and harm it financially. Therefore, banking needs a mechanism that can limit that actions. The ACFE's survey at 2016 and 2018 concluded that the most good and effective method to preventing the fraud is whistleblowing hotline mechanism. Whistleblowing hotline is a service that allows employees and the third suppliers to report

malpractice, behaviour that violates the law, or unethical behaviour at the work place.

Surprise audits can prevent fraud because employees and managers are not given out before the random verification and therefore did not have time to hide the fraud by cover up their traces (Peltier-Rivest et al., 2015). In fact, the random audit and without notice can increase the perception of fraud perpetrators on the detection and fear them to be caught (Wells, 2011).

The results of the survey ACFE (2016) shows that the audit of external and internal audits also can be a medium for detecting the occurrence of fraud. However, the percentage that little thing that shows that the audit of external and internal not contribute to find fraud. Therefore, audit committees had necessary roles in their function which can reduce the chance of the irregularity occurrence in the management of the company and

improve the effectiveness of internal audit and external audit function and ensure the audit findings followed up well. Collier's Research (1993) on the audit committee in the UK indicates that the independence of the audit committee on management was the second most important factor, after the judgment which affects the effectiveness of the committee. Various studies show that the independence of the committee audit has effect against fraud (Bryan et al. (2004), Pamudji and Trihartati (2007), and Kosasih and Widayati (2013). Therefore, the aim of this research is to analyse the effect of hotline whistleblowing against internal fraud, the effect of surprise audits on internal fraud, the effect of the independence of the audit committee on internal fraud, and analyzing the effect of hotline whistleblowing, surprise audits, and the independence of the committee audit against internal fraud simultaneously.

### **Fraud**

According to the Association of Certified Fraud Examiner (ACFE) in the Fraud Examiners Manual 2006: Fraud was the profits were obtained by someone with existing something which not in accordance with real conditions. Including unexpected elements, hokey pokey, cunning, and dishonest way that can harm someone else (Karyono, 2013:3).

### **Fraud Triangle Theory**

Cressey's Research (1973) with 200 prisoners that were convicted of fraud, conclude the end hypotheses of that time it was known as the triangle of fraud. The hypothesis is assumed that: "Trusted People become violators when they consider themselves they have not to be shared problem finances and realize that problem can be resolved secretly with breaking the trust finances positions, and could apply to their behaviour in that situations. Verbalization that allows them to adjust their own concept as users of funds and entrusted property."

Research concluded that fraud consists of three elements, namely the existence of pressure, opportunity, and justification that by the time is better known as fraud triangle theory.

### **Fraud on banking**

Fraud in banking industries can be interpreted as an act of intentional violating the internal provisions consist of policies, systems, and procedures which could potentially harm the bank either material or morale. Bank Indonesia (2011) through Circular Letter of Bank Indonesia (SEBI) 13/28/DPNP issued regulations related to fraud, where fraud is defined as the act of irregularities were deliberately made to deceive, cheat, or manipulate the bank or the customer who performed at the neighborhood bank and/or use the bank's means that resulted suffer

losses in the customer or the other and fraud perpetrators earn a profit finance directly or not directly.

The actions which classified as fraud is cheat, deceive, misappropriation of assets, the leaking of information, banking criminal acts, and the other actions that can be equated with it (Bank Indonesia, 2011). Based on the data Indonesian Financial Services Authority, the types of acts in criminal banking that occurred in 2014 up to quarter III-2016 include : the case of credit (55%), engineering registration (21%), embezzlement of funds (15%), transfers of funds (5% ) and asset procurement (4%) (Sukmana, 2016 ).

### **Whistleblowing Hotline**

Komite Nasional Kebijakan Governance(2008:3)defines whistleblowing as: "Disclosure act violations or disclosure of acts that against the law , the unethical act or immoral act or other that can be harm the organization or stakeholder, which is done by employees or organization leaders to otherorganization leader or other institution which can take actfor that violation. This disclosure is generally carried out in secret."

The fraud reporting mechanism is an important component of an effective fraud prevention and detection system. Organizations must implement a hotline to receive reports from internal and external sources. The ability to report the fraud in anonymous is very important because many employees and others stakeholders may be afraid to report suspicious behaviour because of the threat of retaliation from superiors and negative ratings of co- worker (ACFE, 2010).

Whistleblowing hotline is a service that allows employees and the third suppliers to report malpractice, behaviour that violates the law, or unethical act at the work place. Wells (2011) stated that in the war against fraud, hotline serves as a detection method and prevention act by improves the perception of detection and fear of caught between individual who plans a crime. Priantara (2013) mentions that one of the systems that are used to prevent the occurrence of fraud is to implement a reporting system of fraud allegations (whistleblowing hotlines). Peltier-Rivest and Lanoue's research (2015) found that the hotline had a significant negative effect on fraud, so the hypothesis in this study is as follows. H1: whistleblowing hotlines affect negatively against internal fraud.

### **Surprise Audit**

Based on BI Circular Letter No.13/28/DPNP Regarding Anti-Fraud Strategy for Commercial Banks, there are three techniques for detecting fraud, namely the Whistleblowing System mechanism, surprise audit, and surveillance system. Surprise audits can prevent fraud because employees and managers are not given out before the

random verification (eg, the amount of money in cash, review documents, the buyer secret) and therefore they did not have time to hide the fraud to cover their tracks (Peltier-Rivest and Lanoue, 2015). In fact, the random audit and without notice increase the perception of fraud perpetrators about the possibility of being detected and their fear to be caught (Wells, 2011).

According to Sam Bowercraft and David Hammarberg (2013), the purpose of surprise audit is to evaluate without giving notice of the review/inspection so that the preparation cannot be done by the auditee (audit target), to confirm the readiness of actual operational of the process area, as a detection strategy, and as a prevention strategy. The benefits of the surprise audit implementation are to improve employees caution in carrying out their duties. Every part that related to the operational companies will be cautious because of concerns at any time can be carried out by surprise audits, so that things can decrease the motivation to commit fraud. Peltier-Rivest and Lanoue's research (2015) found that Surprise Audit has a significant negative effect on fraud. Therefore, the hypothesis in the research of this is as follows. H2: surprise audit has a negative effect on internal fraud.

#### **Independence of Audit Committee**

Audit Committee is one of the media to improve the effectiveness of the control system of company. Definition audit committee by Komite Nasional Kebijakan Governance (KNKG, 2006) is a group of people chosen by the bigger group to do specific job or to perform special tasks or a number of members of the commissioner board of client company which responsible to assist the auditor in maintaining its independence from management. In the execution of its duties, the committee audit has functions as follows: (1) Assist the board of commissioners to increase the quality of financial report; (2) Creating a climate of discipline and control that can reduce opportunities for irregularities in company management; (3) Increasing the effectiveness of internal audit functions and external audits; (4) Identifying matters that require the attention of the board of commissioners/supervisory board. Audit Committee has a role which is quite vital in the implementation process of a governance mechanism of companies. Surely that committee audit can carry out their duties with properly and effectively, it is necessary specific qualifications that adequate so that the duties and responsibilities running maximally (Wardhani and Joseph, 2010).

Independence is a major factor in what an examiner must have especially an audit committee. The importance of independence on the audit committee is emphasized by Regulation No.IX.I.5 Appendix Decision of Chairman of

Badan Pengawas Pasar Modal (BAPEPAM) No. KEP-29/PM/2004 date September 24, 2004 concerning the Formation and Guidelines for the Implementation of Audit Committee Work (BAPEPAM, 2004). Various studies show that the independence of the committee audit effect against fraud (Bryan et al. (2004), Pamudji and Trihartati (2007), and Kosasih and Widayati (2013)), so the hypothesis in this study is as follows. H3: The independence of the audit committee has a negative effect on internal fraud.

In addition to testing in partial, testing is simultaneously also conducted to see the effect of the three variables that whistleblowing hotline, surprise audits, and the independence of audit committee internal fraud, therefore the hypothesis, H4: whistleblowing hotline, surprise audits, and the independence of audit committee affect internal fraud simultaneously.

## **II. RESEARCH METHODOLOGY**

### **Location and Research Design**

The aims of this research to test the hypothesis. The type of relationship between variables studied is correlational relationship. Location conducted on Stock Exchange Indonesia by using the secondary data from 2008 up to 2018. The analysis unit is the company level, namely companies banking listed in Indonesia Stock Exchange (IDX). The time horizon in this study is the time series. The variables in this study consisted of the dependent variable and the independent variable. The dependent variable used is Internal Fraud while the independent variable is the whistleblowing hotline, surprise audit, and independence of the audit committee.

### **Population and Research Samples**

This research will look at the effect of whistleblowing hotline, surprise audit, and independence of the audit committee on internal fraud. The Population of this research is the whole enterprise banking which listed on the Stock Exchange Indonesia in 2008-2018. The selection of samples is done with purposive sampling method. Companies that meet the requirements to be used as a sample in this study about 25 companies.

### **Data Analysis Method**

The data in this study is processed by using the software Statistical Package for the Social Sciences (SPSS) version 23.

### **Classical Assumption Test**

The classical Assumption Test is conducted to provide assurance that the regression equation was obtained has accuracy in estimation, not biased, and consistent. The classical Assumption Test is done by normality test, a

multicollinearity test, heteroskedasticity test, and autocorrelation test.

### Multiple Linear Regression Analysis

Multiple linear regression analysis is used to analyze the effect of the whistleblowing hotline, surprise audit, and independence of the audit committee on internal fraud. Regression model in this research shown in the equation below:

$$IF = \beta_0 + \beta_1 WH + \beta_2 SA + \beta_3 IKA + e$$

Description:

IF	=	Internal fraud is measured by the
$\beta_0$	=	constants;
$\beta_1, \beta_2, \beta_3$	=	regression coefficient;
WH	=	whistleblowing hotline is measured by a dummy variable. A value of 1 if there is a hotline that can be contacted when fraud occurs, and a value of 0 if it does not exist;
SA	=	surprise audit is measured by the surprise audit frequency every year;
IKA	=	the independence of the committee audit measured by the percentage of audit committee comes from the outside to the number of members of the audit committee;
E	=	error terms

## III. RESULTS AND DISCUSSION

### Classical Assumption Test

The test results of normality after the data transformation shows the value of the Kolmogorov-Smirnov about 0.642 with a significance 0.805 located in the upper  $\alpha = 0.05$  so it can be concluded that the distribution data is normal. The test results of heteroskedasticity show that there is not a clear pattern and dots spread on top and at the bottom of the numbers 0 on the axis Y, so it can be concluded that heteroskedasticity did not happen. The autocorrelation test results showed a number of significant lags less than two so it can be concluded that there is autocorrelation occurred.

### Hypothesis Test

Table 1 Test results for the coefficient of determination

Model Summary				
Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	.443 <sup>a</sup>	.295	.286	.79303

a. Predictors: (Constant), IKA, WH, SA

The testing results indicate the amount of adjusted  $R^2$  is 0.286, it means 28.6% variation of internal fraud can be explained by the other three independent variables, hotline whistleblowing, surprise audits, and the independence of

the audit committee, while the rest is explained by other causes outside the model.

Table 2 Results of the testing are partial (test statistic t)

		Coefficients <sup>a</sup>				
		Unstandardized Coefficients		Standardized Coefficients	T	Sig.
Model		B	Std. Error	Beta		
1	(Constant)	4.731	.162		29.191	.000
	WH	-.100	.027	-.225	-3.752	.000
	SA	-.100	.034	-.177	-2.911	.004
	IKA	-.114	.033	-.217	-3.437	.001

a. Dependent Variable: IF

Hypothesis test results indicate that the whistleblowing hotline variable has a negative effect on internal fraud. Constant of 4.731 shows without the influence of the whistleblowing hotline variable, the company will increase internal fraud action about 4.731 %. The regression coefficient of whistleblowing hotline variable has a value of -0.100 that shows if the whistleblowing hotline increases by 1%, it will reduce the internal fraud action by 0.100 %. It means whistleblowing hotline affect negatively against internal fraud. The level of significance about 0.000 or smaller than 0.05 indicates that whistleblowing hotline is partially have the effect against internal fraud significantly, so the first hypothesis which states that whistleblowing hotline affect negatively against internal fraud is received.

The test of second hypothesis shows regression coefficient of internal fraud variable about -0.100 indicates when the surprise audits increased by 1% then it will reduce the action of internal fraud about 0.100 %. It means surprise audits affect negatively against internal fraud. The level of significance about 0.004 or smaller than 0.05 indicates that surprise audit is partially have the significant effect against internal fraud, so the second hypothesis that states surprise audits affect negatively against internal fraud is received. The test of third hypothesis shows that the independence of the audit committee has a coefficient about -0.114. It means if the independence of the audit committee increased by 1% then it will reduce the action of internal fraud about -0.114 %. The level of significance about 0.001 or smaller than 0.05 indicates that the independence of the audit committee influences significantly against internal fraud, so the third hypothesis that stated the independence of the audit committee affect negatively against internal fraud is received.



Table 3 Results of the testing are simultaneous (test statistic F)

ANOVA<sup>a</sup>

Model		Sum of Squares	Df	Mean Square	F	Sig.
1	Regression	37.688	3	12.563	19.975	.000 <sup>b</sup>
	Residual	154.710	272	.629		
	Total	192.397	275			

a. Dependent Variable: IF

b. Predictors: (Constant), IKA, WH, SA

The test of fourth hypothesis shows whistleblowing hotline variable, surprise audits, and the independence of the audit committee effect against internal fraud simultaneously. The value of F arithmetic amounted to 19.975 with a 0.000 probability is much smaller than 0.05 so it can be concluded that the fourth hypothesis that states whistleblowing hotline variable, surprise audits, and the independence of the audit committee effect against internal fraud simultaneously is received.

#### The influence of whistleblowing hotlines on internal fraud

The testing results of first hypothesis shows that the whistleblowing hotline variable affect negatively against internal fraud, things are seen from the value of the coefficient whistleblowing hotline variable about -0.100 with a significance level 0.000. It means the higher level of whistleblowing hotline, it will reduce the action of internal fraud. This research result increasingly supports the study results that were conducted by Wells (2011), Priantara (2013), and Peltier-Rivest and Lanoue (2015) who find that whistleblowing hotline is influenced negative significantly against fraud. Whistleblowing hotline will build a healthy neighborhood business, integrity, and reliable so banking companies can provide quality service. Whistleblowing hotline will provide an opportunity for every person to report fraud allegations were carried out by internal company so the company will be supervised every time and opportunity to conduct fraud will be getting smaller.

#### The effect of surprise audit on internal fraud

The testing results of second hypothesis shows that the surprise audits variables affect negatively against internal fraud, things are seen from the value of the coefficient of surprise audit variables about -0.100 with a significance level about 0.004. It means the higher level of surprise audit, it will reduce the action of internal fraud. This research result increasingly supports the study results that were conducted by Wells (2011) and Peltier- Rivest and

Lanoue (2015) who find that a surprise audit is influenced negative significantly against fraud. Bank Indonesia make serious effort to optimize the detection of fraud by making a surprise audit as one of the efforts to detect fraud at the banking institution. Surprise audits can directly detect fraud at the time while audit process was underway because the fraud perpetrators have no time to eliminate his fraud evidence. Implementation of the sudden audit make the parties that are involved in the company will try to carry out the duties and functions as best as possible and be able to suppress the desire to do cheat because feel worried any time for surprise audit, so with the surprise audit, controlling process in the company will be getting better and reduce the risk of internal fraud.

#### The effect of the independence of the audit committee on internal fraud

The testing results of third hypothesis shows that the independence of audit committee variable affect negatively against internal fraud, things are seen from the value of the coefficient of independence of audit committee variable about -0.114 with a significance level about 0.001. It means the higher level of independence of audit committee it will reduce the action of internal fraud. This research result increasingly supports the study results that were conducted by (Bryan et al. (2004), Pamudji and Trihartati (2007), as well as Kosasih and Widayati (2013) who find that the independence of the audit committee is influenced negative significantly against fraud. The audit committee was one of media to improve the effectiveness of the control system at the company. The independent audit committee can carry out the functions of effective controlling and monitoring because of its duties was not affected and depended on the other. In addition, the independent audit committee will be objective in carrying out duties and obligations so they can put forward the professionalism of the work and skepticism that are not affected with pressure or interests of others who can minimize internal fraud that occurred at the company.

#### The effect of the whistleblowing hotline, surprise audit, and independence of the audit committee on internal fraud

The testing results of fourth hypothesis shows that the whistleblowing hotline variables, surprise audits, and the independence of the audit committee affect negatively against internal fraud, things are seen from the significance level of whistleblowing hotline variables, surprise audits, and the independence of the audit committee about 0.000. It means the higher levels of whistleblowing hotline, surprise audits, and the independence of the audit committee it will reduce the action of internal fraud. This research result increasingly supports the study results that

were conducted by (Bryan et al. (2004), Pamudji and Trihartati (2007), as well as Kosasih and Widayati (2013).

#### IV. CONCLUSIONS

Whistleblowing hotline has a negative effect on internal fraud. Surprise audit has influenced negative significantly against internal fraud. The independence of the audit committee has a negative effect on internal fraud. In simultaneous, whistleblowing hotline, surprise audits, and the independence of the audit committee affect negatively against internal fraud. Based on these conclusions, as advice for the next study can use the latest theory as an extension of the theory of fraud triangle (Cressey, 1953) i.e. Fraud pentagon theory that proposed by CrowenHowart (2011) to look at the deciding factors of fraud. The next research can investigate fraud by using the five elements of fraud that is pressure, opportunity, rationalization, capability, and arrogance.

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