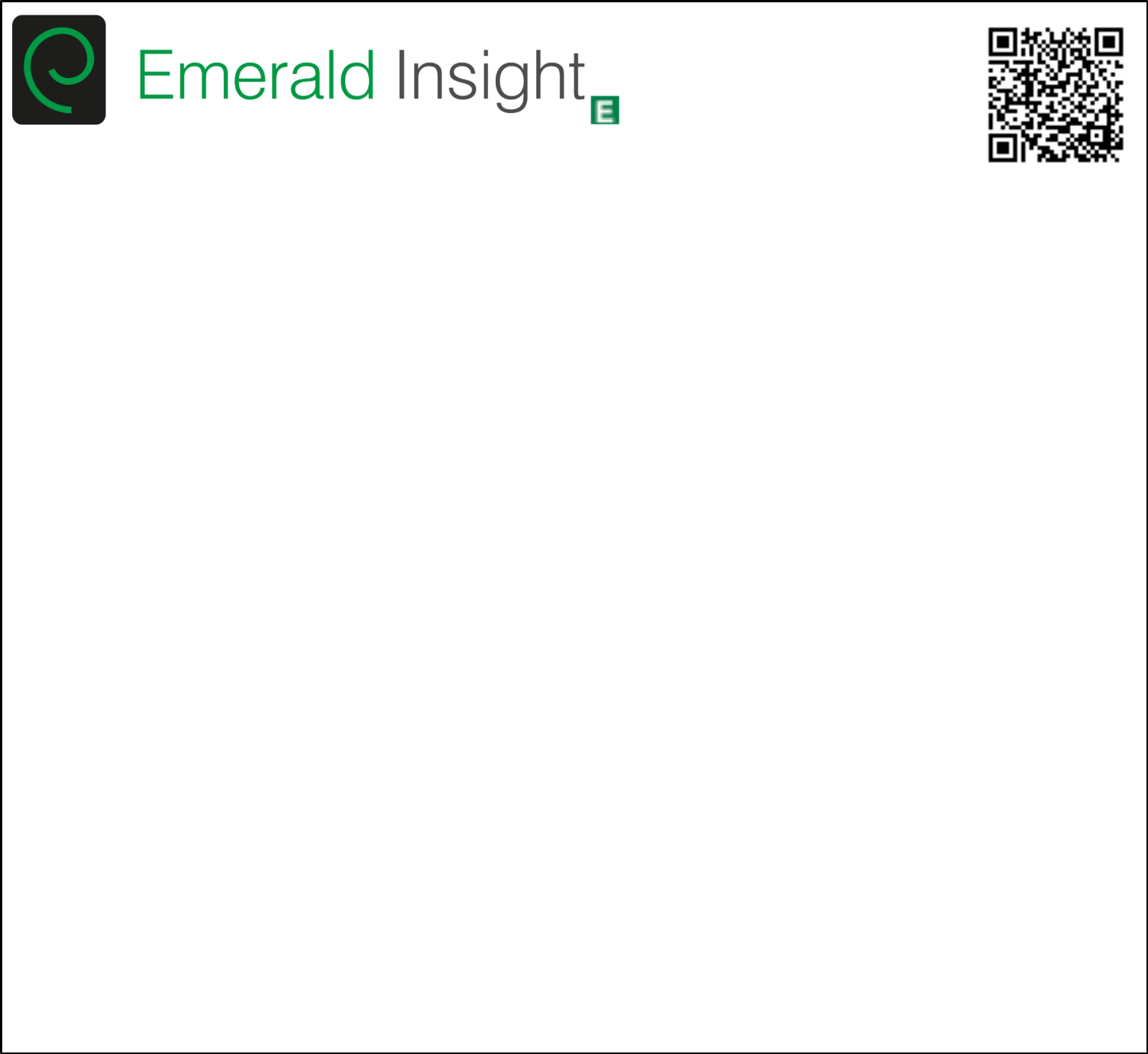
|  |
| --- |
| Downloaded by Cornell University Library At 09:05 14 September 2016 (PT) |

**Journal of Financial Crime**



Internal controls and fraud - empirical evidence from oil & gas company Khairul Mizan Zakaria Anuar Nawawi AHMAD SAIFUL AZLIN PUTEH SALIN

**Article information:**

To cite this document:

Khairul Mizan Zakaria Anuar Nawawi AHMAD SAIFUL AZLIN PUTEH SALIN , (2016),"Internal controls and fraud - empirical evidence from oil & gas company", Journal of Financial Crime, Vol. 23 Iss 4 pp. -

Permanent link to this document:

<http://dx.doi.org/10.1108/JFC-04-2016-0021>

Downloaded on: 14 September 2016, At: 09:05 (PT)

References: this document contains references to 0 other documents.

To copy this document: permissions@emeraldinsight.com

The fulltext of this document has been downloaded 7 times since 2016\*

**Users who downloaded this article also downloaded:**

(2016),"Re-understanding corruption in the Indonesian public sector through three behavioral lenses", Journal of Financial Crime, Vol. 23 Iss 4 pp. -

Access to this document was granted through an Emerald subscription provided by emerald-srm:333301 []

**For Authors**

If you would like to write for this, or any other Emerald publication, then please use our Emerald for Authors service information about how to choose which publication to write for and submission guidelines are available for all. Please visit www.emeraldinsight.com/authors for more information.

**About Emerald www.emeraldinsight.com**

Emerald is a global publisher linking research and practice to the benefit of society. The company manages a portfolio of more than 290 journals and over 2,350 books and book series volumes, as well as providing an extensive range of online products and additional customer resources and services.

Emerald is both COUNTER 4 and TRANSFER compliant. The organization is a partner of the Committee on Publication Ethics (COPE) and also works with Portico and the LOCKSS initiative for digital archive preservation.

\*Related content and download information correct at time of download.

|  |
| --- |
| Downloaded by Cornell University Library At 09:05 14 September 2016 (PT) |

**INTERNAL CONTROLS AND FRAUD – EMPIRICAL EVIDENCE FROM OIL &**

**GAS COMPANY**

**INTRODUCTION**

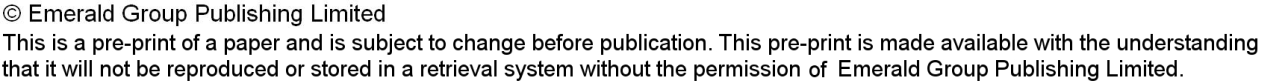
Internal controls can be described as policies and procedures established to provide reasonable assurance that the specific entity objectives will be achieved. It is a process affected by the organisation’s board of directors, management and other personnel (COSO, 2013). The main purpose of internal controls is to support the entity in managing their risk to achieve the entity’s established objectives and sustain their performance. For example, financial and operational information must have strong internal control characteristics such as reliable and possesses integrity, operations are performed efficiently, assets are properly safeguarded, and decisions of the organisation are in compliance with laws, regulations and contracts.

However, inherent limitations in internal controls are inevitable. Human error, deliberate circumvention and cost/benefit considerations are factors that are usually considered when implementing internal controls. If internal controls are inadequate, there will be opportunities for employees, irrespective of age, culture or geographic location to commit fraud and ethical practices in the organization (Baldock, 2016). This is possible when employees have access to assets and information that allows them to both commit and conceal fraud. In general, employees are given access to records and valuables in the ordinary course of their jobs. Unfortunately, that access allows people to commit fraud.

Fraudulent activity represents a significant problem in many companies due to its greater impact on economic and reputation (Free, 2015) including those who operate in oil and gas industry. The problems can vary from outright criminal activity to serious non-compliance issues. Many of these problems are foreseeable but they are still occurring due to factors such as ineffective internal control. Due to this, it is interesting to explore and examine the type of internal control weaknesses and its impact that leads to the fraud activities. By selecting one company in oil and gas industry as a case study, the purpose of this study is to identify the internal control weaknesses and the fraud that is committed by individual as a result of the weaknesses in those controls. In general, this study will attempt to answer the following research question, *“What are the frauds committed by the employees as results of weak internal control practices in the company?”*

This type of company is selected because oil and gas industry is a unique industry with its processes, transactions, operations and functions not well understood by many people. For example, this company applied Financial Reporting Standard (FRS) that dealing with complex and complicated exploration for and evaluation of mineral resources, production and decommissioning oil and gas activities, natural reserves, assets retirement obligations and derivative accounting. In addition, generally there are only a few oil and gas companies established within the country compared to other type of industry such as general trading and manufacturing due to its nature of operation that very expensive, capital intensive and highly specialised. Thus, this will draw invaluable opportunities to explore and examine the relevant

1



|  |
| --- |
| Downloaded by Cornell University Library At 09:05 14 September 2016 (PT) |

issues of the study. Besides, the management of the company allows accessibility of the information to be examined and investigated from the company via various highly confidential and top secret internal generated report and record. The company also have permission of its staff to be interviewed.

So, this study is original and differs from other studies because it has examined various documents and reports of employee fraud that are generally difficult to be accessed by researchers to be published in an academic journal. The findings of this study are inferred from direct access of company documents that are private and confidential.

This study contributes in several ways. First, this study adds to the theoretical understanding and body of the literature by focusing on the specific company, in particular a highly specialised industry namely oil and gas. It is hard to find a literature on fraud and internal control weaknesses that are very specific to this industry, especially for companies that operate in developing countries. Secondly, it employs a case study method by collecting data via internal document analysis and interviews with senior management, which is difficult to access due to confidentiality and sensitivity of the information. The findings from this study are invaluable for academic literature and practitioners such as internal auditor and administration manager. Finally, it provides some recommendations to improve the internal control weaknesses from the real case that will benefit not only the firm in the case but also other companies that may experience similar situations.

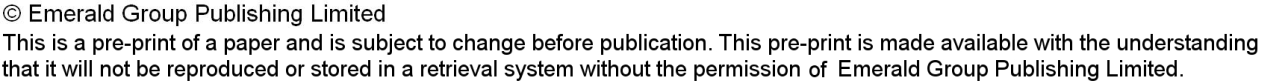
This paper is organised as follows. The next section is the review of literature, followed by a description of methods used to conduct this research. Section four presents the findings and discussion of the case study where it will uncover the internal control weaknesses of the case, as well as frauds committed as a result of those weaknesses and the outcomes of the interviews. Meanwhile, section five put forth recommendations to improve the weaknesses of the internal control so that fraud can be prevented and operational efficiency can be enhanced. It will be followed by the conclusion and the last section is limitations and suggestion for future research.

**LITERATURE REVIEW**

**Internal Control Flaws and Frauds**

Adequacy and effectiveness of the internal control system should always be evaluated to ensure there are no weaknesses that can lead to fraudulent activities (Szymanski, 2007; Tong et al., 2014; Oh et al., 2014). Strong internal controls encourage accountability in managing resources (Asare, 2009), efficient operation (Feng et al., 2015), more analyst coverage (Clinton et al, 2014), less risk-taking behavior (Länsiluoto et al., 2016; Jin et al., 2013), increasing earning persistence and cash-flow predictability (Altamuro and Beatty, 2010), better earnings quality (Brown et al., 2014), minimizing shock from unexpected events (Hajiha and Bazaz, 2016) higher compliance with laws, regulations, policies and procedures as well as able to eliminate fraud and abuse.

2



|  |
| --- |
| Downloaded by Cornell University Library At 09:05 14 September 2016 (PT) |

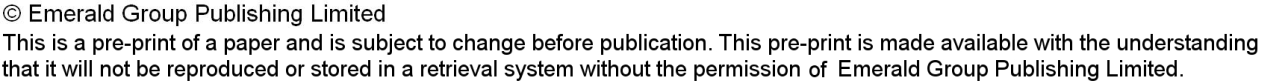
In contrast, internal control weaknesses provide an opportunity for fraudulent activities to occur (Lokanan, 2014; Skaife et al., 2013), lead to decline in sales (Su et al., 2014), lessen future performance (Weiss, 2014), associate with higher private control benefits (Gong et al., 2013), reduce firm's market value and the value relevance of accounting information (Hu et al., 2013), result in low reporting quality (Ghosh and Lee, 2013), higher loan loss reserve and provisions in banking institutions (Cho and Chung, 2016) and negative market reactions (Nishizaki, 2014). For example, a policy of dealing with only one supplier shows weaknesses in internal control and it can be a red flag for fraud (Simser, 2014).

The Committee of Sponsoring Organization of the Treadway Commission (COSO) has developed a framework for the internal control system, which consists of five components that fit various organisations namely control environment, risk assessment, control activities, information and communication and monitoring activities. Control environment is the most fundamental as it is involved in establishing complete standards, process and structures that become a foundation for the implementation of the internal control in the organisation. Risk assessments refer to how various risks, internally or externally, will be identified, assessed and managed to ensure any unexpected events will not harm company activities. Control activities ensure risks were mitigated via preventive and detective activities characteristics and can be performed manually and automatically. Information and communication ensure relevant and quality information is obtained and shared across organisations to support the functions of internal control. Lastly, monitoring activities are continuous evaluations to determine whether the entire internal controls component functions effectively and efficiently (COSO, 2013).

The ultimate benefit of internal control system is it serves as a reasonable assurance mechanism for the organisation to achieve the best performance while able to fully utilise the financial and non-financial resources optimally and simultaneously protect it from unexpected events, includes reducing occupational fraud losses by organizations (Peltier-Rivest and Lanoue, 2015). Having an effective internal control system can strengthen the process, structure and value of the organisation in enhancing the oversight and supervision, hence decrease and prohibit the misconduct and malpractices such as fraud and misappropriation of assets.

Prior study on internal control weaknesses shows that an effective internal control framework assists the workforce to create a control-oriented mindset so that the risk and control issues can be viewed continuously and consistently (Olach and Weeramantri, 2009). Apart from providing a reliable system, internal control can benefit organisations through efficient use of resources, safeguarding assets, fulfilling budgetary objectives, combating fraud and human error as well as increasing compliance with rules and regulations (Allen et al., 2013). Waste can be minimised and information can be obtained quickly, reliably and accurately for precise decision making (Allen and Tommassi, 2001). Audit committee, for example associate with fewer internal control problems (Khlif and Samaha, 2016) that leads to better financial reporting (Rich and Zhang, 2014) and plays an effective role in in fraud prevention and risk management practices (David, 2009).

3



|  |
| --- |
| Downloaded by Cornell University Library At 09:05 14 September 2016 (PT) |

However, fraud, as defined by UK Police as trickery to gain dishonest advantage, usually financial advantage on another person (ActionFraud), is widespread when there is a weakness in the internal control system in the organisation. Poor and inadequate internal control causes fraud and misappropriation to fail to be detected and prevented (KPMG, 2009). Based on ACFE (2008), 23% of frauds were detected through internal controls that were established in place. Puah et al. (2009) found that inadequate cash security practices, poor staff supervision and the failure of internal auditing to operate effectively and efficiently leads to corporate fraud occurrence and business mismanagement, indicates severity consequences of weak internal control practices.

According to KPMG’s Fraud Survey Report Malaysia 2009, a significant number of respondents believe that fraud is a major problem for businesses in Malaysia. 61 percent of respondents expect the level of fraud to increase in future. In addition, 89 percent believe that the trend of fraud will significantly rise as a result of the economic crisis which took place in 2008 (KPMG, 2009).

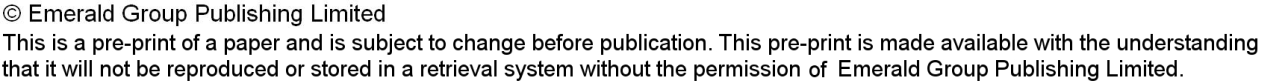
KPMG’s findings were supported by another survey report conducted by PriceWaterhouseCoopers (PWC). In their report of Global Economic Crime Survey 2011, it was found that 44 percent of businesses and other organisations surveyed in Malaysia had been victims of economic crime, representing a 57 percent increase over the 28 percent reported in the 2009 survey. Theft or asset misappropriation (cited by 83 percent of respondents) was the most common type of economic crime reported, followed by bribery and corruption (34 percent) and accounting fraud (27 percent) (PWC, 2011).

The direct costs of economic crimes to an organisation can be difficult to gauge but Malaysian respondents reported rising direct losses. 7 percent of respondents said that they lost between USD 5 million to USD 100 million, while 37 percent said that they lost between USD 100,000 to USD 5 million. Victims of economic crime also reported significant collateral damage due to fraud. This includes damage to employee morale, brand and reputation as well as business relationships. The increasing figures and trend in fraud and corruption represent a significant alarm on the danger of these unethical practices and its consequences not only to the company but to the country as a whole (PWC, 2011). ACFE (2012) for example reported that occupational fraud and abuse worldwide can exceed USD3.5 trillion. Cheng and Ma (2009) informed that bank fraud causes China billions of dollars in loss every year, possibly more than USD2.8 billion annually since the new millennium (Zhou, 2006 in Cheng and Ma, 2009). For occupational fraud, single or individual cases in the UK may cost the company in average £25,000 (Button et al., 2015).

**Fraud Triangle Theory**

The fraud phenomena can be explained using Fraud Triangle Theory originated by Cressey (1973). This theory argues that for fraud to be committed, it needs three solid reasons namely pressure, opportunities and rationalisations. Pressure is a stress and demands that trouble the person, usually financial. Personally, an individual may feel pressure to maintain its current lifestyle while he has limited income. Meanwhile, opportunity is a risk to commit fraud. It

4



|  |
| --- |
| Downloaded by Cornell University Library At 09:05 14 September 2016 (PT) |

has an inverse relationship with an organisation’s internal controls. Weak internal controls mean the risk to commit and get caught due to fraud is low. For example, absence of assets listing documentation will create opportunity for assets misappropriations. Lastly is rationalisation. It is associated with the fraudster’s justification to show that his/her action is morally right and permissible. For example, the fraudster may falsify a sick certificate by justifying that his colleagues also do the same but punishment is not taken.

**RESEARCH METHOD**

This research uses a case study approach in meeting its purpose and objectives. Based on Miller and Brewer (2003), a case study method provides some of the most interesting and inspiring research in social science because it offers in-depth and detailed understanding about the problems and issues under research. In addition, this approach is appropriate to learn and examine little-known and poorly understood environments (Leedy and Omrod, 2005), which are generally hard to access via normal research process and are not publicly available. As the oil and gas industry is a unique industry with its process and operation not well understood by many people, a case study approach offers unique opportunities for the researcher to explore the relevant issues of the study.

**Background of the Case Study**

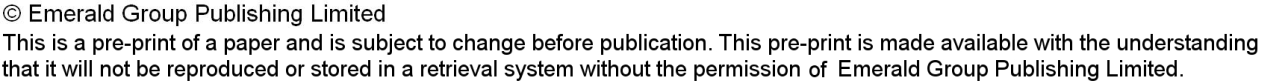
The company that selected in this study is an international oil and gas company that headquartered in the United States. The company is mainly involved in exploration and production of oil and gas. The company is also operating in various foreign countries such as Malaysia, Indonesia, Australia, Canada, United Kingdom and Republic of Congo. In Malaysia, the company started its business in late 1990s by signing a production sharing contracts with one of the local oil and gas company. The company made a major discovery at East Malaysian offshore in 2002 and the first production was in 2007. Subsequently, the company made other oil and gas discoveries in Malaysia. The company expanded the business operations and more Malaysians are being employed by the company. Currently, there are more than 500 Malaysians employed by the company. Most of the support functions such as the Administration Department, Human Resource Department, Procurement Department and Accounting Department are headed by Malaysians.

**Data Collection**

This study employs a mixed method of data collection and analysis namely document analysis and interviews. Using more than one method in collecting the data allows the study to compare and verify the accuracy of the information (Brewer and Hunter 2006). This can enhance the reliability and validity of the findings because bias and mistakes due to over-depending on a single method can be avoided (Yin, 2012).

For document analysis, a study was conducted mainly through a review of internal audit reports and audit working papers for audit engagement relating to the Administration Department on a particular period of time. This report is selected because it represents an independent view or appraisal within an organisation of the accounting, financial and other

5



|  |
| --- |
| Downloaded by Cornell University Library At 09:05 14 September 2016 (PT) |

operations. The main objectives of reviewing internal audit reports in this study are to obtain audit opinions on the adequacy and effectiveness of the internal control system, to identify any internal control weaknesses as highlighted and to identify any fraud occurrences resulting from internal control weaknesses. The Internal Audit Department of the company issued four audit reports for a particular period of time (approximately 30 months) which is two reports for both normal audit report and special audit report. A normal Audit Report is an audit report issued for a routine audit engagement based on risk assessment. Special Audit Report is an audit report issued for audit engagement requested by top management such as an investigation audit.

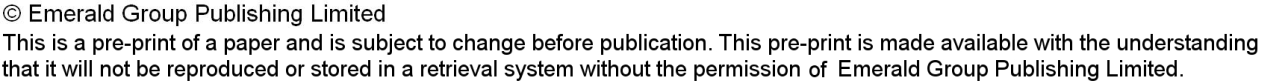
For audit working papers, examination will be conducted to understand the details of the Internal Audit Reports that are subject to the review in this study. These audit working papers are retained in the manual files and database. The Internal Audit Department uses an electronic working papers tool to store the audit working papers into the database. All important information such as program steps, issues, notes, sign-offs and edit histories are contained in database tables. Database driven systems allow real-time, team-based use, facilitate filtering and sorting of key information and are more powerful than simple document-based systems.

The study also includes the interviews of the internal auditors of the company. They were selected because they have extensive experience in auditing the Administration Department. The information was gathered through a face-to-face semi-structured interview to acquire in-depth information about internal control weaknesses and fraud in the company. This method was employed because it facilitates the interviewer to explore more information and clarification of answers from interviewees (Baiball and While, 1994). This includes obtaining their opinions on the adequacy and effectiveness of the Administration Department’s internal control system, efforts by the management to detect and prevent fraud, impact of fraud and the possible reasons of the fraud.

Before the interviews were conducted, respondents were explained about the purposes of the research. Permission was requested for the interview to be recorded and transcribed. Transcription was manually coded and analyzed to identify any emerging patterns or relationship. A similar method was also employed by Ermongkonchai (2010) in his qualitative study on unethical conduct among employees in Thai organizations.

There are two respondents selected and agreed to be interviewed. First, Mr X, who is a Senior Auditor with 10 years of experience and is responsible to execute financial, operational, compliance, IT, Joint Venture and contractor audits for local and international operations. He is a Fellow Member of the Association of Chartered Certified Accountant (ACCA) and is a Certified Internal Auditor (CIA). The second interviewee is Mr Y, who has worked in the internal audit area for seven years. He holds a Bachelor’s degree in Accounting and is a member of the Malaysian Institute of Accountants and Institute of Internal Auditors. Due to privacy, no further demographic information were allowed to be recorded and disclosed.

6



|  |
| --- |
| Downloaded by Cornell University Library At 09:05 14 September 2016 (PT) |

The information gathered from the interviews have been analyzed in three stages, specifically data reduction, data display and data conclusion (Malhotra, 2010). In the first stage, data reduction, the most important information is selected, while less important information is eliminated. The common issues or theme will be constructed and examined. In the second stage, data display, image and visual is used to monitor any emerging pattern and its relationship. In the third or last stage, data conclusion, meaning of theme or pattern is analysed, verified and linked with the purpose of the interview and objective of the study. All these analysis stages were conducted using qualitative software.

**FINDINGS AND DISCUSSION**

Internal control weaknesses in the Administration Department were analysed based on findings highlighted in the normal and special Internal Audit Reports issued. This study found five internal control weaknesses, four of which are from special audits and one from normal audit.

*Improper Record-keeping of Vehicle Log Book*

The Vehicle Log Book is an official document for drivers to record the company’s vehicles usage. The Vehicle Log Book is maintained individually for each of the company’s vehicles. The drivers are required to record the time, mileage and purpose of trip in the Vehicle Log Book. The Administrative Assistant is responsible to collect and compile the Vehicle Log Books from the drivers on a weekly basis.

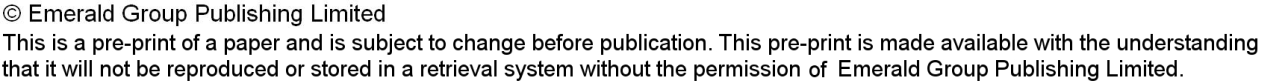
This study found that the Vehicle Log Book was not properly maintained by the Administration Department. The Vehicle Log Book was not consistently submitted by the drivers to the Administrative Assistant. There was an instance where one of the drivers has never submitted the Vehicle Log Book. Lack of control in maintaining the Vehicle Log Book may lead to fraudulent activities such as misuse of the company’s vehicles for non-business purposes.

*Lack of Supervision on Personnel Overtime*

Based on the audit findings, the timesheets verified by the Senior Admin Executive have never been questioned by the Assistant Manager and Senior Manager during payment approvals. The Senior Manager and Assistant Manager posit that they had trusted the Senior Executive to verify the timesheets and they would just sign the invoices after his/her verification. It was also noted that the overtime work recorded in the timesheets were very general and lacked detailed description such as the nature of work performed, driving location and person entertained.

The study found that there was also an abnormal trend related to one of the drivers who consistently claimed eight hours of overtime on two Saturdays of every month for sending the company’s vehicles to service centres. This trend was found to be inconsistent with the vehicle maintenance report. In order to solve such an anomaly, the company car assigned to him was selected for a detailed testing to compare the overtime recorded in his timesheet against actual maintenance service records. It was found that there was no maintenance

7



|  |
| --- |
| Downloaded by Cornell University Library At 09:05 14 September 2016 (PT) |

service recorded on Saturdays for the car. The car was sent to the service centre during office hours on weekdays and no maintenance service was carried out in one particular month.

*Improper Filing of Approval Forms to Remove Goods from Office*

Approval to Remove Goods from Office Form is an official form that needs to be passed to the Security Department when removing goods from the office building. The form needs to be filled in with details of the goods and approved by the appointed company representatives. There is a copy of the form that needs to be kept by the Administration Department in order to monitor the removal of any goods from the office.

This study found that the tenant’s copy of the official form for Permission to Remove Goods from Office Area was not completely filed by the Administration Department. The form should be filled out in two copies where the first copy should be retained by the tenant and the second copy for the Security Division. Furthermore, the form could be issued by any appointed tenant representative without the Administration Department’s acknowledgement.

*Lack of Monitoring over Unutilised Purchase Orders Issued to Vendors/Contractors*

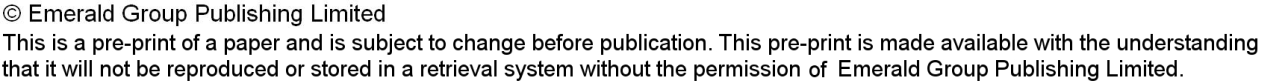
Purchase order is a commercial document issued by the company to vendors indicating types, quantities, and agreed prices for products or services that the vendors will provide to the company. Sending a purchase order to a vendor constitutes a legal offer to buy products or services. Acceptance of a purchase order by a vendor usually forms a contract between the company and vendor, so no contract exists until the purchase order is accepted. It is used to control the purchasing of products and services from external suppliers. All purchase orders needs to be approved by the Procurement Department.

The study found that the unutilised purchase orders were not reported to the Procurement Department for closing. Normally, the purchase orders are not utilised due to cancellation of services or supplies. Nevertheless, if not reported for closing, the purchase orders would then still be considered as active and valid for payable processing. This might expose the purchase order for manipulation. The purchase order could be used for other procurement of products and services without obtaining approval from the Procurement Department.

*Lack of Petty Cash Expenditure Guidelines*

There was a corporate policy on petty cash issued in the previous year. The policy states the procedures for establishing a petty cash fund, procedures for a custodian to monitor fund usage, as well as procedures to replenish, decrease and close funds. However, the study found that there were no clear guidelines on the type of expenses allowable to be paid via petty cash fund and the limits for each transaction, specifically for local operations. In addition, some of the procedures are now irrelevant. Lack of guidelines in petty cash expenditure might lead to fraudulent activities where advantage might be taken of unclear policies and procedures.

8



|  |
| --- |
| Downloaded by Cornell University Library At 09:05 14 September 2016 (PT) |

**Fraudulent Practices Resulting from Internal Control Weaknesses**

The Special Audit Reports were issued for two audit investigations on employee fraud related to the Administration Department. The fraud cases involved an Assistant Manager and a Senior Administration Executive in the Administration Department.

*Creation of a Fictitious Invoice for Office Renovation Works*

The Assistant Manager was the person in-charge for office renovation works and furniture supplies. As part of his job scope, he was required to deal with the appointed contractors in day-to-day operations. He was responsible to call for price quotations, issue service requests, monitor contractors’ performance and review invoices.

In one particular month, the company received a complaint letter from a whistle blower with regards to his unethical behavior. Based on the complaint letter, he was alleged to have received bribes from the contractors while handling the office renovation works. Preliminary investigation was carried out by the Internal Audit Department to establish the facts of the allegations. The investigation process included document reviews, interviews, email reviews and background checks.

The study found that there was a suspicious invoice for renovation services paid to one of the contractors. The services were actually not performed by the contractor. The Assistant Manager had instructed the contractor to create an invoice for fictitious renovation works and labor supplies amounting to a certain amount of money. Strong evidence of his guilt was obtained by the investigation team. There was an email between the contractor and him communicating about the invoice creation. He then voluntarily resigned from the company and no legal action was taken.

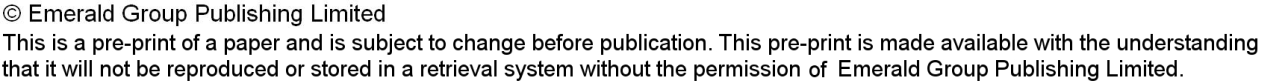
*Kickbacks on Subordinates’ Overtime Pay*

The Senior Administration Executive was responsible to supervise office assistants, drivers and receptionists in day-to-day operations including overtime works. At the end of the month, he was required to review and verify all the overtime claims made by his subordinates.

In one particular month, there was a complaint received by the company from his subordinates of his unethical behavior. The complainers informed that he had been pocketing some amount of money from his subordinates through overtime claims. He had instructed his subordinates to falsify their overtime claims. At the end of the month, he would request the subordinates to give him a portion of their overtime pay. Preliminary investigation was carried out to establish the allegation facts. The investigation process included document reviews and interviews.

The investigation found that suspicious overtime claims were found for some of his subordinates. The working hours claimed by them were unreasonable, especially for the drivers. Interviews were conducted with selected drivers and office assistants. Two of his subordinates admitted giving him some money and falsified their claims based on his instruction. They provided bank deposit slips as evidence of money transfer to his bank

9



|  |
| --- |
| Downloaded by Cornell University Library At 09:05 14 September 2016 (PT) |

account. He had voluntarily resigned from the company and no legal action was taken for this case.

**Interview Outcomes**

Interviews with two Internal Auditors from the Internal Audit Department were conducted with the objective to obtain their opinions of the Department’s internal control system. Both of the Internal Auditors have experience in performing audits for the Administration Department. Details of the interview outcome are elaborated in the following subsection.

*The areas of internal control that need to be improved*

Both internal auditors posit that *the Department needs to improve the supervision process in day-to-day operations*. Most of the internal audit findings highlighted on the lack of asupervision process. For example, there was a finding on lack of monitoring over personnel overtime. One of the reasons was due to work not properly supervised by the immediate superior. The superior had trusted his subordinates almost implicitly to perform their duties effectively. This unhealthy practice had given an opportunity for the subordinates to manipulate the overtime claims.

The Internal Auditors suggest that *the Department needs to improve the record-keeping process*. There were several findings highlighted during the audits that were due to poorrecord-keeping process. For example, the Vehicle Log Books of the company’s vehicles were not completely maintained by the drivers.

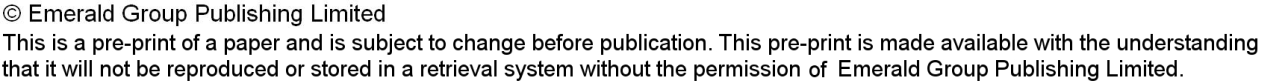
*Possibility of internal control weaknesses to lead to fraudulent activities*

Both internal auditors agree to each other that *internal control weaknesses will create opportunities for fraudulent activities in the Administration Department*. Opportunity opensthe doorway to fraud, and incentive and rationalisation can draw the personnel towards it. Some personnel might then recognise the open doorway as an opportunity and take advantage of it by walking through, not just once, but time and time again. An example is the improper record-keeping of Vehicle Log Book. Lack of this control will create opportunities for the drivers to misuse the company’s vehicles continuously. The Administrative Assistant who is responsible to monitor the vehicles’ usage has failed to put the control in place due to no cooperation from the drivers.

*Role of internal audit in detecting fraudulent activities*

The Internal Auditors advocate that *fraud should be easily detected by personnel in the normal course of performing their duties if strong controls exist*. They also have the sameopinion that *any internal auditors with sufficient knowledge of fraud are able to identify the indicators that fraud might have been committed.* If significant control weaknesses aredetected, any additional tests conducted by internal auditors should include tests directed towards identification of other indicators of fraud. Internal auditors are not expected to have knowledge equivalent to that of a person whose primary responsibility is to detect and

10



|  |
| --- |
| Downloaded by Cornell University Library At 09:05 14 September 2016 (PT) |

investigate fraud. Audit procedures alone, even when carried out with due professional care, do not guarantee that fraud will be detected.

*Role of effective and adequate internal control systems to prevent fraudulent practices*

Both Internal auditors agree that *effective and adequate internal control system can prevent fraudulent practices from occurring in the Administration Department*. However, fraud cannever be prevented completely but the company can implement internal controls to deter and in some cases detect fraudulent acts. Thus, the Internal Auditors suggest that *the company should consider developing formal policies and procedures including a Code of Ethics and a Code of Conduct*. All employees should receive training on the policies and procedures.Employees should be made aware of the expectations and the consequences for failing to meet those expectations. Consequences should be severe and include the risks of job loss and criminal prosecution.

**IMPLICATIONS AND RECOMMENDATIONS**

This study clearly implicate that poor internal controls will give significant opportunities to employees to commit fraud, although they possibly do not have any prior intention. Therefore, a few suggestions are recommended to improve the current weaknesses of the internal control systems. These include:

*Installation of the Global Positioning System (GPS) Tracking Unit*

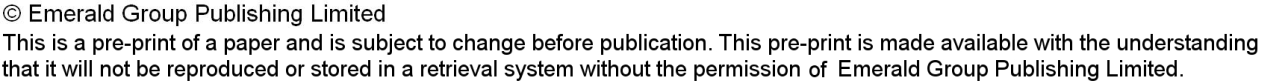
GPS tracking unit is a device that uses the Global Positioning System to determine the precise location of a vehicle, person, or other assets to which it is attached and to record the position of the asset at regular intervals. The recorded location data can be stored within the tracking unit, or it may be transmitted to a central location database or internet-connected computer. This allows the asset's location to be displayed against a map backdrop either in real time or when analysing the track later, using a GPS tracking software.

Installation of GPS Tracking Units in all the company’s vehicles will help the Department to monitor the usage of the vehicles. This is an additional preventive control that the Department can put in place instead of just depending on the manual Vehicle Log Book. By having this control in place, it will reduce the possibility of the company’s vehicles being misused. However, the drivers are still required to submit the Vehicle Log Book as an official report. It is very important to educate the drivers on the importance of the Vehicle Log Book and the introduction of a penalty for not submitting the Vehicle Log Book will also strengthen the control. For example, their overtime pay will not be released until they have submitted the Vehicle Log Book.

*Pre-approval of Overtime Work*

Pre-approval of overtime work is a process that requires all personnel in the Administration to obtain approval from their immediate superior before performing the overtime work. The immediate superior is responsible to determine the scope of work and estimated overtime hours. During the execution of the overtime work, the immediate superior should supervise

11



|  |
| --- |
| Downloaded by Cornell University Library At 09:05 14 September 2016 (PT) |

and monitor the work to ensure it is properly carried out by the personnel. At the end of the work, the personnel should report the work done and actual overtime hours taken to complete the work. Any significant difference should be clarified to the immediate superior. This process will strengthen the internal control system to ensure the legitimacy of the overtime claims.

In addition, the Administration Department is recommended to implement a Time Clock System to monitor the personnel working time. The Time Clock System is a system to track the time-in and time-out of the personnel. This is an additional preventive control to ensure there is no manipulation of the overtime claims. The clock machine should be located at the security counter to avoid any misconduct such as clocking for friends who do not turn up for work. This is an additional preventive control to strengthen the current controls in place.

*Appointment of Focal Person for Filing of Approval Forms to Remove Goods from Office*

The Department should appoint a focal person to manage the filing of the approval forms to remove goods from office. The focal person is responsible to compile all the forms that have been approved by the company’s representatives. Any suspicious removal should be immediately referred to the Security. In addition, it is recommended for the forms to have a pre-printed serial numbers. The serial number will be the control document number of the forms. This is to ensure the completeness of the filing of the forms. Any missing number must be properly investigated by the Administration Department.

*Monitoring of Unutilised Purchase Orders*

The Administration Department should monitor the utilisation of Purchase Orders issued to vendors/contractors. Any unutilised Purchased Order needs to be reported to the Procurement Department for closing process. Unclosed Purchase Orders will expose the company to fraud such as creation of fictitious invoices. The Administration Department should appoint a focal person to monitor the Purchase Order utilisation.

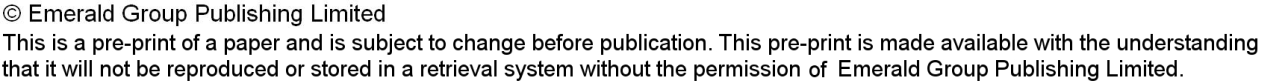
*Enhancement of Petty Cash Expenditure Policy*

The Administration is recommended to enhance the current Petty Cash Expenditure Policies. Currently, there is a lack in the area of the type of expenses allowed to be paid via petty cash fund and the limits for each transaction. The amended Petty Cash Expenditure Policies need to be approved by the management and to be communicated to all employees. Once the new Petty Cash Expenditure Policies are established, it should automatically supersede the current policies.

*Fraud Awareness Program*

The Department should conduct a fraud awareness program for the personnel. The main objective of this program is to educate the personnel on fraud prevention and detection skills. By having such knowledge, the personnel will be more aware of any fraud occurring in the Department. In addition, the program should be able to warn the personnel of the

12



|  |
| --- |
| Downloaded by Cornell University Library At 09:05 14 September 2016 (PT) |

consequences of conducting fraudulent activities. They could be fined and/or imprisoned if they are involved in any fraudulent activities.

**CONCLUSION**

This study found that several internal control weaknesses have been identified that can result in fraudulent activities. This support the Fraud Triangle Theory (Cressey, 1973) that suggests opportunity such as weak internal control can motivate fraud, which conforms to many other prior researches (KPMG, 2009; ACFE, 2008; Puah et al., 2009; PWC, 2011). Poor internal controls offer vast fraud opportunities and make their job easier. However, there is no fraudulent activity detected based on the audits performed because internal auditors are not expected to have knowledge equivalent to that of a person whose primary responsibility is to detect and investigate fraud. Audit procedures alone, even when carried out with due professional care, do not guarantee that fraud will be detected.

The study, however, found two past fraudulent practices that are triggered by whistle-blowers. The first case involved an Administration Manager who colluded with a renovation contractor to falsify an invoice based on unutilised purchase orders. The second case involved a Senior Administration Executive who colluded with his subordinates to falsify overtime claims. Both of the cases are a result of some internal control weaknesses in the Administration Department, namely lack of supervision and improper record-keeping process that led to fraudulent practices.

It can be concluded that fraud is a risk that all businesses face. Fraud can occur internally, externally, or in combination. Many fraud experts believe the most important thing a business can do to try and minimise its risk of loss due to fraud is to design internal controls that make it difficult to commit or conceal fraud. However, fraud can never be prevented completely but the company can implement internal controls to deter and in some cases detect fraudulent acts.

**LIMITATIONS AND SUGGESTION FOR FUTURE RESEARCH**

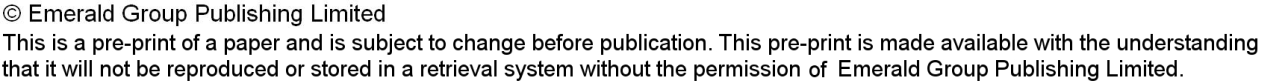
There are several limitations of this study. First, it is unable to access personal files of the staff that are involved in fraud as they are classified as highly confidential. Due to this, the study is unable to suggest the characteristics of the fraudster such as specific age, gender, education level, income level and work experience.

Secondly, as it focuses on only one company, the findings may not be generalised to other companies due to its different nature of business, working environment and practices. Future studies should enlarge the number of samples or firms.

Thirdly, the document analysed are only for a short period of time (30 months). Future research should be conducted by analysing the document in longer periods, i.e. 5 or 10 years so that a trend analysis can be conducted to get more accurate and robust results.

Finally, this study does not reveal the impact of the fraud and internal control weaknesses on the financial figures of the company because access to those documents was denied. Future

13



|  |
| --- |
| Downloaded by Cornell University Library At 09:05 14 September 2016 (PT) |

research should be conducted to examine the impact of those practices not only to the bottom line figures of the company but the other intangible impacts such as reputation of the company, loss of time and energy to conduct investigation and moral effect to other employees.

**References**

Association of Certified Fraud Examiners (ACFE) (2008), *Report to the Nations on Occupational Fraud and Abuse*, ACFE, Austin.

Association of Certified Fraud Examiners (ACFE) (2012). *Report to the Nations on Occupational Fraud and Abuse*, ACFE, Austin.

ActionFraud, “What is fraud”, available at http://www.actionfraud.police.uk/what-is-fraud (accessed 1 April 2016).

Allen, R. and Tommasi, D. (2001), *Managing Public Expenditure - A Reference Book for Transition Countries,* OECD Publishing, Paris.

Allen, R., Hemming, R. and Potter, B. (2013), *The International Handbook of Public Financial Management.* Palgrave Macmillan, London.

Altamuro, J. and Beatty, A. (2010), “How does internal control regulation affect financial reporting?”, [*Journal of Accounting and Economics*](http://www.emeraldinsight.com/action/showLinks?isi=000274677500005), Vol. 49 No. 1, pp. 58-74.

Asare, T. (2009), “Internal auditing in the public sector: promoting good governance and performance improvement”, *International Journal on Governmental Financial Management*, Vol. 9 No. 1, pp. 15-28.

Baldock, G. (2016), “The perception of corruption across Europe, Middle East and Africa”, *Journal of Financial Crime*, Vol. 23 No. 1, pp. 119-131.

Barriball, K. L and While, A. (1994), “Collecting data using a semi‐structured interview: a discussion paper”, [*Journal of Advanced Nursing*](http://www.emeraldinsight.com/action/showLinks?crossref=10.1111%2Fj.1365-2648.1994.tb01088.x&isi=A1994MW46900017), Vol. 19 No. 2, pp. 328-335.

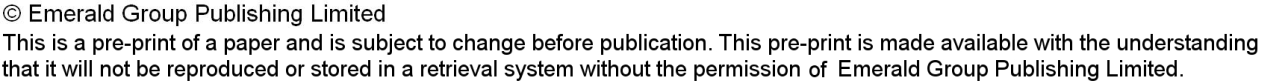
Brewer, J. and Hunter, A. (2006), *Foundations of Multimethod Research: Synthesizing Styles*, Sage, Thousands Oak, CA.

Brown, N. C., Pott, C. and Wömpener, A. (2014), “The effect of internal control and risk management regulation on earnings quality: evidence from Germany”, [*Journal of*](http://www.emeraldinsight.com/action/showLinks?crossref=10.1016%2Fj.jaccpubpol.2013.10.003&isi=000331668800001)[*Accounting and Public Policy*](http://www.emeraldinsight.com/action/showLinks?crossref=10.1016%2Fj.jaccpubpol.2013.10.003&isi=000331668800001), Vol. 33 No. 1, pp. 1-31.

Button, M., Blackbourn, D., Lewis, C. and Shepherd, D. (2015), “Uncovering the hidden cost of staff fraud: an assessment of 45 cases in the UK”, [*Journal of Financial Crime*](http://www.emeraldinsight.com/action/showLinks?system=10.1108%2FJFC-11-2013-0070), *22*(2), 170-183.

Cheng, H. and Ma, L. (2009), “White collar crime and the criminal justice system: government response to bank fraud and corruption in China”, [*Journal of Financial*](http://www.emeraldinsight.com/action/showLinks?system=10.1108%2F13590790910951849)[*Crime*](http://www.emeraldinsight.com/action/showLinks?system=10.1108%2F13590790910951849), Vol. 16 No. 2, pp. 166-179.

14



|  |
| --- |
| Downloaded by Cornell University Library At 09:05 14 September 2016 (PT) |

Cho, M. and Chung, K. H. (2016), “The effect of commercial banks' internal control weaknesses on loan loss reserves and provisions”, [*Journal of Contemporary*](http://www.emeraldinsight.com/action/showLinks?crossref=10.1016%2Fj.jcae.2016.02.004)[*Accounting & Economics*](http://www.emeraldinsight.com/action/showLinks?crossref=10.1016%2Fj.jcae.2016.02.004), Vol. 12 No. 1, pp. 61-72.

Clinton, S. B., Pinello, A. S. and Skaife, H. A. (2014), “The implications of ineffective internal control and SOX 404 reporting for financial analysts”, [*Journal of Accounting*](http://www.emeraldinsight.com/action/showLinks?isi=000340994800001)[*and Public Policy*](http://www.emeraldinsight.com/action/showLinks?isi=000340994800001), Vol. 33 No. 4, pp. 303-327.

Committee of Sponsoring Organizations of the Treadway Commission (COSO) (2013), *Internal Control—Integrated Framework*, COSO, Durham.

Cressey, D. R. (1973), *Other People’s Money*, Patterson Smith, Montclair.

David, I. T. (2009), “Characteristics of effective audit committees in federal, state, and local governments”, *The Journal of Government Financial Management*, Vol. 58 No. 1, pp. 45-48.

Feng, M., Li, C., McVay, S. E. and Skaife, H. A. (2015), “Does ineffective internal control over financial reporting affect a firm's operations? Evidence from firms' inventory management”, [*The Accounting Review,*](http://www.emeraldinsight.com/action/showLinks?crossref=10.2308%2Faccr-50909&isi=000351807000005) Vol. 90 No. 2, pp. 529-557.

Free, C. (2015), “Looking through the fraud triangle: a review and call for new directions”, *Meditari Accountancy Research*, Vol. 23 No. 2, pp. 175-196.

Ghosh, A. A. and Lee, Y. G. (2013), “Financial reporting quality, structural problems and the informativeness of mandated disclosures on internal controls”, [*Journal of Business*](http://www.emeraldinsight.com/action/showLinks?isi=000318236100002)[*Finance & Accounting,*](http://www.emeraldinsight.com/action/showLinks?isi=000318236100002) Vol. 40 No. 3-4, pp. 318-349.

Gong, G., Ke, B. and Yu, Y. (2013), “Home country investor protection, ownership structure and cross‐listed firms' compliance with SOX‐mandated internal control deficiency disclosures”, [*Contemporary Accounting Research*](http://www.emeraldinsight.com/action/showLinks?isi=000328696100010), Vol. 30 No. 4, pp. 1490-1523.

Hajiha, Z. and Bazaz, M. S. (2016), “Impact of internal control material weaknesses on executive compensation: evidence from Iran”, *International Journal of Accounting, Auditing and Performance Evaluation*, Vol. 12 No. 1, pp. 70-84.

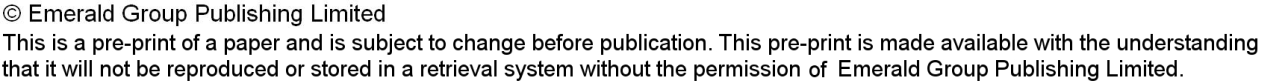
Hu, N., Qi, B., Tian, G., Yao, L. and Zeng, Z. (2013), “The impact of ineffective internal control on the value relevance of accounting information”, [*Asia-Pacific Journal of*](http://www.emeraldinsight.com/action/showLinks?crossref=10.1080%2F16081625.2013.765026&isi=000322906100007)[*Accounting & Economics,*](http://www.emeraldinsight.com/action/showLinks?crossref=10.1080%2F16081625.2013.765026&isi=000322906100007) Vol. 20 No. 3, pp. 334-347.

Jin, J. Y., Kanagaretnam, K., Lobo, G. J. and Mathieu, R. (2013), “Impact of FDICIA internal controls on bank risk taking”, [*Journal of Banking & Finance*](http://www.emeraldinsight.com/action/showLinks?crossref=10.1016%2Fj.jbankfin.2012.09.013&isi=000312979100027), Vol. 37 No. 2, pp. 614-624.

Khlif, H. and Samaha, K. (2016), “Audit committee activity and internal control quality in Egypt: does external auditor’s size matter?”, [*Managerial Auditing Journal*](http://www.emeraldinsight.com/action/showLinks?isi=000374173500002), Vol. 31 No. 3, pp. 269-289.

KPMG (2009), *KPMG Malaysia Fraud Survey Report,* KPMG Malaysia.

15



|  |
| --- |
| Downloaded by Cornell University Library At 09:05 14 September 2016 (PT) |

Leedy, P. D. and Ormrod, J. E. (2005), *Practical Research Planning and Design*, Pearson Merrill Prentice Hall, New Jersey.

Länsiluoto, A., Jokipii, A. and Eklund, T. (2016), “Internal control effectiveness–a clustering approach”, [*Managerial Auditing Journal*](http://www.emeraldinsight.com/action/showLinks?system=10.1108%2FMAJ-08-2013-0910&isi=000370049800002), Vol. 31 No. 1, pp. 5-34.

Lokanan, M. E. (2014), “How senior managers perpetuate accounting fraud? Lessons for fraud examiners from an instructional case”, *Journal of Financial Crime*, Vol. 21 No. 4, pp. 411-423.

Malhotra, N.K. (2010), *Marketing Research: An Applied Orientation*, Pearson Education Limited, London.

Miller, R.L. and Brewer, J.D. (2003), [*The A-Z of Social Research*](http://www.emeraldinsight.com/action/showLinks?crossref=10.4135%2F9780857020024), Sage, London.

Nishizaki, R., Takano, Y. and Takeda, F. (2014), “Information content of internal control weaknesses: the evidence from Japan”, [*The International Journal of Accounting*](http://www.emeraldinsight.com/action/showLinks?crossref=10.1016%2Fj.intacc.2014.01.009), Vol. 49 No. 1, pp. 1-26.

Oh, K., Choi, W., Jeong, S. W. and Pae, J. (2014), “The effect of different levels of internal control over financial reporting regulation on the quality of accounting information: evidence from Korea”, [*Asia-Pacific Journal of Accounting & Economics,*](http://www.emeraldinsight.com/action/showLinks?crossref=10.1080%2F16081625.2014.880203&isi=000341003500004) Vol. 21 No.

4, 412-442.

Olach, T. and Weeramantri, S. (2009), “How COSO has improved internal controls in the United States”, *Internal Auditing*, Vol. 31 No. 6, pp. 3-12.

Peltier-Rivest, D. and Lanoue, N. (2015), “Cutting fraud losses in Canadian organizations”, *Journal of Financial Crime*, 22(3), 295-304.

Puah, C.H., Voon, S.L. and Entebang, H., (2009), “Factors stimulating corporate crime in Malaysia”, *Economics, Management, and Financial Markets,* Vol. 4 No. 3, pp. 87-99.

PWC (2011), *Global Economic Crime Survey.*

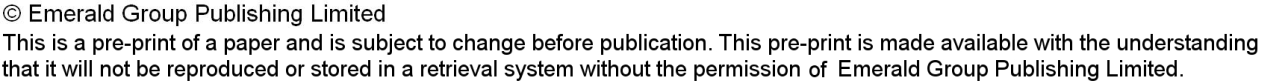
Rich, K. T. and Zhang, J. X. (2014), “Does audit committee monitoring matter in the government sector? Evidence from municipal internal control quality”, [*Journal of*](http://www.emeraldinsight.com/action/showLinks?crossref=10.2308%2Fogna-50832)[*Governmental & Nonprofit Accounting*](http://www.emeraldinsight.com/action/showLinks?crossref=10.2308%2Fogna-50832), Vol. 3 No. 1, pp. 58-80.

Simser, J. (2014), “Culpable insiders – The enemy within, the victim without”, *Journal of Financial Crime,* Vol. 21 No. 3, pp. 310-320.

Skaife, H. A., Veenman, D. and Wangerin, D. (2013), “Internal control over financial reporting and managerial rent extraction: evidence from the profitability of insider trading”, *Journal of Accounting and Economics,* Vol. 55 No. 1, pp. 91-110.

Szymanski, S. (2007), *How to Implement Economic Reforms: How to Fight Corruption Effectively in Public Procurement in SEE Countries*, OECD Publications, Paris.

16



Su, L. N., Zhao, X. R. and Zhou, G. S. (2014), “Do customers respond to the disclosure of internal control weakness?”, [*Journal of Business Research,*](http://www.emeraldinsight.com/action/showLinks?crossref=10.1016%2Fj.jbusres.2013.06.009&isi=000336696200024) Vol. 67 No. 7, pp. 1508-1518.

Tong, Y., Wang, M., and Xu, F. (2014), “Internal control, related party transactions and corporate value of enterprises directly controlled by Chinese central government”, [*Journal of Chinese Management*](http://www.emeraldinsight.com/action/showLinks?crossref=10.1186%2Fs40527-014-0001-9), Vol. 1 No. 1, pp. 1-14.

Weiss, D. (2014), “Internal controls in family-owned firms”, *European Accounting Review,* Vol. 23 No. 3, pp. 463-482.

Yin, R. K. (2012), *Applications of Case Study Research,* Sage Publications, California.

|  |
| --- |
| Downloaded by Cornell University Library At 09:05 14 September 2016 (PT) |

17

