INTERNATIONAL JOURNAL OF FINANCIAL ECONOMICS (IJEFE) e-ISSN: 3063-3648
Vol. 1 No. 1 Juli 2024, page 26-38

INTERNAL CONTROL AND RISK MANAGEMENT ON FRAUD PREVENTION IN FINANCIAL STATEMENTS

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Abstract

Why is fraud high in financial statements? This is because bias towards the organization leads to serious risks and losses to the organizations and other stakeholders. Therefore it becomes necessary to find ways in which such issues may be avoided in the first place. The research method that has been employed is the literature research method. The research findings confirmed that both internal control and risk management positively affect the level of fraud occurrence in financial statements. Although, the emphasis of this study was on the need for strong internal control and proper deployment of risk management as an aspect of fraud risk management in financial statements.

Keywords: Internal Control, Risk Management, Fraud Prevention, Financial Statements.

Introduction

With the dawn of globalization and the fast-paced economic growth in the recent past, the reliability of the financial statements of an organization has become more important for its very existence and reputation. Still, the incidents of misrepresentation in financial statements are still present and they endanger the business environment and the economy as a whole. The major accounting scandals of the twentieth century, Enron, World Com, and Tyco, as well as the latest fraud, Wirecard in Germany, have only served to dent the trust of the common person in the honesty of financial reporting and finance as a whole. (Kumar & Singh, 2024).

Fraud cases mean that there are a number of premeditated fraudulent or deceptive actions taken with the intent of making illegal gains or causing other losses. With reference to fraud perpetrated in financial statements, it may involve distortion of facts, omission of significant facts, aggressiveness in asset or income recognition, conservativeness in liability or expense recognition, among other accounting sins (Chapman, 2022). Such fraud acts are mostly driven by a breach of the applicable laws, code of ethics and accounting standards and sometimes come at a substantial loss to investors, creditors and even employees among other parties. Apart from incurring losses from fraud cases, they also have other negative implications that include tarnishing of corporate reputation, decreased investor trust in the capital markets, and potentially greater impacts on economic health (Mahony, 2022).

In any country including in Indonesia, cases of fraud such as falsifying financial statements definitely are also still existing. One example headlined is PT Garuda Indonesia which was reported in 2018 where there were allegations of financial

statement irregularities by the company. Cases like this affect not only investors and other interested parties, but also the economy as a whole. (Yuliastuti & Tandio, 2020)..

There are many reasons for fraud in financial statements such as weak internal control systems and ineffective risk management. Appropriate internal control should be able to prevent, detect and correct any error or irregularity which will harbor fraud. In the same vein, efficient management of risk can help organizations to recognize, evaluate and contained risks that may turn out to be fraudulent. (Yang, 2023).

It is evident that although a lot of organizations have put in place internal control and risk management systems, still there are incidents of fraud. (Azizah, 2024). This raises questions on whether there is internal control and risk management in place that would help in mitigating incidences of fraud shocks in financial statements. Moreover, understanding of how lateral risk and internal control isolate-fraud prevention strategies in financial statements is still incomplete.

So with this, this research is to review existing literature on internal control, risk management, fraud and other issues and make conclusions.

Research Methods

The study in this research uses the literature research method. This method is a systematic research approach to collect, analyze, and synthesize information from various literature sources relevant to the research topic. (Setiowati, 2016); (Syahran, 2020); (Helaluddin, 2019).

Results and Discussion

Internal Control

Internal control is a series of policies, procedures, and mechanisms designed and implemented by an organization to ensure operational effectiveness and efficiency, reliability of financial reporting, compliance with applicable laws and regulations, and protection of company assets. This system involves various elements such as control environment, risk assessment, control activities, information and communication, and monitoring, which collectively aim to reduce the risk of errors, fraud, or irregularities in the organization's operations. (Tian & Sun, 2023). Internal control serves as an important management tool in achieving organizational objectives, maintaining operational integrity, and providing reasonable assurance to stakeholders that the organization is managed responsibly and in accordance with established standards. (Kassem, 2021).

Internal control consists of five main components that are interrelated and integrated, as formulated by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). These components are: (1) Control Environment, which includes the integrity, ethical values, and competence of personnel as well as management's philosophy; (2) Risk Assessment, involving the identification and analysis

of risks relevant to the achievement of organizational objectives; (3) Control Activities, which are policies and procedures that help ensure that management directives are carried out; (4) Information and Communication, which enables personnel to obtain and exchange information necessary to conduct, manage, and control their operations; and (5) Monitoring, which is a process that assesses the quality of internal control performance over time. These five components work together to create an effective internal control system, help the organization achieve its objectives, and reduce the risk of failure or irregularities. (Muniandy et al., 2022)..

The objective of internal control is to provide reasonable assurance in achieving three main categories: effectiveness and efficiency of operations, reliability of financial reporting, and compliance with applicable laws and regulations. In more detail, internal control aims to protect company assets from misuse or theft, ensure the accuracy and completeness of financial records, encourage compliance with management policies, improve operational efficiency, prevent and detect fraud, and facilitate timely and reliable financial reporting. (Ferdiani et al., 2023).. In addition, internal control also aims to assist management in making the right decisions, increase investor and other stakeholder confidence, and support the achievement of the organization's overall strategic objectives. Thus, internal control serves as an important tool in good corporate governance and effective risk management. (LU, 2020).

Risk Management

Risk management is a systematic and structured process applied by organizations to identify, analyze, evaluate, and address potential risks that may affect the achievement of organizational objectives. This process involves a series of activities that include identifying different types of risks (such as operational, financial, strategic, and compliance risks), assessing the impact and likelihood of those risks occurring, developing strategies to manage or mitigate risks, implementing control measures, and continuously monitoring and reviewing the effectiveness of the measures taken. (Strawser, 2024). The main objective of risk management is to maximize opportunities and minimize threats, thereby enabling organizations to make better decisions, improve operational efficiency, protect assets and reputation, and increase organizational resilience in the face of uncertainty and changes in the business environment. (Lee, 2021).

The risk management process generally consists of several interrelated and sequential stages, starting with the establishment of the organization's context and objectives. The main steps include: (1) Risk identification, which recognizes and documents all potential risks that may affect the achievement of the organization's objectives; (2) Risk analysis, which involves assessing the likelihood of a risk occurring and its potential impact; (3) Risk evaluation, where the risks that have been identified and analyzed are compared against established risk criteria to determine priorities for

handling; (4) Risk handling, which involves selecting and implementing appropriate strategies to manage or mitigate risks, such as avoiding, transferring, reducing, or accepting risks; (5) Monitoring and review, which involves ongoing oversight of the effectiveness of risk handling strategies and changes in the organization's risk profile; and (6) Communication and consultation, which is an ongoing process to involve internal and external stakeholders in each stage of risk management. This process is iterative and dynamic, allowing the organization to continuously adjust its risk management approach according to changes in the environment and business conditions. (Pasko et al., 2024); (Dou et al., 2024).

Risk management provides a range of important benefits to organizations, both in the short and long term. First, it enhances an organization's ability to make more informed and strategic decisions by considering potential risks and opportunities. Second, risk management helps protect an organization's assets and reputation by proactively identifying and addressing potential threats. Third, it improves operational efficiency by optimizing resource allocation and reducing unnecessary losses. Fourth, risk management encourages the creation of a risk-aware culture throughout the organization, increasing employee alertness and responsiveness to potential problems. Fifth, it helps organizations meet regulatory requirements and improve corporate governance. (Handayani & Biduri, 2023). Sixth, risk management can increase stakeholder confidence, including investors, customers, and business partners, by demonstrating a systematic approach to managing uncertainty. Lastly, it increases an organization's resilience, enabling it to be better prepared for unforeseen changes and disruptions, so as to maintain business sustainability in the long term. (Febriana & Biduri, 2022).

Fraud in Financial Statements

Fraud, or cheating in Indonesian, is a deliberate and premeditated act of deception committed by one or more individuals to unlawfully gain personal or organizational advantage and harm others. These actions generally involve abuse of trust, concealment of facts, manipulation of data or information, and violation of applicable rules or laws. Fraud can occur in various forms, such as asset misappropriation, corruption, financial statement fraud, embezzlement of funds, or identity theft. (Waromi et al., 2024). These actions can be carried out by internal parties of the organization such as employees or management, as well as external parties such as customers or suppliers. The impact of fraud can be very significant, not only financially detrimental but also can damage the reputation of the organization, disrupt business operations, and even threaten the survival of the company. Therefore, a good understanding of fraud and the implementation of effective prevention and detection systems are very important for every organization. (Cho & Kang, 2024).

Fraud in financial statements includes several types of fraudulent actions aimed at manipulating the company's financial information. These types of fraud include: (1) Overstating revenues, where the company reports higher revenues than actual, for example by recording fictitious sales or accelerating revenue recognition; (2) Understating expenses, which is reporting lower expenses than actually incurred, for example by delaying expense recognition or capitalizing operating expenses; (3) Improper asset valuation, such as reporting an overestimated value of inventory or fixed assets; (4) Hiding liabilities and expenses, for example by not reporting payables or contingent liabilities; (5) Inadequate or misleading disclosures, including omitting important information in the notes to the financial statements; (6) Improper revenue recognition, namely recognizing revenue at an inappropriate time; and (7) Cash flow manipulation, such as classifying investment cash flows as operating cash flows to improve reported operating performance. All of these types of fraud aim to provide a better financial picture than the actual condition, which can mislead users of financial statements in making decisions. (Kassem, 2021); (Feghali et al., 2022).

Fraud occurs due to a combination of interrelated factors, often referred to as the "Fraud Triangle". These factors include: (1) Pressure, which can be in the form of financial pressure such as mounting debt, a luxurious lifestyle, or performance targets that are difficult to achieve; (2) Opportunity, which is an opportunity to commit fraud due to a weak internal control system, lack of supervision, or a position that allows access to assets or sensitive information; and (3) Rationalization, where the perpetrator justifies his fraud actions with various reasons, such as feeling entitled to more compensation or considering his actions only a temporary loan. (Afjal et al., 2023). In addition, some experts add a fourth factor, namely Capability, which refers to the ability and skills of individuals to commit fraud. Other factors that also contribute to fraud include weak organizational culture, poor leadership, lack of integrity, unfair reward systems, and a highly competitive business environment. Understanding these factors is important for developing effective fraud prevention and detection strategies in an organization. (Amina, 2021).

The Effect of Internal Control on Fraud Prevention in Financial Statements

Internal control has a very important role in preventing fraud in financial statements. A strong and effective internal control system can significantly reduce the chance of fraud and increase the likelihood of early detection if fraud occurs. (Yami & Poletti-Hughes, 2022).. Good internal control creates a work environment that encourages integrity and ethics, establishes clear policies and procedures, and ensures proper segregation of duties. This can reduce the opportunity for individuals or groups to manipulate financial statements without being detected. (Nguyen & Le, 2023)..

Effective internal control implementation includes several key components, such as control environment, risk assessment, control activities, information and

communication, and monitoring. A strong control environment creates an organizational culture that emphasizes integrity and ethical values. Risk assessment helps organizations identify areas that are vulnerable to fraud. (Chapman, 2022). Control activities, such as authorization, verification, and reconciliation, can prevent or detect fraud in the financial reporting process. Effective information and communication systems ensure that relevant information is collected, processed, and reported accurately. Continuous monitoring allows the organization to evaluate the effectiveness of internal controls on an ongoing basis and make improvements if needed. (Othman, 2021).

The positive effect of internal control on fraud prevention in financial statements has been proven in various studies. Organizations with strong internal control systems tend to have lower fraud rates. Effective internal control not only prevents fraud, but also improves the overall quality of financial reporting. This increases stakeholder confidence in the financial statements and the integrity of the organization. (Manginte, 2024). However, it is important to remember that internal controls are not an absolute guarantee against fraud. Internal control systems must be continuously evaluated and updated to deal with evolving fraud risks. In addition, internal controls must be supported by a strong organizational culture, ethical leadership, and commitment from all levels of the organization to create a fraud-free environment. (Priambada, 2023).

The Effect of Risk Management on Fraud Prevention in Financial Statements

Risk management plays a crucial role in efforts to prevent fraud in financial statements. By implementing an effective risk management system, companies can identify, analyze, and manage various potential risks that may create opportunities for fraud in financial reporting. This process involves a comprehensive assessment of internal and external vulnerabilities, as well as the development of appropriate mitigation strategies to minimize the risk of fraud. (Prajanto et al., 2023)..

One important aspect of risk management in the context of fraud prevention is strengthening internal controls. Through the implementation of strict procedures and policies, companies can build a solid layer of defense against the manipulation of financial data. This includes clear segregation of duties, multilevel authorization for financial transactions, and regular monitoring and inspection of the financial reporting process. Thus, the opportunity for fraud can be significantly minimized. (Li, 2023).

Risk management also promotes a culture of transparency and accountability within the organization. By emphasizing the importance of integrity and ethics in financial reporting, companies can build a work environment that is intolerant of fraudulent practices. This can be achieved through regular employee training, the implementation of a clear code of conduct, and the establishment of safe reporting channels for whistleblowers. These measures collectively contribute to the creation of an atmosphere that is not conducive to fraud. (Kim, 2024).

Furthermore, risk management enables companies to adopt a proactive approach in detecting and preventing fraud. By utilizing advanced technology and data analytics, companies can identify suspicious patterns or anomalies in financial transactions in real-time. (Hepworth, 2023). This enables early intervention before fraud develops into a more serious problem. In addition, internal and external audits driven by risk management can provide additional assurance of the accuracy and integrity of financial statements, thereby increasing stakeholder confidence in the financial information presented. (OUMA & (Ph.D), 2020).

Risk management also plays an important role in improving the quality of decision making related to financial reporting. With a comprehensive understanding of the risks faced, management can make more informed and prudent decisions in presenting financial information. This not only helps prevent unintentional errors, but also reduces the temptation to manipulate the numbers to achieve certain financial targets. (Yang, 2023).

Effective risk management practices also encourage companies to consistently evaluate and update their procedures and policies. In a dynamic business environment, fraud risks can change and evolve over time. Therefore, an adaptive risk management approach allows companies to stay one step ahead in anticipating and addressing new fraud risks that may arise.

Furthermore, risk management assists companies in building a strong reputation in the eyes of investors, regulators and the general public. By demonstrating a strong commitment to financial statement integrity through rigorous risk management practices, companies can increase stakeholder confidence. This is not only beneficial in terms of regulatory compliance, but can also provide a competitive advantage in terms of access to capital and business opportunities. (Wali & Masmoudi, 2020).

Thus, risk management has a significant and multi-dimensional influence on fraud prevention in financial statements. Through systematic risk identification and mitigation, strengthening internal controls, establishing an ethical culture, utilizing advanced technology, improving the quality of decision-making, and adapting to changes in the business environment, risk management provides a comprehensive framework for maintaining the integrity of financial reporting. Effective implementation of risk management not only protects the company from financial and reputational losses due to fraud, but also builds a strong foundation for sustainable growth and stakeholder trust. Therefore, investing in the development and implementation of a robust risk management strategy should be a priority for any organization committed to maintaining the credibility of its financial statements and building long-term trust with stakeholders.

Simultaneous Effect of Internal Control and Risk Management on Fraud Prevention in Financial Statements

Internal control and risk management, when applied together, create a strong synergy in the effort to prevent fraud in financial statements. Internal controls provide the structural and operational framework to ensure compliance with procedures and policies, while risk management provides a strategic approach in identifying, assessing, and managing potential fraud risks. This combination results in a layered defense system that is not only reactive but also proactive in dealing with fraud threats. (Indriana & Anshori, 2022).

The simultaneous application of these two elements significantly improves an organization's ability to detect and prevent fraud. Internal controls help in establishing the necessary checks and balances in day-to-day operations, while risk management allows the organization to anticipate and prepare for fraud scenarios that may occur in the future. The interaction between these two systems creates an early warning mechanism that is more sensitive and responsive to indications of fraud. (Yu, 2021).

An integrated approach between internal control and risk management allows for a more efficient and effective allocation of resources in fraud prevention efforts. Risk management helps identify areas that are most vulnerable to fraud, while internal controls can focus on those areas. This allows organizations to optimize the use of their resources, both financial and human, in the fight against fraud. (Pattawe, 2023).

The simultaneous implementation of internal control and risk management contributes to the establishment of a strong organizational culture against fraud. Internal controls set standards and expectations of ethical behavior in daily operations, while risk management reinforces awareness of the importance of vigilance against fraud risks. This combination creates an environment where integrity and transparency become core values, naturally reducing the likelihood of fraud in financial reporting. (Musyoki, 2023).

The simultaneous implementation of internal control and risk management significantly improves the accuracy and reliability of financial statements. Internal controls ensure that every transaction is recorded correctly and in accordance with applicable accounting standards, while risk management helps identify and manage factors that could threaten the integrity of financial data. The result is more reliable financial statements, which in turn increases stakeholder confidence and strengthens the organization's reputation. (Chi & Gooda, 2023).

The combination of internal control and risk management provides greater flexibility in the face of a changing business environment. Risk management allows organizations to anticipate and respond to changes in the risk landscape, while internal controls can be adjusted to accommodate those changes. This integrated approach allows organizations to remain vigilant against new forms of fraud that may emerge as a result of changes in technology or business practices. (Chizue, 2020).

The simultaneous implementation of these two elements contributes to the overall strengthening of corporate governance. Internal controls strengthen

accountability and transparency in day-to-day operations, while risk management enhances the capacity for risk-based strategic decision-making. This combination creates a more robust governance structure, which is not only effective in preventing fraud but also in improving operational efficiency and overall organizational performance. (Crovini & Ossola, 2021).

Thus, the simultaneous effect of internal control and risk management on fraud prevention in financial statements is significant and multidimensional. This integrated approach not only improves the organization's ability to detect and prevent fraud, but also contributes to improving the quality of financial reporting, strengthening organizational culture, and improving overall corporate governance. By combining the structural strength of internal controls and the strategic approach of risk management, organizations can build a comprehensive and adaptive defense system against fraud threats. This ultimately not only protects the organization's assets and reputation, but also enhances stakeholder confidence and supports long-term sustainable growth.

Conclusion

In curbing fraudulent activities in financial statements, internal control and risk management are crucial elements. If both components are used, they make a well—systemic and efficient counterfeiting prevention and detection system. Internal controls consist of organizational features and activities that ensure correct operations and reliable reports, while risk management seeks to strategically identify, analyze and control fraud exposure.

Adoption of both internal control and risk management at the same time offers quite some synergies. Internal controls enhance routine operational activities therefore making the environment less prone to manipulation and abuse. As opposed to that, management of risk enables an organization to be able to predict fraud threats and be able to act on them beforehand. Improvement in fraud detection and prevention is especially heralded as well as efficiency in the quality of financial reporting.

Moreover, the integration of these two elements at the same time is beneficial to the organization in greater measure. Strengthening of the ethical and moral corporate culture, operational efficiency and trust of the stakeholders, or shareholders, cannot be left behind. With this integrated approach, organizations are not limited to mere defensive mechanisms against fraudulent risks, but such risks are turned into opportunities for better growth and enhancement of governance structures. Hence, the integration of internal control with risk management, some say, is an essential part of the strategy turned towards creating a more built and trustworthy finance system of an organization.

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