

# **INTERNAL CONTROL AND FRAUD IN CONSTRUCTION INDUSTRY OF MALAYSIA**

**Wan Noor Asmuni Wan Fauzi<sup>1\*</sup>**

*Faculty of Accountancy, Universiti Teknologi MARA Cawangan Kelantan  
asmuni@uitm.edu.my*

**Siti Haliza Asat<sup>2</sup>**

*Faculty of Accountancy, Universiti Teknologi MARA Cawangan Kelantan  
haliza710@uitm.edu.my*

**Junaidah Hanim Ahmad<sup>3</sup>**

*Faculty of Accountancy, Universiti Teknologi MARA Cawangan Kelantan  
jun372@uitm.edu.my*

**Abstract:** The purpose of this paper is to develop an understanding about the internal control and fraud problem in the Malaysian construction industry. It is believed that the construction industry is one of the riskiest industries regarding internal fraud due to its complex and costly nature, and dense third-party contract relationships. If this situation is left untreated, it will lead to more serious problems in the future of construction industry in Malaysia. Therefore, this study is aimed to discuss the fraud phenomenon, lack of internal control and the reasons behind fraud in construction industry. It also proposes that organizations should periodically perform formal risk assessments and internal control reviews to reduce fraud activities. It is recommended to all parties to promote and practice effective internal control in their project to minimize the occurrence of fraud and failures.

**Keywords:** Construction Industry, Fraud, Internal Control

## **1. Introduction**

The construction sector is considered one of the most important sectors in economic activity and wealth creation as it helps in the development of the infrastructure and influences the development of other sectors. This industry has a huge impact on the community and these important industrial products comprise various types such as buildings, roads and bridges, airports and ports. According to the Association of Certified Fraud Examiners' (ACFE) fraud in the construction industry reports the third highest median losses per case compared to other industries. The construction industry is affected by the current economic crisis which causes companies to lay off workers, reduces salary and etc. This puts financial pressure on people working in the industry and gives them motivation and rationalization to commit fraud; for example, items can be stolen and sold for extra cash. There are many opportunities for fraud to be committed but proper internal controls can help reduce the risk.

Internal control provides a way for companies to achieve operational and financial goals. Each company needs to implement a network of internal controls to ensure that their business operates at an optimal level. The Treadway Commission Sponsoring Organization Committee (COSO Commission) 1992 sets out internal control as a process performed by the board of directors, management and employees of the company designed to provide reasonable assurance about the achievement of objectives in operational efficiency and efficiency, reliability of financial reporting, and compliance with laws and the applicable regulations. The basic purpose of internal control is providing a reasonable assurance that adequate internal controls and best practices are in place by which the objectives of the company/organisation are achieved. In September 1998, following wide consultation, the Basel Committee published a document entitled 'Framework for internal control systems in the banking organisation'. The paper makes many familiar claims for the benefits of a strong internal control system such as helping to meet goals and objectives, helping to achieve long-term profitability targets, maintaining

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\* Corresponding author: Faculty of Accountancy, Universiti Teknologi Mara cawangan Kelantan, [asmuni@uitm.edu.my](mailto:asmuni@uitm.edu.my)

reliable financial and management reporting, ensuring compliance with laws and regulations, ensuring compliance with policies, plans, internal rules, and procedures and decreasing the risk of unexpected losses or damage to reputation.

According to Hamed (2009), internal control is a systematic way of carrying out organizational activities and procedures guided by rules and regulations for the success of the entire company. Reid and Ashelby (2002) identify two types of internal control that are financial and non-financial. Financial control is an activity involving controlling the company's debtors and creditors, financing operations and how the company manages inflows and cash outflows. On the other hand, non-financial control involves non-financial activities such as human resource management, operations, asset control and control over the designated structure.

## **2. Problem Statement**

The problem to be addressed in this study is that many small and medium construction companies have no internal control to prevent, detect and respond to fraud incidents. Krishnan and Visvanathan (2007) argues that it is not a surprising fact that the construction sector is the most corrupt sector because of its complex nature of doing business with so many involvements. Certain characteristics of the construction business also makes the construction sector more complicated than some other sectors. These characteristics are a large flow of public money, a very competitive nature of the tender process, lack of transparent selection criteria for projects, political interference, the nature of delivery of monopoly services, tight margins, and close relationships between contractors (Sohail and Cavill 2008; De Jong et al 2009, Rodriguez et al 2005). These specific features and conditions of the construction sector increase the tendency to fraud.

This is because the construction sector in the current situation is experiencing many problems such as weak domestic investment due to economic conditions, lack of access of building materials requirements as well as high costs for purchasing materials and equipment maintenance and operations. Rahman et al (2016) conducted a survey of 57 construction firms with fraudulent financial statements and determined that 36.9% of unapproved revenues were associated with discretionary accruals. According to Larsen (2013), ACFE reported the largest scam schemes in the construction industry as a result of collection (36.2%), bribes (34.0%), dismissal checks (21.3%), non-cash (21.3%), 19.1%).

There is a series of cases of fraud in many organizations. It is difficult for management to influence employee motivation but by limiting opportunities for fraud, organizations can reduce risk. Liu (2005) and Rittenberg et al. (2005), highlight six internal control benefits including; detecting mistakes and fraud, minimize illegal activities, increase the knowledge of entities to ensure quality data, the creation of business physical facilities and reduce audit fees. Therefore, in this context the paper literature review relates to factors that will lead to weak internal fraud and internal control in the construction industry. Enhancement of internal control is important for an organization to deal with changes in business, technology, law, competition, economic conditions and industry practices. By strengthening internal control, most financial fraud can be prevented.

## **3. Literature Analysis**

### **3.1 Fraud**

The term fraud has been widely defined in literature by scholars and experts. Hornby (1998) defines fraud as an action or an instance of checking somebody in order to make money or obtain goods illegally. Fraud is an act by individuals against businesses (Mui & Mailley, 2015). According to ICAN study pack (2006b) fraud consists of both the use of deception to obtain an unjust or illegal financial advantage and intentional misrepresentations, affecting the financial statements by the one or more individuals among management, employees, or third parties.

Some surveys have been reviewed to attract statistical views on fraud and corruption occurring in the construction sector. The reasons that drive people to perpetrate fraud were elaborated on by the Auditing Standards Board of the American Institute of Certified Public Accountants under the Statement on Auditing Standards (SAS) No: 99: Consideration of Fraud in a Financial Statement Audit and embodied within the fraud triangle theory. According to this theory, the causes of fraud are financial pressures, rationalizations and opportunities. Financial pressure often comes from personal problems such as addiction, divorce, debt, homelessness, or health problems. But they may also be due to bad financial decisions or living beyond one's capabilities. In any case, life situations often provide motivation which is the first step towards fraud.

ACFE (2010) indicates that the three main types of occupational fraud attempted by fraudsters are asset misappropriation, corruption and financial statement fraud. Asset misappropriation (stealing or misusing the organization's resources) is the most frequent but least costly type of occupational fraud. Furthermore, ACFE 2014 reported that the median loss per fraud scheme in the construction industry is about \$245,000. This loss can be devastating to small and medium companies. The ACFE notes the construction industry's most common fraud schemes include the following:

- Corruption — In the construction industry, this category includes conflicts of interest, bribery, illegal rewards, and economic extortion.
- Billing — Invoices are submitted for fictitious goods or services or from fictitious vendors. Invoices may also be for personal purchases.
- Expense Reimbursements — Employees make claims for fictitious or inflated business expenses.
- Check Tampering — Fraudster may bypass, falsify, or alter checks drawn on one of the organization's bank accounts in order to divert assets.
- Bidding — Personnel may gain unauthorized access to confidential bidding information and share bids with contractors.

A study done by Ewa and Udoayang (2012) to determine whether the ability to probe fraud among staff and their lifestyle and detection of fraud was as a result of design of internal controls. They obtained data from 13 banks registered in Nigeria using questionnaires and analyzed the data using ratio and percentage. The study concludes that the design of internal controls affects staff on fraud. Strong internal controls prevent staff from fraudulent activity.

According to Olumbe (2012), effective internal control systems help organizations prevent and eradicate errors, fraud and minimize wastage. The best way to reduce the impact of fraud is to investigate suspected fraud immediately. These frauds can be done by employees, owners, subcontractors, vendors, and collaborators. The construction industry is closer to fraud than other industries as it often empowers spending on project managers and field supervisors. Strong internal controls can provide companies with the opportunity to detect and prevent fraud. However, he added that weak internal controls led to ineffective and that bring losses.

### **3.2 Internal Control**

As defined by COSO (2013), internal control is a process, affected by an entity's board of directors, management, and other personnel, designed to provide reasonable assurance regarding the achievement of objectives relating to operations, reporting, and compliance. Major components of internal control and the fundamentals of the internal control framework are as Control environment, Risk assessment, Control activities, Information and communication as well as Monitoring. If one of the components is not well implemented in one organization, then it may lead to fraud activities.

Iskandar et al (2018) conducted a study to identify the impact of the internal control systems according to the COSO model with its elements (control environment, risk assessment, control activities,

information and communication, monitoring and follow up) on the operational performance of construction companies in the Gaza Strip. The study was implemented on 46 construction companies that operate efficiently and effectively in this sector and have organized financial and administrative systems governing their work. Thus, the researcher created a questionnaire for a study consisting of 49 paragraphs as a tool for collecting the required data and distributed it to a sample of the survey consisting of 460 individuals and obtained 90.2% valid questionnaire for analysis. Researchers also use descriptive analysis methods. After analysing the results, the study found that there was a great commitment to the company's narrowing to the internal control structure (COSO) model and there was a statistically positive impact for each model element on operational performance. Additionally, current studies recommend that construction companies need to strengthen the efficient and effective internal control system by allowing the structure of their control systems to depend on the elements of the model COSO.

According to Liu et al (2015), internal control is defined as a process designed to prevent unethical behavior such as fraud, theft, and resource abuse. It enables managers to achieve operational efficiency and efficiency goals, reliability of financial reporting, and compliance with applicable rules and policies (Lansiluoto et al, 2016). Doyle et al. (2005) said that internal controls play a major role in finding key weaknesses and fraudulent activities, revenue management and replenishment especially in low income organizations. Ackah (2013) reviews the need to assess the effectiveness and efficiency of internal controls as an essential element in achieving quality control mechanisms. He finds that internal controls need to examine all important aspects of the system and that all risks are being adequately handled with appropriate controls. The existence of internal control measures within the organization should lead to an efficient and accurate control system by detecting and minimizing fraud and mistakes when it happens. While the system cannot remove all frauds and other errors and malfunctions when conceived and carefully censured, it reduces the incidence. After all, the problem of mistakes, frauds and irregularities still persists.

According to Rahman et al (2016), the specific business problem is that some business leaders responsible for financial reporting lack strategies to develop and implement effective internal controls for recognizing contracting revenues. There are more than 30 cases of corporate scandals reported in the United States between 2010 and 2013 due to the lack of effective internal control processes (Gray & Ehoff, 2015). Some of the leading businesses involved in scandals include Enron, WorldCom, Waste Management, and Fannie Mae. Therefore, business owners find it necessary to enhance the process of internal control to avoid bankruptcy and negative financial performance (Al-Thuneibat et al 2015).

Ghaleb A. (2018) in his research stated that one of the business leaders in Qatar's business contracted to develop appropriate internal controls on revenue estimates to reduce the risk of manipulation of financial statements. Based on the internal control framework of the Treadway Commission Organizing Committee of the Treadway Commission, the purpose is to explore strategies led by business leaders responsible for the use of financial reports in developing and implementing effective internal controls to recognize contract revenue. Nine participants from 3 private contract companies in Qatar have implemented strategies to develop and implement effective internal controls to recognize contractual results involved in face-to-face semi-structured interviews. Through the process of triangulation methodology, observations and documentation evidence add data collected through semi-structured interviews. Different themes come through data analysis that involves narrative segments. Research findings include the theme of control environment, control activities, systematic project budgeting, compliance with accounting standards, and risk assessment and monitoring.

Effective internal controls are essential no matter how small the company for many valid reasons. Fraud prevention, embezzlement detection and accurate financials are all reasons to justify for good internal control practices. Results of research conducted by Mappanyuki et al. (2012) showed that there is a positive and significant effect of internal control implementation either partially or simultaneously on the prevention of procurement fraud. The theory of fraud, fraud awareness, and methodology is the systematic steps that can be done to detect fraud in financial reporting (Suprajadi 2009). Tuanakotta

(2012) also stated that it is more than a concept of internal control in the prevention of fraud, in which it is to create awareness towards the fraud (fraud awareness).

### **3.3 Factors Affecting Fraud**

According to Kaplan and Schultz (2007) collapsing of Enron and WorldCom of United States is largely due to bad corporate governance standards and lack of sufficient internal controls. Insufficient internal controls provide opportunity for mismanagement of resources, corruption, wastage and gross violation of laid down rules and regulations thus leading to total business collapse. Organizations that have weak internal control lack the ability to deliver quality products and services. This leads to inability to compete within the industry resulting to poor performance. According to the survey done by Kroll (2010), the most common types of fraud in the construction sector were i) Management conflict of interest ii) Theft of physical assets or stock iii) Information theft, loss or attack iv) Corruption and bribery v) Vendor, supplier or procurement fraud.

Efozie (2010) notes that weak internal control result in theft of funds, decline of sales proceeds, deliberate omissions in records, corruption, and loss of business property, collusion and refusal to be transparent and accountable for cash management. It is important that management familiarize themselves with procedures and mechanisms that will ensure the delivery of expected services and financial performance. Ethical issues in the construction industry does not only involve bribery or corruption, but also conflict of interest and collusive tendering. Transparency International (2005) has described how corruption can add up to 25% to the cost of public contracts, generating waste of public resources, unrealized development opportunities, and unstable environments for businesses. The statistics also further indicate that the scale of corruption is higher in construction than other economic sectors. For the Malaysian construction industry, the report shows that 17.3% of 417 government projects are considered 'sick' (Ministry of Works Malaysia, 2005) and these sick projects are partly due to unethical behaviour among project participants.

Quality of site surveillance has a major influence on the overall performance and efficiency of the construction project. The supervisor's performance relies on skilled communication with individual employees and planning and directing work (Ahzahar et al, 2011). The main objective of the surveillance activity is to ensure that the operating activities are carried out properly in accordance with the policies and procedures. Lalic et al. (2011) suggested that internal control efficiency should always be audited. However, it is not easy to find competent and appropriate supervisors who are able to monitor business activities. At minimum, one must have sufficient qualification, work experience, and technical and soft skills. The absence of these skills can lead to the collapse of internal controls (Ahmad Saiful et al., 2018). Their study also shows types of internal control weaknesses and their impact on a company, specifically their contribution to fraud activities. One company was selected as a study case, and a mixed method of data collection and analysis was employed. This study found that internal control weaknesses can be a major contributing factor for fraud to be committed. Some examples of weak internal controls discovered in this research include poor supervision and lack of documentation processes, which ultimately provide opportunities to fraudsters to misappropriate company assets. This is worse if the fraud was carefully planned and involved employee cooperation.

The study by Cheng (2010) analysed some of the major problems of internal control in highway construction which included lack of environmental awareness, weak risk awareness, weak control activities, restricted information communication and weak internal monitoring. Then the paper proposes some guidance and advice for highway construction companies to enhance internal control, such as strengthening the control environment, conducting accurate internal accounting controls, strengthening internal audit controls and so on. Quality of site surveillance has a major influence on the overall performance and efficiency of the construction project. Inadequate surveillance is believed to be one of the major causes of work. Therefore, experienced and trained supervisors have an important role in minimizing the amount of work done due to construction defects.

Many construction business owners fail to focus on risk management procedures to enhance the process of internal control to detect potential fraud (Gerard & Weber, 2014). Risk Management means a series of company activities that manage the various internal and external risks associated with its business, in corporate management, to maintain and enhance its value. While risk management and internal controls stand in different backgrounds and have been developed on different paths, they have many similar objectives, addressing various risks around the industry and working to maintain and enhance the value of the company. In recent times, the environment surrounding construction projects are changing and perceptions of organizations are exposed to increasingly stringent criticisms from stakeholders. It becomes necessary to relate risk management with internal control and enable them to function appropriately.

Construction business owners face challenges involving sustainability, growth, and positive performance by employees due to the lack of useful internal processes in detecting and minimizing risks. As risk management and internal control are necessary for any construction project to achieve its primal objectives in terms of cost, time and quality they should be established and operated respectively for each construction projects. However, the level of effort varies from organization to organization, and projects for projects and recognition of such efforts are not necessarily shared by and between the parties concerned (Mutnuru, 2016).

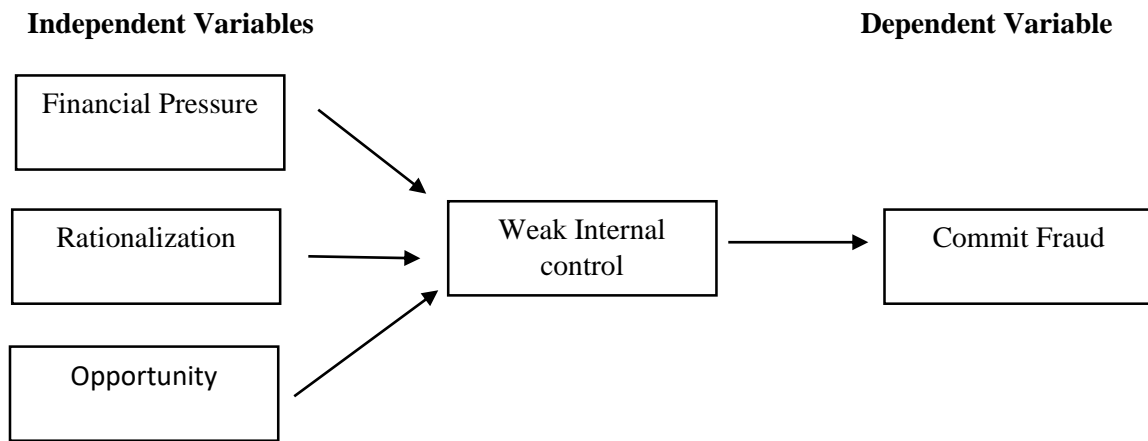
### **3.4 Research Framework**

Several models have been developed to identify the elements that lead perpetrators to commit fraud. Donald Cressey proposes a fraud triangle framework that describes three factors that are present in every situation of fraud which is 1) Pressure, the need for committing fraud (need for money, etc.) 2) Rationalization, the mindset of the fraudster that justifies them to commit fraud and 3) Opportunity, the situation that enables fraud to occur (often when internal controls are weak or non-existent).

Furthermore, the reasons that drive people to perpetrate fraud were elaborated on by the Auditing Standards Board of the American Institute of Certified Public Accountants under the Statement on Auditing Standards (SAS) No: 99: Consideration of Fraud in a Financial Statement Audit<sup>1</sup> and embodied within the fraud triangle theory. According to this theory, the reasons for perpetrating fraud are financial pressure, rationalization and opportunity. Perceived financial pressure is one of the three elements in the fraud triangle theory. According to this theory, one may commit fraud, if he/she perceives non-shareable financial pressure and believes that the only solution is the violation of the individuals' financial trust. In other words, the potential fraudster has a driving need for additional income for various purposes and holds the belief that he/she would be unable to compensate these costs with his/her legitimate income. Another component of the fraud triangle is rationalization. The fraudster tries to find a way to justify his/her improper acts. In this respect, Cendrowski et al. (2007) state that there are three types of perceptions; the first one is not admitting the wrongdoing as a crime, the second perception is the idea that he/she deserves more, and finally the feeling of revenge against the company. The fraudster sometimes discovers weaknesses in control processes/procedures and turns these weaknesses into opportunities to commit fraud.

Thus, the following figure below shows the framework which presenting the relationship between independent and dependent variables. The intention of fraud is the dependent variable. Financial pressure, rationalization and opportunity as independent variables. The same independent variables used by Ahzahar N et al (2011) to identify contribution factors to intention of fraud. Meantime, this study will be used internal control as moderating variables.

Figure 1: Proposed Research Framework



This is a conceptual paper that is based solely on a review of literature on the topic of internal control and fraud. For future research, self-administered questionnaires will be distributed to a list Malaysian construction companies in order to investigate fraud awareness in construction companies and the reactions of construction companies towards cases of fraud. The type of fraud experienced by Malaysian construction companies will also be surveyed in the questionnaire. The respondents will be the members of top management and construction teams (including project managers, technical office chiefs and site chiefs) of the companies.

The questionnaire will be abstracted and analysed through the Statistical Package for the Social Sciences (SPSS). The statistical methods such as frequencies and arithmetic mean, Cronbach's Alpha test, Pearson Correlation Coefficient, T-test and Simple Regression Test will be used.

#### 4. Conclusion and Suggestion

Internal control is the most important, fundamental and effective way of managing the modern enterprise. A large number of actual cases indicate that the majority of the causes and failures of the enterprise are the lack of internal control and are largely due to ineffective internal controls. Therefore, to secure a place in the market and maintain a stable and healthy development, the enterprise must create a perfect internal control system. Internal control includes not only preventing accounting errors, but also using ethical focus on management in designing, implementing, controlling and improving business processes (Lakis & Giriunas, 2012).

Internal control should be implemented to ensure the effectiveness and efficiency of their operations and compliance with laws and regulations. Leaders at all levels should first strengthen the internal consciousness of internal control. From the chairman and general manager to the project leader, they will provide sufficient insight into the establishment and implementation of a system of internal control and strong support for the establishment of internal audit activities and the conduct of audits and audit findings. Quality of site surveillance has a major influence on the overall performance and efficiency of the construction project. Inadequate surveillance could be one of the major causes of work. Experienced and trained supervisors must have an important role in minimizing the amount of work done due to construction defects. The performance of supervisors depends on skilled communication with individual employees, and planning and directing work.

Furthermore, the contractors need to develop strong audit mechanisms and control processes to avoid fraud. However, factors such as the increase in construction business complexity, high labour turnover ratio, infrequent construction projects, inadequate regulations and lack of energy due to cost reduction strategies make it difficult to develop internal audit structures. Additionally, supervision over operation was very low since operations were conducted in remote sites, mostly away from the company headquarters.

Apart from that, an implementation of an independent internal and external audit program would help to identify new vulnerabilities, and to measure the effectiveness of the existing controls. Employees should also be trained about policies and procedures related to fraud, internal controls, code of conduct and ethic policies of the company. Alternatively, the enterprise can work on seminars, conferences and workshops to raise awareness of the importance of internal control systems and their role in the development of operational, financial and strategic performance in companies. For internal controls to be effective, they must be constantly reviewed and evaluated for effectiveness and kept updated as business environment and technological processes are fast changed and dynamically evolved.

Thus, it is apparent that internal control expression is used in a wide sense and includes internal check and internal audit besides other forms of controls.

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