

FRAUD THEORY EVOLUTION AND ITS RELEVANCE TO FRAUD PREVENTION IN THE VILLAGE GOVERNMENT IN INDONESIA*

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ARTICLE INFORMATION

Article history:

Received July 29, 2015

Revised November 12, 2015

Accepted June 24, 2016

JEL Classifications

H79

Key Words:

Fraud Theory,
Prevention of Fraud,
Village Government

DOI:

10.21532/apfj.001.16.01.02.15

ABSTRACT

This paper discusses the evolution of fraud theory from time to time, starting from initial fraud theories, such as White-Collar Crime, Fraud Triangle, and Fraud Scale, to modern fraud theories, such as Fraud Diamond, M. I. C. E model and ABC analysis. Studying the evolution of fraud theory will be very helpful to prevent the occurrence fraud in the future. In addition, this paper also discusses the relevance of fraud theory and fraud prevention in the village government. Village fund can be the object of fraud because of its significant amount, lack of control, and conflict of interest of various parties. Modern fraud theories, such as Fraud Diamond, M. I. C. E model, and ABC analysis are used to analyze the possibility of who will be the perpetrators of fraud in the village government (who), why they commit fraud (why), and how to prevent fraud in the village government (how). Fraud theory analysis in the village fund management could be a foundation for related parties (village stakeholders) to make relevant policies as well as a basis to conduct village fund research in the future.

I. INTRODUCTION

Since the 1998 reforms, the demand for the accountability of state financial management has been increasing significantly. The public, who previously did not have access to the state financial management information, is now being flooded with a variety of information related to the state finances. However, the state financial management information received is mostly information about corruption committed by government employees and

* This article becomes the most inspiring paper in the Indonesia Call for Paper ACFE Chapter 2015

officials. Decentralization of the state financial management also decentralizes opportunities for corruption from central government to regional government. In the first half of 2010, BPS (Central Bureau of Statistics) noted that corruption in financial sector in the regional government was on the highest rank, with a percentage of 38%, followed by the sector of education, land, health and others. Report of Indonesia Corruption Watch (ICW) in 2014 stated that there were 43 Regional Heads entangled by corruption issues. In the first quarter of 2014, BPK (Financial Investigation Bureau of Indonesia) found 670 finding objects in the government sector. Still from the data of BPK, there were about 14,854 cases of noncompliance worth IDR 30.87 trillion in 2014. In addition, in 2014, Transparency International reported that Indonesia ranked 107 out of 183 countries with the highest corruption index in the world. The higher the rank, the greater the number of corruption cases in the country.

Wells (2007) states that there are three types of fraud, namely: fraud in financial statements, assets misappropriation, and corruption. All three are equally dangerous and harmful. Based on the study of the Association of Certified Fraud Examiners (ACFE) in 2002, 2004, 2006, 2008 and 2010, contained in the Report to the Nation on Occupational Fraud & Abuse, can be concluded that fraud in organization has resulted in losses to the organization about 5% -7% of the total annual income. This does not occur in the private sector only, but also in the public sector, in which fraud is also detrimental to the

state finances in large amount. In the research conducted by Syahril and Saleh (2013), it is stated that the state loss due to fraud, including corruption, in the 28 cases identified, is IDR 2,623,212,042,642.62.

In 1944 Edwin H. Sutherland introduced the term '*white-collar crime*', or the crime committed by professionals. In 1950s, Donald R. Cressey developed Sutherland's study and formulated the *Fraud Triangle*. According to Cressey, there are three reasons why people commit fraud: opportunity, rationalization, and financial pressure. *The Fraud Triangle* then became the basis for auditors in identifying perpetrators of fraud for decades. The study of fraud continued to grow and so was born new theories such as *Fraud Scale*; the improvement of *Fraud Triangle* named *Fraud Diamond*, M. I. C. E. model, and A-B-C Analysis. These theories continue to evolve in line with the development of the characteristics of fraud perpetrators and their environment. The developed theories are trying to read the existing reality that supports the reduction and prevention of fraud, both in the private sector and in the government sector.

The state finance managed by the government is a vital sector because it involves the lives of many people. Therefore, it requires accountability in its management. Johnson (2014) stated that both central government and regional government are prone to commit fraud because of the environment and how they do the job. In the government sector in Indonesia, the three forms of fraud occur not only in central government but also in regional government. The Regional Autonomy ratified by Law No.

32 on Regional Government has opened the tap for the occurrence of fraud in-group in the regional government.

The public concern about fraud decentralization to lower levels reappeared after the passing of Act 2014 No. 6 on Village (Village Act). The public concern is very great because the funds disbursed for the village are very large. Based on rough calculation, in 2015, 10 percent of the transfer to regional government, according to state budget, was IDR 59.2 trillion, plus the fund from regional budget amounting to 10 percent, or about IDR 45.4 trillion. Total fund for the village in 2015 was IDR 104.6 trillion, which would be distributed to 72 thousand villages throughout Indonesia. It is estimated that every village will have about 1.4 billion per year (Puspasari, 2015).

Public trauma on regional autonomy, in which there would be more funds embezzled by the regional government officials, made the enactment of Act 2014 No. 6 greeted pessimistically. Error and fraud could possibly occur in the village administration. Error may still be addressed by mentoring and training regularly, but fraud, which tends to be systemic and harmful, should be prevented and controlled from the beginning of the implementation of the Act, so that the noble purpose of the Village Act for the welfare of rural communities can be achieved.

Studying the fraud theory evolution from time to time means to learn the patterns, such as the patterns of behavior and environment, actors and systems. Understanding and

application of the theories as tools to solve real-world problems are needed. This paper invites the readers to recognize various theories of fraud and to see how far its relevance to the prevention of fraud in the village government in Indonesia. It is expected that village autonomy not suffer from the same fate as the regional autonomy in terms of the decentralization of fraud opportunities.

II. REVIEW OF RELATED LITERATURE Fraud Theory, the Beginning of *White-Collar Crime*

In 1940, the term “*crime*” referred more to the crime in the streets or violent crime. Edwin H. Sutherland, who first introduced the term ‘*white collar crime*’ which is identical with the economic and business activities, states that earlier theories regarding criminality assume that poverty is the root causes of criminal acts, but in *white-collar crime*, poverty rarely becomes the root causes for the people to commit crime.

According to Sutherland (1940.1944), there are three differences between *white-collar criminals* and *street or violent criminals*. First, the white collar criminals are usually professionals. Second, since the perpetrators are professional, the legal charged against them are not so heavy. Third, since this crime is invisible to most people, it is more difficult to identify the perpetrators and their victims. Early theory about white-collar crime has become a foundation for further theories related to fraud.

Fraud Triangle

In the 1950s, Donald R. Cressey, a

criminologist, made an observation on the study conducted by Sutherland. According to Cressey, there were three factors that encouraged the occurrence of fraud: pressure, rationalization, and opportunity. These three factors were then known as the *Fraud Triangle* theory. Here is the figure of *Fraud Triangle*.

Figure 1. The Fraud Triangle



Source: Wells (2007)

Pressure, which cannot be told in terms of finance, may be one of the triggers to the occurrence of fraud. The pressure, as described by Cressey, refers more to the financial pressures, such as debt, luxurious lifestyle, dependence on drug, and others.

Opportunity enables fraud to occur. It is usually caused by the weak internal controls in an organization, the lack of supervision, and the authority abuse. Among the three elements of fraud triangle, opportunity is the element that most likely to be minimized through the process, procedures, control and early detection efforts against fraud.

Rationalization is an important element for the occurrence of fraud, where perpetrator always seeks justification for his action. For

example, the perpetrator rationalizes that his action in committing fraud is for the happiness of his family and the people he loves, his working period has been long enough and he feels that he is entitled to get more (in position, salary, promotion), the corporate profit is so large that it does not matter for him to take part of it.

According to Dorminey (2012), Cressey's fundamental study which mentions that with the financial pressures that cannot be told, the perceived opportunity that the stealing would not be detected, and the rationalization that the acts done is correct, can make professional individuals commit fraud. The *Fraud Triangle* has been the basis for most discussions of *white-collar crime* in the accounting curriculum for years. The *Fraud Triangle* also becomes a helpful tool for auditors to observe the motive of perpetrators in committing fraud.

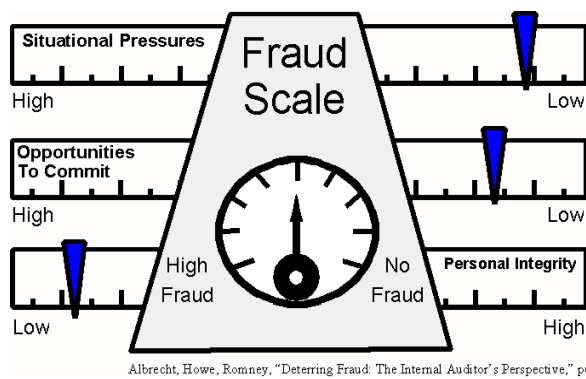
Fraud Scale

In addition to Cressey's *Fraud Triangle*, there is another theory about fraud called *Fraud scale* by Albrecht (1984). In the *Fraud Scale*, there are three factors that lead to the occurrence of fraud: *situational pressures*, *opportunity to commit fraud*, and *personal integrity*. Albrecht replaced rationalization factor with personal integrity so that it could be observed more. Rationalization is more abstract to be known by other people, while the personal integrity of individuals can be traced from their behavior in the past.

According to Albrecht (2006), violations of ethics, honesty and responsibility are the essence of the action of accounting fraud. Ethical

problems are caused by rationalization, and to some extent, pressure factor is associated with fraud by examining the condition of individual who commits fraud when considering whether his action is right / wrong. Here is the figure of *Fraud Scale* initiated by Albrecht.

Figure 2. *Fraud Scale*



Source: Wells (2007)

From the figure of *Fraud Scale* above, it can be found that the three factors causing fraud relate to each other. If the situational pressure is high and the opportunity to commit fraud is also high but the personal integrity is low, the possibility of fraud will be high. Conversely, if the situational pressure and the opportunity are low, but the personal integrity is high, there will be no fraud.

Modern Fraud Theories

A-B-C Analysis

Ramamoorti (2008) made a study stating that the root cause of fraud is on behavior. He observed fraud through sociological and psychological approaches. A year later, Ramamoorti (2009) proposed an A-B-C model to analyze and categorize fraud. According to Ramamoorti (2009), there were three types of

fraud described as: *a bad Apple, a bad Bushel, a bad crop*.

A bad Apple refers to individual fraud, the fraud committed by individual. *A bad Bushel* refers to collusive fraud, the fraud committed in collusion. And, a *bad Crop* refers to fraud committed in collusion with cultural and social mechanism that affects the occurrence of fraud.

Of the three types, the most dangerous one is a bad crop. A bad Crop is characterized by moral deficiency of the leaders of an organization, and this moral deficiency quickly spreads to their subordinates. Since it spreads almost throughout the organization, fraud eventually becomes a culture in the organization, performed in congregation from the leaders to the subordinates. Dorminey (2012) called a bad crop as epidemic.

Fraud Diamond and M.I.C.E. Model

In the Fraud Diamond, after considering the four elements of fraud, Wolfe and Hermanson (2004) argued that Fraud Triangle can be extended by adding the fourth element called *capability*. The *capability* attached to the perpetrator can be position and adequate knowledge. According to Dorminey et al. (2010), the opportunity to open the door to fraud, pressure, and rationalization make the perpetrator closer to the door, but the perpetrator must have capability to realize the presence of opportunity to step into the door and commit fraudulent actions.

Besides modifying the additional element of capability, the *Fraud Diamond* also modifies the pressure element. According to Dorminey

et al. (2012), the pressure element in the *Fraud Triangle* does not necessarily refer to the financial pressure. For example, in bribery case involving more than one party, in which perhaps not all the parties involved in bribery are motivated by financial need. As another example, Ramamoorti (2009) revealed that the executives who are wealthy and influential in the community also commit fraud. It is obvious that financial factor is not the main motive. In this context, *Fraud Triangle* cannot observe the pressure element comprehensively.

According to Dorminey (2010) and Kranacher (2011), the situational pressure, that can motivate the occurrence of fraud, can be explained by four factors: *money, ideology, coercion, and entitlement*, better known by the acronym M.I.C.E. The factor of money refers to the financial pressure which makes the person commit fraud. The financial pressure can be caused by prodigal lifestyle, debt, urgent family needs, and others. These pressures are the same as those expressed by Cressey ((1950) in the *Fraud Triangle*.

Factor of ideology means that the perpetrator considers his behavior of committing is for the greater goodness. For example, he considers that obtaining illegal income is not a problem because he will donate the money to many people in need. The factor of coercion means that there is third party who provides an example, intimidates, threatens, and forces others to commit fraud. While entitlement refers to the ego of individual who feels that if he commits fraud, it will not be detected. Besides, ego is also driven by the desire to

maintain or obtain a certain lifestyle. Wealth and success have become identity and social status comparison in some circles.

III. DISCUSSION

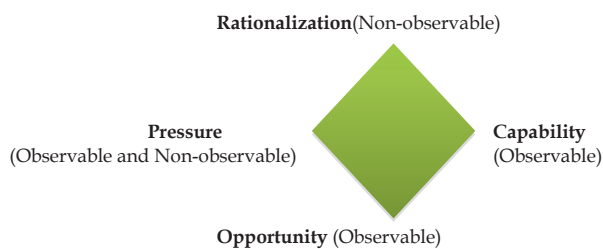
The Relevance of Modern Fraud Theory to Fraud Prevention in the Village Government

The evolution of fraud theory describes the evolution of the characteristics of the perpetrators of fraud and the environment in the community. The development of this theory is trying to capture reality and offers an alternative solution to solve the problems of fraud. In the modern era, the study of fraud can no longer be a mono-disciplinary study. The study of fraud is a multi-disciplinary study. It requires economic, psychological, sociological, criminological and political approaches in order to be able to capture the fraud phenomenon comprehensively.

In Indonesia, fraud, in the form of corruption, has cost the country in large amount. According to Sudiby (2012), the work environment is one of the determinants for corruption in Indonesia. In the government sector in Indonesia, there is an evolution of fraud perpetrators. Before 1998 reforms, corruption was done only by a handful of parties, namely the central government. But after the reform and regional autonomy, the opportunities for corruption have been decentralized to lower levels, or regional government. In 2014 alone, 43 Regional Heads became the suspects of corruption (ICW, 2014). With the implementation of Village Act, the opportunities for corruption will likely be decentralized to the village level.

Modern fraud theory can be used as the basis for early prevention of fraud in the village government. Modern fraud theories, such as *Fraud Diamond*, *M. I. C. E. Model* and *A-B-C Analysis* are used to analyze the possibility of who the perpetrators of fraud in the village (who), the motive of the perpetrators to commit fraud (why) and how to prevent fraud in the village government (how).

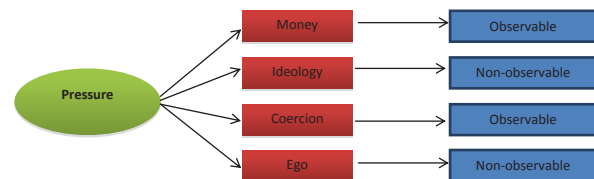
Figure 3. The Development of Fraud Diamond Analysis



For the starter, the elements in Diamond Fraud are divided into two criteria: observable and non-observable. Observable means that outside parties, such as auditors and colleagues, can observe and get information about the element from the individual who commits fraud. Non-observable means that outside parties cannot observe and obtain information about the element. Of the four elements in Diamond Fraud, rationalization is a non-observable element. Rationalization cannot be observed because it is impossible for the auditors or any other parties to know the thinking process of the perpetrator. Capability and opportunity are observable elements. Capability, such as position and adequate knowledge, can be easily observed by the auditors. Opportunity is associated with an organization's internal

control system. If the auditors find that internal control is weak, it is a sign that fraud may occur in the organization. Pressure is both observable and non-observable element. According to *M. I. C. E. model*, there are four types of pressure that could encourage the occurrence of fraud: money, ideology, coercion and ego. The factors of money and coercion can be observed by outside parties. Auditors can track financial needs and coercion existing in the workplace, but auditors get difficulty to observe the ideology and ego that make someone commit fraud. The following is the figure of *M. I. C. E. model* and the characteristic of observations.

Figure 4. The Development of M. I. C. E. Model



By knowing what observable and unobservable elements, it will be easier for the auditors to perform their work. Auditors had better focus on the observable elements. In the case of the village government, for example, the observable elements are situational pressure, opportunity and capability. So, these three factors will be the main focus. The following is the table of the elaboration of the analyzes of Fraud Diamond in the village government.

Table 1. The Outline of *Fraud Diamond* Analysis in the Village

Element	Analysis
Pressure	<p><i>Money:</i></p> <ul style="list-style-type: none"> • Most of the villagers are poor, including the village officials (Central Bureau of Statistics / BPS, 2011) • Politic of returning the money spent by the Village Head during the Village Head Election <p><i>Coercion:</i></p> <ul style="list-style-type: none"> • Do the village officials (Village Head, Secretary, etc.) provide examples of committing fraud?
Opportunity	<ul style="list-style-type: none"> • The internal control system in the village is still inadequate • How is the control of the stakeholders? • How will the audit be done?
Capability	<ul style="list-style-type: none"> • How are the capabilities of the village officials (Village Head, Secretary, Treasurer, etc.?)

One factor that becomes the key in the prevention of fraud is supervision. According to Article 1 of the Regulation of the Ministry of Home Affairs (PERMENDAGRI) No. 7 of 2008, the supervision over the village government is the process of activities aimed at ensuring that the village government runs efficiently and effectively in accordance with the plan and the provisions of the legislation.

Supervision of the implementation of the Village Act under Article 112 of Law of 2014 No. 6 is in the hands of the Government, Provincial Government, and the District / City and Sub-District Government. According to Article 44 Paragraph 1 of the Regulation of The Ministry of Home Affairs No. 113 of 2014, provincial governments shall foster and supervise the administration and disbursement of the village fund, the village fund allocation, and the revenue from taxes and levies from districts / cities to villages.

In the government, there is a function of the auditor who is in charge of supervising the government administration including the use of budget. Auditor is one type of government accountants. The role of auditor in the era of the implementation of Village Act is very large because the function of supervision, especially the supervision of the budget implementation, will determine whether the budget is used appropriately to empower the rural communities.

In Indonesia there are government's external and internal auditors. The government's external auditors are the Audit Board of the Republic of Indonesia (BPK RI), while the government's internal auditors are the Board of Finance and Development Supervision (BPKP) and the Inspectorate. Unfortunately, the performance of inspectorate in conducting preventive measures to prevent financial fraud has been less successful. From the results of the mapping of the capability of the Inspectorate in 2012 conducted by BPKP shows that the capacity and professionalism of the Inspectorate

are still weak. Based on the mapping, 93.96% of Inspectorate auditors are still at level one of the five levels as the basis of the assessment. Another condition faced by the Inspectorate is inadequate number of auditors. Of the needs of about 40,000 auditors, there are only about 11,000 people. The legal basis for the supervision of the village, the Regulation of the Ministry of Home Affairs (PERMENDAGRI) No 7 of 2008, has not been able to describe technically on what types of supervision that will be executed in the village government.

Another factor that must be considered is the identification of anyone who may be perpetrators of fraud. According to Abiola (2013), there are three types of fraud committed by the perpetrators, namely: internal fraud, external fraud and mixed fraud. Internal fraud is the fraud committed by individuals within the organization. External fraud is the fraud committed by individuals outside the organization. Mixed fraud is the fraud committed by individuals within the organizations cooperating with the parties outside the organization.

Meanwhile, according to Ramamoorti (2009), with his A-B-C analysis, the perpetrators of fraud can be an individual (a bad Apple), collusion between individuals (a bad Bushel) and the collusion between individuals with a supportive environment (a bad Crop). Mapping on any parties who can commit fraud on the village fund helps to know who should be monitored and what systems that should be built in the village.

Zimbelman et al. (2014) stated that the greatest fraud is the misuse of assets, both cash asset and non-cash asset. Protection over the village assets should be tightened. Good reporting mechanism can be one tool to prevent fraud in the misuse of assets. Actually, there have been several reports mandated by Law No.6 of 2014, such as Accountability Statements on the Realization of Village Budget Implementation, Village Fund Accountability Statements, and Financial Aid Statements. In addition, there is a supplementary report, namely Village-owned Wealth Report. If the reporting is done correctly, it will be a guarantee that the village funds are managed properly.

CONCLUSION AND SUGGESTION

The villages are given the mandate by the Law No.6 of 2014 to regulate themselves. With the Village Act, it is expected that the villages will be able to empower themselves in order to be strong, advanced, independent and democratic. The powerful village would be the firm foundation in the government of a country so that just and prosperous society can be achieved. According to Swasono (2009), empowering the people is the national duty to improve the productivity of the people so that the people can become active assets of the development.

Systemic fraud in the government in Indonesia makes the state suffer huge loss of money. The democratic process that makes the power decentralized to lower levels in fact also helps decentralize fraud (including corruption) to the regional level. Concerns arising when the

Law No. 6 of 2014 was about to be implemented was “Would fraud also be decentralized to the level of village government?”

Zimbelman (2014) states that most organizations do not have a proactive approach to the prevention of fraud. Since fraud prevention is not emphasized in most organizations, there are a number of confusion related to who has responsibility in the detection, prevention and investigation of fraud. This confusion can be eliminated if the organization knows earlier what to do against the possibility of fraud.

Knowing the motive of the perpetrator, projecting potential perpetrator, and identifying the objects of fraud are expected to facilitate the prevention of fraud in the village government. The evolving fraud theories are helpful in analyzing the motives of the potential perpetrator to commit fraud, anyone who might commit fraud, and how to prevent fraud. According to Zimbelman (2014), the cost of prevention is cheaper than the cost to detect and combat fraud. The most appropriate model for the village government today is the prevention method (prevention and deterrence) so that fraud will not be entrenched and become endemic in the village government.

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