The Implementation of Fraud Risk Assessment in Anticipating Fraud in the Goods Purchasing Cycle. Case Study on Small and Medium Enterprise: PT X

Mega Silvia Fahriani
Department of Accounting
Faculty of Economics and Business
Universitas Indonesia
Depok, Indonesia
mega_silviaf@yahoo.com

Agustinus Nicholas Tobing
Department of Accounting
Faculty of Economics and Business
Universitas Indonesia
Depok, Indonesia
augie.nicholas@gmail.com

Abstract—**The aim of this study is to conduct a fraud risk assessment on the goods purchasing cycle in a company denoted as 'PT X' among the strategies it should deploy to anticipate fraud that may threaten its sustainability. By deploying Fraud Risk Assessment, the management can set priority controls and adopt appropriate prevention strategies to counter various fraud schemes based on the level of risk. The Fraud Risk Assessment in this study was conducted in accordance with the guidelines of the Committee of Sponsoring Organizations Fraud Risk Management Guide (2017). This study used a qualitative approach with field study data collection techniques. Based on the results of the assessment on the goods purchasing cycle of PT X, the greatest vulnerability was found in its Mark-up Billing, Kickback, and Theft of Inventory and Equipment schemes. Consequently, the management was advised to pay particular attention to anticipating risk in these areas. The recommended anti-fraud strategy - based on the application of the twin pillars of fraud prevention and fraud detection – should be implemented to minimize the risk of fraud and potential losses, and to secure the company's assets.**

Keywords—Fraud Risk Assessment, Fraud, Purchasing, SME, Internal Control.

I. INTRODUCTION

Small and medium enterprises (SMEs) that the majority of small business activities in terms of income, assets, and human resources are very vulnerable to shocks. The 2016 global study on Occupational Fraud and Abuse, conducted by The Association of Certified Fraud Examiners (ACFE) [1], states that businesses that employ fewer than 100 people are the most vulnerable to fraud. Such criminality needs to be anticipated because failure to prevent and detect fraud can have a serious impact on an SME's sustainability. Companies need to manage such risks to secure assets and reduce the likelihood of bankruptcy. Adequate risk management can be intrinsic in strengthening the development and sustainability of SMEs in Indonesia.

In this study, researchers conducted a case study on PT X which is an SME engaged in the provision of cleaning services. In 2016, PT X experienced problems that slowed its business growth rate - it transpired that fraud was the cause. PT X racked up losses as certain employees took advantage of lax controls on ordering, purchasing, and receiving goods, which went undetected for six months.

The purchasing cycle fraud was perpetrated in several ways. For example, one scheme involved raising the purchase prices of hygiene equipment and chemicals in collusion with a supplier who, in turn, gave a kickback to the fraudster. Or in other cases, the fraudster might purchase liquid chemicals and other hygiene items on behalf of the company but would pay over the odds and pocket the surplus funds. This is a relatively simple process, facilitated by asking the supplier to vouch for the inflated price or even hand over a blank receipt that the perpetrator can fill in.

Consequently, PT X had to spend more on supplies, adding to its cost base. This cost the company Rp 76,000,000. The perpetrator was dismissed as a result of his fraudulent behavior.

The director of PT X informed researchers that the company had never conducted a risk assessment to anticipate such behavior. In the absence of identification and risk assessment, the company has difficulty in managing the fraud risks it encountered, including setting priority controls and introducing prevention efforts to address such risks. Both management and employees must be continually alert to the threats posed by fraud because it threatens the sustainability of any business. However, it is particularly important in the case of SMEs, which are more vulnerable compared with larger companies [2].

One way to anticipate and minimize the potential for fraud is to conduct a Fraud Risk Assessment. In this case, the researcher applied an assessment of the purchasing cycle of PT X. The assessment was conducted using the principles of the Committee of Sponsoring Organizations (COSO) Fraud Risk Management [3], which provides guidance on the consideration of potential fraud as a principle in the risk assessment component. Comprehensive assessment is conducted to identify schemes or fraud scenarios; assess the likelihood and significance of risks; evaluate existing fraud control activities; and apply measures to reduce the risk of residual fraud.

This study is based on a Fraud Risk Assessment on the goods purchasing cycle of PT X. This research is designed to inform the management of PT X on the establishment of priority controls in various fraud scenarios so as to reduce the possibility of significant fraud risks as a result of fraudulent behavior, which in turn will mitigate potential losses and safeguard company assets.

Researchers asked the following:

1. How should fraud risk assessment be applied to the goods purchasing cycle of PT X?

2. What kind of fraud scenarios might occur in the goods purchasing cycle of PT X?

3. How robust is the relevant anti-fraud strategy in anticipating significant fraud risks in the goods purchasing cycle of PT X?

II. LITERATURE REVIEW

This section describes previous research and theory concerning fraud and anti-fraud strategy, including fraud risk assessment, internal controls, and SMEs in Indonesia.

A. Fraud

The Institute of Internal Auditors [4] defines fraud as any illegal act characterized by deceit, concealment, or violation of trust. These acts do not necessarily involve the threat of violence or physical force. Fraud is perpetrated by parties and organizations to obtain money, property, or services; to avoid payment or loss of services; or to secure personal or business advantage.

Donald R. Cressey in Albrecht [5] postulates the so-called Fraud triangle of three factors that are omnipresent in every fraud situation: Pressure, Opportunity, and Rationalization. The ACFE [6] classifies various types of fraud into the Fraud Tree chart containing three main branches: Corruption, Asset Misappropriation, and Fraudulent Statement.

B. Maintaining the Integrity of the Specifications Anti-Fraud Strategy

According to Widoretno [7], an organization should deploy anti-fraud strategy by implementing a Fraud Risk Assessment, a Code of Conduct, a whistleblowing program, and fraud training for employees.

C. Purchasing Cycle

According to Brinks in Modern Internal Auditing [8], the goods purchasing cycle is a business process comprising the purchasing of goods, their receipt, and, finally, payment for them. The buying cycle is a key cycle in the operational and financial control of an organization because a significant proportion of the money spent by any organization goes on buying goods and services. Improper control, in this case, can lead to various operational problems and financial problems.

D. Internal Control

According to the COSO [3], internal control is a process consisting of policies and procedures designed to achieve objectives related to the reliability of financial reporting, encouraging effectiveness and efficiency, promoting compliance with laws and regulations, and safeguarding wealth organization. The implementation of internal controls in every company's operations can be expected to reduce the risk of fraud.

E. Small and Medium Enterprises (SMEs)

The definition of an SME in accordance with Law Number 20 Year 2008 on Micro, Small and Medium Enterprises (MSMEs) [9] is as follows:

a. A Small Enterprise is a stand-alone productive economic enterprise, conducted by an individual or a business entity that is not a subsidiary or branch of a company, that is owned, controlled, or part of the direct or indirect business of a medium-sized or large-scale business.

TABLE I.   MSME CLASSIFICATION ACCORDING TO LAW NUMBER 20 YEAR 2008

No	Type	Criteria	
		Asset (Rp)	Revenue (Rp)
1	Micro	Max. 50 million	Max 300 million
2	Small	> 50 – 500 million	> 300 million – 2,5 billion
3	Medium	> 500 million – 10 billion	> 2,5 million – 50 billion

b. A Medium Enterprise is a stand-alone productive economic enterprise, conducted by an individual or business entity that is not a subsidiary or branch of a company, that is owned, controlled, or becomes part, directly or indirectly, with a small business or a large business with a net worth or annual sales proceeds as provided in this Law.

Law Number 20 Year 2008 classifies an MSME based on the amount of assets and turnover owned by a business as shown in Table I

III. RESEARCH METHODOLOGY

This research uses a qualitative approach involving observations, interviews, and documentation. Observations were made regarding the company's purchasing activities; interviews were conducted to obtain information related to fraud risk in PT X; and documentation was compiled to determine the flow of goods purchased by PT X. Data was collated through observations, interviews, and documentation to produce quantitative and qualitative data. Quantitative data is in the form of financial data related to the purchase values of goods, while the qualitative data is derived from observations and interviews.

Quantitative data were analyzed by using qualitative descriptive analysis. This analysis aims to provide data about the problems in the cycle. Qualitative data were analyzed by doing content analysis and descriptive analysis.

In this study, content analysis of the testimony of the interviewees is used to examine the results of interviews and documentation. Descriptive analysis is a technique employed to hone in more specifically on any problems that may be apparent. Also, in preparing the Fraud Risk Assessment, this study refers to the COSO Fraud Risk Management Guide [3].

IV. RESEARCH FINDINGS AND DISCUSSIONS

A. Abbreviations and Acronyms Implementation of Fraud Risk Assessment on the Goods Purchasing Cycle at PT X

Since its establishment in 2014, PT X has not implemented a fraud risk assessment to anticipate and obviate fraud. The awareness and understanding of the risk of fraud among management and employees remains low, even though such criminal activity could put the company

out of business. Based on the results of the research interviews with the management of PT X, fraud as an issue was never contemplated and the potential costs were certainly never calculated. Management considered that fraud was unlikely to occur if there was a sense of kinship within the company. Therefore, management had little motivation to dedicate resources to ameliorate the risk of fraud because as far as they were concerned, it was unlikely to occur and, consequently, there was little or no threat to the company

Awareness of the possibility of and the threat of fraud should be promoted constantly to the management and employees in every company. One way to anticipate the risk of fraud is to apply fraud risk assessment. The main idea of fraud risk assessment is to help the management see the inherent fraud risk in every process within the company so that the relevant personnel can more easily manage the risks, including setting priority controls and prevention efforts to address these risks. Each identified risk must be measured, prioritized, and logged in a risk register so that it is easy to manage and handle. Then, every risk should be mitigated or managed so as to eliminate it. Risks are dynamic – they change constantly over time and situations - so they must be monitored and evaluated consistently to militate against them.

COSO issued guidelines in the Fraud Risk Management Guide [3] to conduct a risk assessment. The following is the recommended fraud risk assessment process for PT X. It should be adopted among the strategies it uses to anticipate the risk of fraud faced by the company.

1) Establish a fraud risk assessment team

The fraud risk assessment team may comprise an employee from the purchasing department as the main risk owner; an employee from the accounting or finance department; someone from the operations department; an employee from the Human Resource Department (HRD); a sales and marketing officer; a security officer, and director leaders who are responsible for the effectiveness of risk management.

2) Identify fraudulent schemes and risks

To identify fraud risks, potential vulnerabilities must be identified (both internal and external). achieving company objectives for one year.

3) Estimate the likelihood and significance of each fraud scheme and fraud risk

This evaluation is based on historical information, known fraud schemes, and on interviews with those involved in a business process. There are five levels of the likelihood of a fraud occurring:

    I. Improbable

    II. Remote

    III. Occasional

    IV. Probable

    V. Frequent

Significance Impact states the degree of gravity or impact that occurs when the risks faced actually become a reality. There are five levels of the significance of the effects of

fraud based on the size of the impact on a company's finances, reputation, and operations:

    I. Negligible

    II. Minor

    III. Moderate

    IV. Major

    V. Catastrophic

4) Determine what individuals and departments may be involved

The determination of the individuals and departments that may engage in fraudulent behavior can be gauged using the fraud triangle theory. These may include: the incentives and pressures that motivate individuals to commit fraud; the prevalence of opportunities that may give an individual confidence that he/she can commit fraud indiscriminately; and the behavior or rationalization an individual uses to justify acts of fraud.

5) Identify existing controls and assess the effectiveness of those controls

The next step is to examine the controls the company already has in place and employing before assessing the effectiveness of these controls.

6) Assess and determine the response to residual risks that need to be mitigated

Risk-handling is conducted to reduce the impact of risk and the likelihood of it occurring. This process consists of modeling alternatives to deal with risks, assessing response options or handling, preparing risk management plans, and implementing them.

7) Documenting the Fraud Risk Assessment

The results of fraud risk assessment are documented using a fraud risk register table or a fraud risk assessment matrix.

8) Perform risk assessment regularly

Each company will experience certain changes and this means the vulnerabilities to fraud will also change. Therefore, companies need to conduct regular assessments to minimize the risk on a continuous basis.

B. Fraud Scenarios on the Goods Purchasing Cycle at PT X

In identifying fraud scenarios in the goods purchasing cycle of PT X, researchers collected and processed data obtained from interviews with the PT X management, company historical information, known fraud schemes, and interviews with people involved in the process. This produced 11 possible fraud scenarios in the company's goods purchasing cycle. The identified scenarios were classified based on the level of probability they would become reality and on the resulting impacts, which allowed them to be categorized into the various levels of risk set out in the following Table II.

The classification of schemes and fraud scenarios based on the risk rankings listed above can be used by companies in

setting priority controls and in prevention efforts. The higher the level of risk, the higher the priority it should receive. Management must pay attention to allocating the necessary resources to ensure the risks concerned take precedence. Conversely, the lower the risk, the fewer resources management should allocate.

TABLE II. FRAUD SCHEMES AND SCENARIOS AT PT X

Risk Ranking	Fraud Schemes and Scenarios
High	**Mark-up Billing Scheme** An employee marks up the value indicated on the invoice as well as the receipt for the purchase so that the amount of money the company pays on the purchase of the item is greater than the money paid to the supplier.
	Theft of Inventory and Equipment Theft of goods by taking some goods that have been purchased by the company for personal use or resale.
	Kickbacks Employees collude with suppliers to replace goods with a specification or quality that is lower than the specification or quality required/ordered by the company.
Medium	**Shell Company** Employees invoice for payments to fictitious companies that they themselves control by: - Creating a fictitious company - Creating fictitious invoices - Make fictitious purchases, and/or - Buying products through pass-through suppliers
	Bribery A supplier may provide undisclosed benefits to an employee in return for purchases.
	Overbilling and Kickbacks Employees receive kickbacks for buying goods above market value
	Conflicts of interest The employee purchases goods from a supplier that they may have a preferential relationship with, excluding other qualified applicants in the process.
	Insider trading Running a personal business within the company by acting as a supplier without authorization.
Low	**Billing for Personal Purchases** Add personal expenses into the purchase of company goods or make purchases of goods that companies do not need and use them for personal use.
	Cash Larceny The theft of money that should be paid to the supplier by way of delaying or taking payment money for personal gain.
	Purchasing and Receiving Changing the quantity of purchased goods so that it does not match the quantity required by the company. Employees ask for more material than is needed to complete the job and steal the excess.

After conducting a fraud risk assessment on the PT X goods purchasing cycle, the researcher formulated control proposals to address each of the risks identified. Based on the proposed controls summarized in the Fraud Risk Register table, the researcher assessed the possibility and the possible impact of fraud to PT X so that the risk ranking estimates after the implementation of control. Mapping of the company's fraud risks before and after the implementation of proposed controls is summarized in Fig. 1.
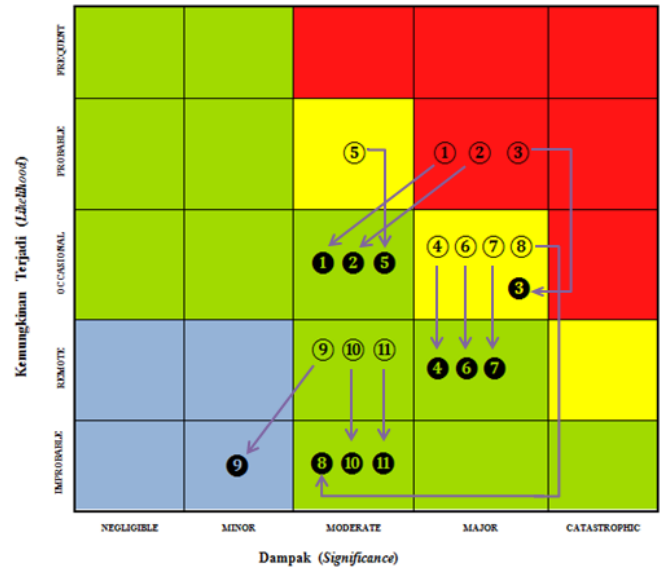
a. Sumber: Pengolahan Data dari Peneliti

Fig. 1. Fraud Scenario – Risk Mapping

C. *Anti-fraud Strategy on the Goods Purchasing Cycle at PT X*

In this research, the anti-fraud strategy designed to anticipate fraud at PT X was based on the twin pillars of fraud prevention and fraud detection.

1) *Prevention strategies that can be used by PT X are:*
  1. Increasing anti-fraud awareness through:

     a. Fraud Training for Employees

        All employees should be trained on the company's anti-fraud policy and culture. Employees should sign recognition statements, certifying that they have received training and that they understand the policies.

     b. Background checks on employees and prospective employees should be company policy. Background checks may include employee criminal records and/or credit ratings. Particular attention should be paid to key employees who have control or access to purchasing goods.

     c. Enhance awareness of the detection process

        One way to improve awareness of the process of fraud detection is by announcing to all stakeholders that supervision has been, is, and will be ongoing. Companies should ensure that supervision is done in such a way that people are

confident that the company will actually follow up on suspicious activities.

2. Fraud Risk Assessment

The head of each division should perform the process of identifying any possible opportunities for fraud, whether from systemic or individual employee behavior, and take the steps necessary to overcome the fraud (fraud risk response).

3. Code of Conduct

Companies need to document and apply a code of ethics as one of the key mechanisms for communicating with employees and to demonstrate the management's commitment to creating entity integrity (clear organizational structures, fraud-related policy formulation, etc.).

4. Tone at the Top

Honesty and integrity among the management will strengthen the honesty and integrity of employees throughout the organization. Through its actions and communications, the management can demonstrate that dishonest and unethical behavior will not be tolerated, even if the results might be seen to benefit the company. The successful implementation of a comprehensive anti-fraud strategy relies heavily on the direction and enthusiasm of the management to create a positive work environment and build anti- fraud awareness across the entire organization.

5. Establish a company's internal control system

The element of opportunity in the fraud triangle can be anticipated through internal controls. Improvements in the internal control system of PT X should include the following:

a. Adequate separation of duties and responsibilities

A common weakness in the control activities of small and medium enterprises is the lack of separation of duties. Resources tend to be limited to the extent that checks and balances are not followed. It may be difficult in practice but attempts should be made to ensure a separation in the authorizing, storing, and recording functions. In the case of PT X, the researcher recommends improvement in the organizational structure so as to minimize the likelihood and impact of fraud. This might include:

- The purchase function should be separate from the goods receiving function

- The purchase function should be separate from the payment function

- The purchase function should be separate from the accounting function

- The purchase function should be separate from the storage function

- The purchase function should be separate from the inventory recording function

- The receipt function should be separate from the goods storage function

- Purchase transactions should be carried out by the storage function, the purchasing function, the receipt of goods, the debt recorder, and other accounting functions

b. Adequate documentation and records

PT X must adopt adequate recording procedures. More than 50 percent of the demand for goods purchases is still made through oral requests to the purchasing function. Therefore, less than half of all purchasing requests are supported by requisition documents from the relevant divisions. In addition, Purchase Order documentation is only created when a supplier requires the document. Therefore, PT X should make the necessary corrections to ensure that every process in the buying cycle is recorded and documented correctly and consistently. Documents relating to the buying cycle should be numbered and controlled appropriately. Therefore, the researcher recommends improvement in the recording procedures, including:

- Each purchase request needs to be made in the form of a Purchase Request Form containing information on the quantity of goods and specifications of the desired item

- Any purchase request that has been approved must be accompanied by a Purchase Order document to the Supplier that:

  -Contains information regarding the description of goods, quantity, price, and date

  -Is reviewed and authorized by management

  -Is pre-numbered

  -Is recorded on the company's purchasing list

  -Is completely documented (including cancelled orders)

- The receipt function must be documented in the form of a Goods Receipt Report containing the following provisions:

  -It must cover all receipts of goods

  -It should contain a record of the amount of goods received on the basis of actual calculations

  -It should be pre-numbered

  -All details should be saved for every invoice, including cancelled orders

  -Copies should be sent to the Accounting department to be matched with Purchase Orders and invoices, as well as parts of the purchase as proof of receipt

  -Liability recording should be based on the Purchase Order document, the Goods Receipt Report, and the invoice from the supplier

c. Procedures for authorizing transactions and activities

All activities and transactions conducted by PT X should be carried out by the head of each division. Management and division heads may reduce the likelihood of fraud risk by reviewing purchase documents prior to authorizing any transaction. This procedure may include examining the company's requirements for the goods, checking the purchase budget, checking purchase support documents, etc. Therefore, the researcher recommends improvements in the authorization system, including:

- Purchase requisitions must be reviewed in advance by the relevant function head regarding the company's needs for the goods as well as checking the purchase budget and the supporting documents for the purchase

- Purchase requisition should be authorized by the head of division

- A Purchase Order should be authorized by purchasing function and manager

- A Goods Receipt Report should be authorized by the goods receiving function

    d. Physical control of assets

The company must compile a detailed inventory of its goods. PT X needs to separate ready-to-use items from high-value items. In addition, access should be limited to store rooms. At present, every PT X employee can access the goods storage area. This is extremely risky because it provides an opportunity to commit fraud.

    e. Anti-fraud Procedures and Policy

The management needs to communicate its anti-fraud policies to all employees as part of its new hire induction process. Companies need to confirm the procedures in the event of uncovering fraud, emphasizing the various sanctions that it will apply depending on the degree of the offense. This is a useful deterrent measure. If implemented, it will reduce the risk of fraud. Therefore, the researchers believe companies should apply this and other internal control practices, including:

- Purchase requisitions should be pre-numbered and their use must be monitored by the relative division

- Purchase Orders should be pre-numbered and their use must be monitored by the purchasing function

- Goods receiving Reports should be pre-numbered and their use must be accounted for by the goods receiving function

- Suppliers should be selected on the basis of competitive pricing from various suppliers

- Items should only be checked and received by the goods receipt function, which should compare these with a copy of the relevant Purchase Order from the purchase function

- The goods receiving function should inspect the goods received from the supplier by counting and inspecting the goods and comparing them with a copy of the Purchase Order

- There should be a check for conformity between the Purchase Order, the Goods Receiving Report, and the invoice from the supplier prior to payment of the invoice

- Cash disbursement with supporting documents should be stamped "paid off" by the finance department after payment has been sent to the supplier

The full recommendations are available in the final research paper.

2) Fraud detection strategies PT X might usefully adopt include:

1. Supervision
   Companies need to monitor areas where there is a high risk of theft, such as stores and loading bays. Supervision might entail the deployment of surveillance cameras and dedicated security personnel in key areas.
2. Independent inspection
   Performance checks should be conducted directly by the management through observation. Accounting functions in small and medium enterprises can help management to detect fraud. Random audits not only detect instances of fraud, they also act as a deterrent. The perpetrators will never know when an audit is due so they do not have a chance to cover up their fraud.
3. Whistleblowing
   Encouraging whistleblowing can be an effective way of detecting fraud. Employees who see something suspicious can inform the management using a hotline or a complaint box. Best practices in creating an anonymous complaint program include proper management involvement and the use of multiple communication methods (telephone, mail, email, etc.). These make the implementation of the program easy, strategic, and convenient for employees to bring their concerns to the management.
   The successful implementation of a comprehensive anti-fraud strategy relies on the direction and spirit of management to build an anti-fraud culture across the entire organization.

The strategies to prevent and detect fraud in PT X are shown in Fig. 2 below:
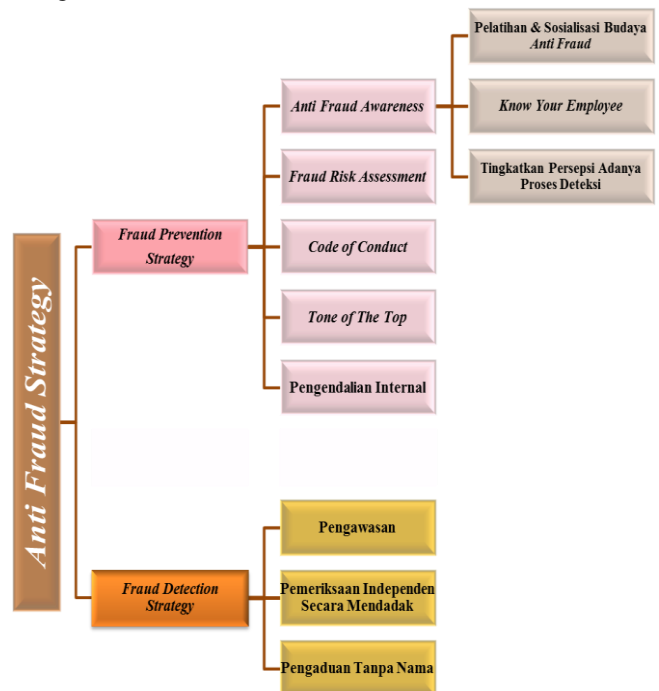
b. Source: Author

Fig. 2. Anti-Fraud Strategy at PT X

V. CONCLUSIONS AND RECOMMENDATIONS

A. Conclusions

Among the strategies that PT X might use to anticipate and mitigate fraudulent practices, it should apply fraud risk

assessment in accordance with the guidelines contained in the COSO Fraud Risk Management Guide [3]. Fraud risk assessment can help the management view the risks involved in various processes within the company and manage these. This may include setting priority controls and prevention efforts to anticipate such risks.

Based on the results of the assessment on the purchasing cycle of goods of PT X, there are three fraud scenarios that should be considered as high risk. At present, the company is particularly vulnerable to the following frauds:

1. The employee may mark up the value stated on the invoice so that the amount of money the company spends on the purchase of the item is greater than the money paid to the supplier (Mark-up Billing Scheme).

2. An employee may simply steal goods by taking items purchased by the company for personal use and resale (Theft of Inventory and Equipment Scheme)

3. Employees may collude with suppliers to replace goods with a specification or quality lower than the specification or quality required by the company (Kickback Scheme)

The anti-fraud strategy to anticipate fraud in PT X is based on the application of the twin pillars: prevention and detection. The successful implementation of an anti-fraud strategy depends on the direction and willingness of the management to engender an anti-fraud culture in all levels of the organization.

B. Recommendations

Suggestions for the management:

1. Increase anti-fraud awareness across the company and to external parties associated with the company.

2. Conduct periodic fraud risk assessment so as to anticipate ever-changing risks, which in turn will allow the company to set priority controls and appropriate prevention policies.

3. Document and implement policies that govern fraudulent behavior; the sanctions imposed; and how to report it.

4. Management should set an example to encourage ethical behavior throughout the company.

5. Establish adequate internal control systems, including improvements in the organizational structure, recording procedures, and corporate authorization systems.

6. Conduct supervision and inspections, as well as providing anonymous ways of reporting alleged violations of policies and fraud through a hotline or a complaints box handled directly by the management.

7. Since PT X does not have an internal audit function, the author recommends that it uses the recommendation contained in this research as a basis for introducing audit procedures and corporate standard operating procedures relative to the level of risk faced

Suggestions for future researchers:

1. Conduct fraud risk assessment on micro-enterprises that are engaged in other industries.

2. Design anti-fraud strategies by adapting or adopting relevant anti-fraud strategies used by other micro-enterprises

C. Limitation of The Study

This study attempts to apply the concept of the COSO Fraud Risk Management to SMEs which is still not commonly implemented in Indonesia. The authors acknowledge limitations in data collection and analysis of fraud risk in PT X.

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