THE IMPORTANCE OF CONTROL ENVIRONMENT AND ITS IMPLEMENTATION BY SELECTED MALAYSIAN PUBLIC UNIVERSITIES IN PREVENTING FRAUD

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ABSTRACT

This study intend to gain insights on selected public universities’ perceptions on control environment as fraud prevention tools and their implementation in the organization based on suggestion by Committee of Sponsoring Organization of the Treadway Commission (COSO), Internal Control Integrated Framework (1992).

The results reveal that both UUM and UNIMAP view highly on the importance of control environment in preventing fraud. Both teams of university’s management aware that the five components of the control environment need to be implement especially code of ethics. Unfortunately, this study found that lack of internal audit staff especially faced by UNIMAP lead to their inability to perform pro-active auditing which is part of monitoring components in control environment. The results of this study could assist management to impose better system fraud detection.

Keywords: Fraud prevention, control environment, ethics
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1.0 Introduction

The emergence of recent Port Klang Free Zone (PKFZ) fraud scandals has much debated in Malaysia. The huge amount of RM4.6 billion in the PKFZ not only involved the corporate entities but also engaged the government agencies including the Port Klang Authority and Ministries of Transport. Even though this case is still under investigation, public as the taxpayers are questioning the integrity of the public servant in managing the public fund. Follow the PKFZ scandals were the misused of fund by various government agencies released in the Auditor-General’s Report for 2008, which was tabled in Parliament on Oct 19. The report revealed weaknesses that had been highlighted in the previous year’s report were a continuing thorn in the side of proper financial management at every level of government. For example, Kolej Kemahiran Tinggi Mara Balik Pulau in Penang paid RM84,640 for two laptops or RM42,320 per laptop and spent RM2.08mil on computer software that was not used, among other things (The Star, 2009).

Fraud is defined as the intentional deception to cause a person to give up property or some lawful right (Webster’s New World Dictionary) while Albrecht, Albrecht and Albrecht (2006) defines fraud as a generic term, and embraces all the multifarious means which human ingenuity can devise, which are resorted to one individual, to get an advantage over another by false representations. There is no definite and invariable rule can be laid own as a general proposition in defining fraud and generally it includes surprise, trickery, cunning and unfair ways by which another is cheated.

There are three categories of fraud divided by Coffin (2003) namely asset misappropriation, corruption and fraudulent statement. Association Certified of Fraud Examiner (ACFE) identifies that assets misappropriation accounted for 80 percent of the fraud activities, while corruption accounted to 13 percent and fraudulent statement holds the least common form of fraud (Coffin, 2003). Corruption is pointed to be caused by
dishonesty individuals who give in to temptations when provided with opportunities to do so (Koon, 1998). The focal point of corruption is claims to be when opportunity meets with the inclination (Stapenhurst and Langseth, 1997).

The existence of weak internal control structures, lack of compliance, lack of internal controls, inadequate financial reporting, management style and lack of integrity, high level of related party transactions are among the others contributory factors of fraudulent activities occur in an organization (Rock and Severson, 1996). Some views that short term rewards, insufficiently vigilant culture, and advancement of technology are the added opportunities for fraud and abuse to occur (Steven, 2004). KPMG Fraud Survey in year 2004 reported that 56 percent of the fraud take place due to inadequate internal controls (KPMG Fraud Survey 2004 Report, 2005).

In a government scenario, accounting fraud is stated to inherent the feature of government (Dilorenzo, 2002). This is because there is no such thing as real accounting in government since there is no profit and loss accounting (Dilorenzo, 2002). Therefore, it is unknown whether what is being reported in the budgets of government agencies is adding value or destroying it (Dilorenzo, 2002). In relation to this, quotation from Tunku Abdul Aziz claims that public procurement is an area of business that is vulnerable to malpractice (Tunku Abdul Aziz – The Star, March 3, 2001). He emphasized that many governments and business leaders have recognized the high cost of bribery and extortion in procurement contract (Tunku Abdul Aziz – The Star, March 3, 2001).

Despite the apparent important of the control environment as an internal control component, little empirical research has been conducted to investigate the importance of the control environment in preventing fraud activities. Therefore, this research is conducted to determine the importance of control environment in preventing fraud and to know the extent of that organization implement the control environment. This study also focuses on all the elements of control environment as stated in Malaysian Approved Standards on Auditing (MASA). The focus on the elements of control environment include factors as the function of boards of directors, management philosophy and
operating style, entity organizational structure and methods of assigning authority and responsibility, management control system such as personnel policies and procedure (AI 400, Para 18, p1)

1.2 Significant Of The Study

Fraud imposed significant implications to governing bodies and private sectors. Incidence of fraud could cause companies and government a fortune. ACFE for example, estimated that the total fraud cost incurred by the United States’s organisation are more than $400 billion annually (Albrecht, 2003). On top of that, the increase of fraudulent activities would deteriorate investor’s confidence in a country. For example, the recent spate of accounting scandals in the United States such as Enron and WorldCom has given a strong financial effect to the country and not to mention the whole world. The staggering lost of public funds amounted to $70 billion damaged the public confidence on the authority (Morton, 2003). Therefore, it is important for a country as a whole to formulate a stringent rules and regulation to shield against any fraudulent events in order to restore investors confidence.

There are three parties would benefits from the outcome of the study. The regulators for example, would benefits in terms of improving their system in their organization. The outcome would input ideas for the regulators to perhaps revise on the present law and regulation in regards to penalties and sanction which will deter from perpetrating fraudulent activities. Perhaps in the future the authority would introduce training on the awareness of fraud. It is also hope that this study would show some light in introducing whistle blowers act to safeguard the interest of persons reported on the fraudulent activities.

As of the management, this study hopes to provide input to the management in terms of instilling awareness of the unhealthy behavior of employees in the workplace. Perhaps the findings would assist management to impose better system of fraud detection. Apart
from that, the management could also benefit the findings to instill ethical values and virtues among persons in positions of trust

In regards to the academician, this study hopes to highlight the importance of fraud research. The findings of the study could provide empirical verification on the issues of fraud in state and local government.

1.3 objective of the study

The main purpose of this study is to examine the importance of control environment for a government entity which public university and how does they implements the control environment in their organization as suggested by Committee of Sponsoring Organisation of the Treadway Commission, (COSO), Internal Control Integrated Framework (1992).

The objectives are formulated to answer the following questions:

1. Does environment in local government influence occurrence of fraud?
2. How does management prevent fraud from occurring in public university?

2.0 Problem Statement

Recently, there has been an increase in fraud cases in Malaysia in both the private and government sector. It has been reported that the fraudulent activities has rose from 9,117,759 in 2003 to 19,507,858 in year 2004 (Fiesal Libertus Abdullah – DSP, Deputy Head Criminal Department, Alor Star). A survey report reveals by KPMG recently, indicates that 82 percent of the respondents of the survey agreed that their organization had been affected by fraud. The survey also reported that 36 percent of the companies suffered fraud losses of more than RM10,000.

Few predicted that the rise in the fraudulent activities are due to the awareness of the menace in the business fraternity (Singh – NST, May 30, 2005). Fraud is also in the rise due to opportunity, pressure and rationalization that is also known as fraud triangle
The advancement of technology is viewed to be one of the factors in the raised of the opportunity for fraud. As said by Tun Dr Mahathir Mohamad, ‘the advent of the internet opens not only a lot of opportunity for trade but also immense possibilities for computer fraud and other negative elements’ (Singh – NST, May 30, 2005). It has also been reported that the most prevalent offence is criminal breach of trust (CBT) which accounted for the loss of RM468 million within the year 1995-1999. During the economic crisis period (1997-1998), the most obvious fraud noted are fraudulent transfer, disposal and sale of shares by broking agents without permission from owner (Singh – NST, May 30, 2005).

In fact, the new millennium has created big challenges to enforcement agencies whereby the act of fraud has become more sophisticated. Recent intelligence and experience revealed that these syndicates have even penetrated into government agencies. Cases such as EPF, Lembaga Tabung Haji, Ministries of Defence, PPRT, and Land Scam are the many cases occurred in government agencies recently (Fiesal Libertus Abdullah – DSP, Deputy Head Criminal Department, Alor Star -2005). Evidently, it has been stated that the loss incurred due to commercial crimes involving government agencies has increase from RM1,260.00 in the year 2003 to RM71,966.50 in the year 2004 (Fiesal Libertus Abdullah – DSP, Deputy Head Criminal Department, Alor Star -2005).

Despite the many efforts taken and the various laws introduce to combat fraud the continuing fraud related scandals still occur. For example, early this year, an ex-bank manager was charged with CBT totaling RM18.5 million of fixed deposits with Bumiputra Commerce Bank (The Star, June 21, 2005). Furthermore, the Umno vice-president Tan Sri Mohd Isa Abdul Samad was reported to have been suspended from the ruling party for six years for vote buying. He has been charged for misused his powers as Federal Territories Minster and involved in political corruption (Zubaidah Abu Bakar, NST- June 25, 2005). Previous hit case, is the Tabung Haji case which involved two of its managers. The managers were charged with criminal breach of trust and fraud amounted to RM200 million (Utusan Malaysia, May 21, 2003). Perwaja which is a big case happened in Malaysia involved corruption breach of trust amounted to RM76.4
million. The Perwaja case is the most longest case handled by Malaysian Anti Corruption Committtee (MACC) formerly known as Anti Corruption Agency (ACA) because it involves a foreign bank (Amree Ahmad - Massa, 2004).

Our former Prime Minister, Tun Mahathir has also expressed his concern in regards to the rising trend of corruption and misuse of power in the government sector (Star- 2005). He said that crime and misuse of power such as bad financial management are committed by educated and senior officers in the government and private sector (Star-2005). He stressed that the unethical behaviour of these culprit is becoming a culture which will worsen the corruption practices.

It is even troublesome to know that, out of one case reported there are about 10 unreported cases (Massa, 2003). Therefore, the frauds issue should not be taken lightly as it could increase the business cost up to 20 percents (Massa, 2003). In fact, fraud survey conducted by KPMG reveals that 59 percent of the respondents in the survey believe that fraud will become a problem in the future (Belkaoui and Picur, 2000; KPMG Fraud Survey 2004 Report, 2005).

Realizing the importance of this issues, this study is therefore conducted to examine the role of environment in relation to the government on preventing fraud. In light of the increasing of fraud level in the country, this study proposes to investigate the factors contributing to the fraudulent activities.

3.0 Literature Review

Previous studies

Many corporations unwittingly provide their employees to commit fraud due to various reasons such as lack of control, poor internal control system, lack of management policies and rules, lack of security, negligence, access power, collusion between personnel or third parties, management override of controls, afforded opportunities and failure to
monitor employee behavior. Many found that fraud occurs in organizations due to inadequate internal controls, especially control environment (Ziegenfuss, 2001). Lack of Internal control for example, would lead to a breakdown in management resulting in loss of confidence, unpleasantness and recriminations in human terms and inadequate commercial performance, loss of assets and legal action in company terms.

**Fraud in the corporate and government sector**

Holmes, Strawser and Welch (2000) conducted a study on fraud in government and private sectors. In this study, questionnaires were distributed to the 8000 active members of the Association Certified Fraud Examines (ACFE). The results shows that 611 reported cases of fraud were committed within a governmental unit and 1,860 described frauds in the private sector. Univariate and frequency statistics were employed to identify the characteristics that aid the detection and prevention of fraud. It reveals the characteristics perpetrators. The study found that the profiles of the perpetrator of fraud are middle-age, married male and college students. The study also reveals various methods used in fraud scheme and the detection and confirmation of fraud schemes.

Zigenfuss (1996) conducted a survey study on state and local governments in United States. The study was conducted to determine the amount and type of fraud occurring in state and local governments. He found that fraud is a significant problem for the governments. Based on the findings, misappropriation of funds and theft are the two major type of fraud identified in state and local government.

The study by Ziegenfuss (2001) examined fraud in local government by determining a local government’s control environment related to fraud incident. A survey approached was used where the questionnaires were distributed to the internal auditors employed in the local government. The study employed regression analysis. The results shows that counties encounter less fraud than cities, the strength of a local government’s ethical environment is negatively related to its incidence of fraud, local government size, follow-
up action by management to red flag and the presence of legal government policy with fraud are not statistically related to fraud.

Gavira (2002) studied on the effects of corruption and crime on firm performance. The study use a survey of private firms to assess the effects of corruption on the economic prospects of firms. The study found that levels of corruption and bureaucratic interferences are positively correlated at the firm level. The study also found that corruption and crime reduce firm competitiveness. Corruption and crimes reduce sales growth. The results show that, corruption is an obstacle of doing business. However, the study found that the 28% of the respondents reported that bribe payment are common in their line of business while 30% reported that at least one government official requested bribes.

**Internal Control**

Internal control has been defined by COSO (1992) report as a process effected by those charged with governance, management and other personnel that is designed to provide reasonable assurance to achieve the following objectives

i. effectiveness and efficiency of operations

ii. reliability and timelines of financial reporting

iii. prevention and detection of fraud and errors; and

iv. compliance with applicable law and regulations.

In order to achieve the four internal control objectives requires the presence of specific organizational control objectives and procedures relating to five interrelated components, namely control environment, risk assessment, monitoring, information and communication and control activities.
Control Environment

According to COSO (1992), the control environment sets the tone of an organization, influencing the control consciousness of its people. It is the foundation for all other components of internal control, providing discipline and structure’ (Zigenfuss, 2001). Factors that affect the control environment are namely; integrity, ethical values and competence of the entity’s people, commitment to competence, management’s philosophy and operating style, the way management assigns authority and responsibility, organize structure and human resource policies and practices (Messier and Boh, 2004). Four aspects are identified to measure the control environment that is integrity and ethical values, commitment to competence, management philosophy and operating style, organizational structure and human resource policies and practices (Arens et al., 2006).

However, lack of regulations could lead to various forms of deviant behaviour. Anomie theories explain that disorderly relation between an individual and social order due to the lack of regulation (Belkaoui and Picur, 2000). It has been claimed that anomie results in accounting related unwise activities such as corporate fraud, fraudulent reporting, white collar crime and audit failures (Belkaoui and Picur, 2000). Several surveys have been conducted to disclose the problems of fraudulent of financial reporting. Studies conducted by KPMG and Ernst & Young on the document fraud for profit organization for example, found that fraud occurs in organization due to inadequate internal controls, especially control environment (Ziegenfuss, 2001). The study conducted by Ernst & Young concludes that local government’s control environment is related to its incident of fraud (Ziegenfuss (2001). Study document fraud related to internal control conducted by Treadway Report implemented by COSO (1992) also found that fraud occurs in organizations because of inadequate internal control, especially in control environment, management attitude towards internal control and control procedures, lack of segregation of duties and independent checks.
Integrity and ethical values

Criminological studies found that poor corporate governance has been a crucial cause of high profile corporate failure due to senior managers and professionals by their failure to uphold high ethical standard which contribute to the detrimental culture, fraudulent behaviour, deceit, rule breaking, secrecy and violations of the laws (Fraud- Control and Law, 2005). This is supported by agency theory which suggests that due to financial pressure in their company, managers may engage in fraudulent activities such as financial statement fraud (Macey, 1991). Factors such as poor financial performance, threat to insolvency are amongst the factors that motivate managers to commit fraud (Saksena, 2001).

Commitment to competence

Competence is defined as the knowledge and skills necessary to accomplish task (Messier & Boh, 2004). Messier and Boh (2004) suggests that management must specify the competence level for job in order to retain competence and trustworthy employees. However, employee’s behaviour in an organization depends on the ethics code set by leader of that organization (Kouzes & Posner, 2008). Which means that in order to develop ethical leaders, management must be committed to recruit, select and promote leaders with core ethical values (Engelbrech, Aswegen and Tehron, 2004). It also viewed that training in ethical skills would results in ethical behaviour in order to build ethical organization (Engelbrech, et al., 2004).

Management philosophy and operating style

Messier and Boh (2004) pointed that management style may affect the quality of internal control. Messier and Boh (2004) identify three elements that constitute management philosophy and operating style which are management approach to take and monitor business risk, management attitudes and actions towards financial reporting and managements attitudes towards information processing and accounting functions and
personnel. Consequently, disregard for internal control work – culture, corporate attitude may results in the red flags (Fraud – Control and Law). In addition, it has been viewed that aristocratic management style and reckless disregard for facts are the other contributing factors lead to red flags (Fraud – Control and Law). Study conducted by Apostolou, Hassell, Webber and Sumners (2001) on 140 auditors rated the relative importance of 25 risk factors (red flag) identified in SAS No. 82 with potential management fraud. They found that management characteristics and influence over the control environment red flags were twice as important as operating and financial stability characteristics red flags and four times more important than the industry.

**Organisational structure**

Organisation structure are the guide use by management to delegate and monitor responsibility and authority of an organization (Messier & Boh, 2004). However, organizations structures are influence by size and nature of business. Vaughan (1983) claims that increase in decentralization and additional units increase opportunities for illegal activities. His statement was supported by Finney and Lesieur (1982) that structural controls has inverse affect with firm grows which resulting in violations. A study conducted by Geiger, Cooper and Boyle (2004) on Rhode Island state agencies on internal control weakness found that type of weaknesses identified were marginally significant with the size of organization (as measured by total operating budgets). Ziegenfuss (2001), who study the local government in the Virginia Tidewater area, however, found that local government size did not statistically significant related to fraud.

**Human resources policy and practices**

Quality of personnel operating the system reflects the quality of the internal control of an organization (Messier & Boh, 2004). A strong human resources policy would demonstrate a sound internal control. Evidently, it has been found that personnel related issue cause major errors in the accounting system (Wright & Ashton, 1989). The study found that about 55 percent of the errors detected by auditors resulted from personnel
problems, insufficient accounting knowledge and judgment errors. Supported by Buscaglia and Dijk (2003), it is found that high level of organized crime and corruption are linked to low levels of human development. Organized crime and corruption is claimed to prosper in an environment of bad governance (Buscaglia & Dijk, 2003). Empirical verification of the links between organized crime and its main economic, administrative, legal judicial and political causes has been research by Buscaglia and Dijk (2003). The links were identified through simple correlation analysis. The results of the study show that levels of organized crime and of corruption in the public sector are determined by the quality of core public state institutions. Ziegenfuss (2001) on the other hand, proved that legal department policy dealing with fraud is not significantly related to fraud.

4.0 METHODOLOGY

4.1 Interview

This study employs a semi-structured interview approach based on KPMG Fraud Survey (2006) and Ziegenfuss (2001). This approach is suitable since the researchers have developed the themes and at the same time allows flexibility to ask additional relevant and probing questions (Lyndlof and Taylor, 2002). However, some modifications were done to suit the objective of the study. Interviews were done with the head of internal audit department of UUM and UNIMAP. The researchers did not keep verbatim record however salient information are recorded for the purpose of discussion,

5.0 Results and discussion

Two in-depth interviews were conducted with the head of internal auditors of Universiti Utara Malaysia (UUM) and Universiti Malaysia Perlis (UNIMAP). Both higher learning institutions are distinctive in term of years of operation and geographical coverage. UUM is mainly administered in Sintok while UNIMAP has various locations for its faculties
and campus in Perlis. As such, UNIMAP would deem to have higher inherent risk due to lack of monitoring and communication. However, the head of internal audit of UNIMAP mentioned that frequent communication between the management and his department is a norm to alleviate inherent risk.

Both interviewees agreed that strong internal controls should be in place to prevent fraudulent acts. However, their routine jobs as internal auditor are relatively passive and from time to time received specific instructions or ad-hoc basis from the Vice Chancellor or the audit committee. Audit plan is properly defined in advanced and discussed between the head of internal auditor and his or her assistants. For instance in UUM, the head of internal audit has eight assistants and the head himself is at grade 52 meanwhile in UNIMAP has only four internal audit staffs and one clerk and the head is at grade 44. As such, UUM has a senior civil servant appointed as the head meanwhile UNIMAP internal audit department received some comments from the audit committee on the lack of manpower to cover overall UNIMAP operations that spans throughout Perlis.

The top management in UNIMAP stressed the importance of ethics among the staffs. From time to time, the Vice Chancellor would highlight ethical issues during weekly staff assembly or through e-mail circulated to all staffs. Among ethical issues highlighted by the vice chancellor was absenteeism and the particular person was heavily penalized after due process including counseling and show-cause letter. The head of internal audit disclosed that all academic and administrative staffs are aware code of ethics.

As human resource is undoubtfully the pinnacle of a leading university, thus strong hiring policy and procedures are a must. It is learnt that both institutions adopt adequate policies for screening potential staffs and vendors. For instance, potential staffs who have garnered some working experience will be screened via preliminary investigation of former employers. Similarly, potential vendors would be screened from previous track record. Critical position at Bursary department would receive stringent screening especially on background and previous employment as discussed earlier. In addition,
closed-circuit televisions (CCTV) would be installed at strategic places including the Bursary.

The head internal audit of UNIMAP employs risk management or risk-based audit approach especially of areas prone to inefficiencies and defaults such as new courses offered and of new buildings since UNIMAP is still developed in stages. In some way, it shows that internal audit of UNIMAP follows closely its corporate counterparts though the head himself is not a member of Institute of Internal Auditor who frequents the many seminars and conferences conducted in the heart of Kuala Lumpur or other major cities in Malaysia. Moreover, the head of internal audit had conducted several unchartered audit assignments including evaluation of construction in progress and then coming up with proper suggestions that mimics balanced reporting unlike the old days of internal auditors who are perceived as police or the common watchdog. However, he did mention that some recommendations turned to deaf ears.

Albrecht et al. (2006) suggests that culture of honesty, openness and assistance would prevent fraudulent acts. Interestingly, both institutions have proper channel to express dissatisfactions or recommendations such as Majlis Bersama Jabatan and thus would alleviate future unwanted repercussions.

In sum, results from both interviews offer several insights on the role of internal auditors and control environment to minimize fraud opportunities and also wastage and inefficiencies at public universities. Common logistics issues such as lack of manpower and a fully independent internal audit department are worth noted.
6.0 Conclusion

This study looks at the importance of control environment in reducing the risk of fraud in an organization especially for the government sector. Control environment is a primary component in the evaluation of control risk and thus, the reliability of the accounting system and internal control of the government sector will be tenuous if management’s integrity and ethical values are suspect. If the control environment is weak, the opportunity for fraud increases as fraud becomes easier to commit because detection of fraud is less likely (Marden, Sandra and Schneider, 1996).

Previous study has shown that fraud is basically caused by dishonest people who give in to temptations when there is an opportunity to do so. There must be combination of opportunity and the wish to commit the offense (Koon, 1998). However, Alatas (1990) pointed that, there are people with opportunities open to them, but do not wish to commit fraud. The best way in combating fraud is by reducing the fraud opportunity as experienced by UNIMAP. After three years of operation, by strengthening its internal control, UNIMAP managed to reduce the number of suspicious and excessive claims from vendors.

It is also learned that procedures, law, and enforcement should be clearly mentioned so that the employees can perform their task well. According to Omar (1990), law and enforcement alone are not sufficient answer to commercial crime and they should come together with ethics. Law and regulations impose demand from outside, while ethics should come from insight. Even though, the government agencies make provision for more severe punishments to be meted out for crimes such as fraud and forgeries, yet the penalties and sanction will not deter everyone from committing the crimes. From this study, all of the organizations were aware of good ethics and promoted to the staffs in several ways such as UUM and UNIMAP’s management used its customary staff’s assembly as means to uphold ethics.
Omar (1990) suggested the inculcation of ethics must be rooted in the home and throughout the learning process. Educational system can play its part by incorporating the appropriate ethical values in their curriculum such as honesty, responsibility, accountability and justice (Koon, 1990). The government agencies also can do their role by organizing talks and seminars on ethics for every level of employees in order to produce well balanced individuals for managing the organization.

Good control environment also concern with the human resources policies and procedures. The quality of internal control is a direct function of the personnel operating the system (Messier and Margaret, 2000). All organization in this study have sound personnel policies for hiring, training, evaluating, counseling, promoting, compensating and taking remedial action. As an example, in hiring an employee, they are seeking the most qualified person according to their educational background, prior work experience and evidence of integrity and ethical behavior if any.

The management’s philosophy and operating style is the most crucial components of the control environment and significantly affect the quality of internal control. The management of the government agencies has fulfilled their duties by establishing, maintaining and monitoring the agencies’ internal control. They also regularly discuss with the internal audit unit in maintaining the entity’s integrity and monitoring its risk.
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