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INTEGRITY AS A MODERATOR OF THE INFLUENCE OF THE INTERNAL CONTROL SYSTEM ON ACCOUNTING FRAUD

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Abstract:

Financial sector organizations like the Village Credit Institution (L.P.D.) in Bali are highly prone to accounting fraud. Despite their importance, fraudulent actions by L.P.D. managers are still every day. To reduce fraud, an effective internal control system is essential. Motivated by inconsistent results in previous studies, this research introduces individual integrity as a moderating variable. The study focuses on L.P.D.s in Badung Regency, using purposive sampling to select participants based on specific criteria. The criteria used as the basis for selecting sample members in this study were L.P.D.s with healthy and pretty healthy categories, totaling 71 L.P.D.s. Meanwhile, the respondents to the study in each L.P.D. were the Head of L.P.D., L.P.D. Treasurer and Credit Division, while the number of respondents was 213 research respondents. The data analysis technique in this study uses the structural equation modeling (S.E.M.) method based on partial least squares (P.L.S.). The statistical test results showed that the internal control system variable significantly negatively affects the tendency of accounting fraud. At the same time, the individual integrity level variable strengthens the influence of the internal control system on the tendency of accounting fraud.

Keywords: Internal Control System, Individual Integrity, Accounting Fraud Tendency

INTRODUCTION

The tendency of fraud, especially in the accounting world, has been the center of public attention until now. Fraud is an action carried out by one or more parties that results in another party suffering a loss while the perpetrator of the fraud gains benefits either directly or indirectly. Accounting fraud is dishonest or manipulative actions on an entity's financial records to mislead or deceive interested parties. The Indonesian Institute of Accountants (I.A.I.) explains accounting fraud as a misstatement arising from fraud in financial reporting and a misstatement arising from improper treatment of assets (often referred to as misuse or embezzlement). Accounting fraud can include various practices involving manipulation of financial data, violations of accounting ethics, or violations of laws related to financial reporting. According to Saputra (2015) and Putra and Latrini (2018), fraudulent actions can be in the form of eliminating amounts or disclosures in financial statements to deceive users of financial statements. Accounting fraud can have a severe impact not only on the company's finances but also on the trust of shareholders, investors, and other parties involved.

Organizations in the financial sector or financial institutions have the highest chance of accounting fraud. One example of a famous financial institution in Bali is the Village Credit Institution (L.P.D.). The Village Credit Institution (L.P.D.) is a financial institution owned by a traditional village that has developed and provided its citizens with social, economic and cultural benefits. The operational basis of the Village Credit Institution (L.P.D.) is based on the customary village awig-awig, which prioritizes family ties and cooperation between traditional village residents. Each traditional village is expected to have a Village Credit Institution (L.P.D.), which will



later collect funds from the community and channel them back to the community needing funds. The profits obtained by the Village Credit Institution (L.P.D.) can finance customary needs in the village.

According to Regional Regulation No. 3 of 2017 concerning Village Credit Institutions, the purpose of establishing a Village Credit Institution (L.P.D.) in each village is to support economic activities in rural areas through community activities by saving and providing credit for small businesses. L.P.D. also creates opportunities and equal employment for rural residents by working directly in L.P.D. In addition to supporting community activities, L.P.D. supports traditional village activities by providing development funds. Based on the description, it can be said that L.P.D. has a vital role for the Balinese people. Therefore, the management of L.P.D. depends on the system implemented by each L.P.D. according to the rules set. Ironically, however, there are still many fraudulent acts committed by managers who have been given the authority to manage Village Credit Institutions (L.P.D.). Several have indicated that there are indications of accounting fraud committed by individuals who harm financial institutions and other parties concerned. This study focuses on L.P.D. in Badung Regency because, based on data from the Village Credit Institution Empowerment Institution (L.P.L.P.D.) of Bali Province, it can be seen that Badung Regency is in the first place which is considered to have an unhealthy L.P.D. percentage of 10%, meaning that L.P.D. in Badung Regency has the most unhealthy L.P.D.s in Bali Province. The unhealthy nature of an L.P.D. is usually inseparable from the internal parties of the L.P.D., who abuse their authority to commit fraud and can harm other parties or financial institutions (Parmini et al., 2017).

Agency theory states a difference of interest between the principal (owner/shareholder) and agent (company management). In agency theory, it is assumed that a company's management knows more about its internal information than shareholders, so there will be a condition of information imbalance (information asymmetry) between managers and shareholders. This can cause agency conflicts where shareholders are interested in making a profit. At the same time, managers desire to obtain satisfaction through sizeable financial compensation. When associated with the L.P.D. financial institution, the company management is the L.P.D. management, while the shareholder is the customary village where the L.P.D. was established. This condition of information asymmetry opens up opportunities for accounting fraud. Such fraud can be minimized by implementing an effective internal control system. A sound internal control system is expected to reduce deviant behavior in the reporting system, including accounting fraud.

The internal control system is a set of policies and procedures to protect the company's assets or wealth from all forms of misuse, ensure the availability of accurate company accounting information, and ensure that all legal/statutory provisions (regulations) and management policies have been complied with or implemented correctly by all company employees (Hery, 2016, p. 159). The internal control system is carried out to monitor whether the company's operational and financial activities have been carried out by the procedures and policies set by management. A low internal control system and low employee compliance with internal control can trigger fraud. Meanwhile, a sound internal control system can reduce the opportunity for committing fraudulent accounting tendencies.

Previous studies that tested the effect of internal control system variables on fraud prevention have obtained mixed results. Research conducted by Dewi et al. (2017), Laksmi and Sujana (2019), and Dewi and Damayanthi (2019) found that the internal control system affects fraud prevention. An adequate internal control system in the control environment, risk assessment, control activities, information and communication and internal control monitoring can prevent fraud in village fund management (Laksmi & Sujana, 2019). These results are supported by research conducted by



Widiutami et al. (2017), which found that the effectiveness of internal control has a negative and significant effect on the tendency of accounting fraud. The same results were also obtained from research conducted by Parmini et al. (2017), which found a significant adverse effect between the internal control system and the tendency of accounting fraud. Likewise, research conducted by Putra et al. (2018) and Nitimiani and Suardika (2020) stated that internal control hurt the tendency of fraud. However, in contrast to research conducted by Rahmi and Helmayunita (2019) and Anggriani (2019), internal control did not significantly affect the tendency of accounting fraud. Likewise, research conducted by Atmadja and Saputra (2017) stated that the internal control system did not prevent accounting fraud.

The inconsistency of previous research results motivated the researcher to add a moderating variable to the research model. This study added a moderating variable because it was suspected that other variables influenced the relationship between the independent and dependent variables, either strengthening or weakening. Theoretically, the selection of a moderating variable in a relationship model is based on the idea that the independent variable does not influence the moderating variable. However, the moderating variable influences the dependent variable. The moderating variable in this study is the individual integrity level variable. The integrity level variable is added because it is based on the grand theory of fraud hexagon, which explains the six driving factors for the emergence of fraud: pressure, ability, opportunity, rationalization, ego, and collusion. Of the six driving factors, fraud can be prevented if the individual has integrity in their duties. Integrity requires a person to be honest and transparent, brave, wise and responsible. An organization needs to minimize fraud by increasing the integrity of each individual so that even though there is a wide-open opportunity to commit fraud, it will not be able to influence someone to cheat. With each individual's increasing level of integrity towards the organization, the effectiveness of internal control is also maintained so that fraudulent acts can be minimized.

Dewi et al. (2017) conducted a study on fraud prevention in villages in Buleleng Regency, where the results showed that integrity and organizational commitment were able to reduce accounting fraud. The results of this study stated that integrity requires a person to be honest, and organizational commitment is built on employee trust in organizational values in realizing organizational goals. Individuals' high integrity and organizational commitment can prevent fraud in every agency or organization. The various research results indicate that the results are not yet conclusive, thus encouraging further research.

Fraud Hexagon Theory. Fraud Hexagon Theory is the latest fraud theory proposed by Georgios L. Vousinas from the National Technical University of Athens, Athens, Greece, 2017 in his article entitled "Advancing theory of fraud: The S.C.O.R.E. Model." This theory is a development of previous fraud theories, namely the fraud triangle theory proposed by Cressey Donald (1953), the fraud diamond theory proposed by Wolfe & Hermanson (2004), and the fraud pentagon theory proposed by Marks (2012). Fraud Hexagon consists of six components, namely stimulus (pressure), capability (ability), collusion (collusion), opportunity (opportunity), rationalization (rationalization), and arrogance (ego). This theory has a difference in the names of the components used. Several components with different names in this theory have the same meaning as previous theories. The pressure component in this theory is called stimulus, which has the same meaning as pressure, as explained in the previous theory by Cressey Donald (1953), Wolfe & Hermanson (2004), and Marks (2011). Next is the ego component, which has the same meaning as arrogance, as Marks (2012) explained in the fraud pentagon theory. The component added to the fraud hexagon theory is the collusion component. According to Vousinas (2019), collusion is a collaboration carried out by several parties, either by a group of individuals with parties outside or between employees within



the organization. When collusive fraud occurs, honest employees will participate in the fraud due to the dishonest organizational environment. As a result, this dishonest environment will continue to grow and become an organizational culture that is difficult to eliminate. Vousinas also explains that someone with a persuasive personality will find it easier to invite their environment to commit fraud. Collusion can also be done by utilizing their abilities to take someone else's position.



Source: Vousinas' Fraud Hexagon (2019)

Figure 1. Fraud Hexagon Theory

Attribution Theory. This theory was developed by Fritz Heider (1958), quoted by Lubis (2017: 129), stating that a person's behavior is determined by a combination of internal forces, namely factors that come from within a person, such as business ability factors and external forces, namely factors that come from outside, such as difficulties in work or luck. Based on this, a person will be motivated to understand their environment and the causes of certain events. This theory is applied in behavioral research using the locus of control variable (Lubis, 2017, p. 129).

Hypothesis. The more adequate the internal control system in the control environment, risk assessment, control activities, information and communication and internal control monitoring, the more it can increase fraud prevention (Laksmi & Sujana, 2019). This statement is by research from Dewi et al. (2017), Widiutami et al. (2017), Padmini et al. (2017), Putra et al. (2018), Laksmi and Sujana (2019), Dewi and Damayanthi (2019), and Nitimiani and Suardika (2020) which states that the internal control system hurts the tendency of accounting fraud.

H1: The internal control system hurts the tendency of accounting fraud in Village Credit Institutions (L.P.D.) in Badung Regency.

The high level of integrity individuals possess can prevent fraud in every agency or organization because integrity requires a person to be honest, transparent, brave, wise and responsible (Dewi et al., 2017). By increasing the level of integrity of each individual towards the organization, the effectiveness of internal control is also maintained so that fraudulent acts can be minimized. Theoretically, the selection of moderating variables in a relationship model is based on the idea that moderating variables are not influenced by independent variables, but moderating variables affect dependent variables. Dewi et al. (2017) conducted a study on fraud prevention in villages in Buleleng Regency, where the results showed that integrity and organizational commitment were able to reduce accounting fraud.

H2: The level of individual integrity can moderate the influence of the internal control system on the tendency of accounting fraud in Village Credit Institutions (L.P.D.) in Badung Regency.

METHODS

This research was conducted at L.P.D. in Badung Regency, registered with the Village Credit Institution Empowerment Institution (L.P.L.P.D.) of Badung Regency. The population in this study were all L.P.D.s in Badung Regency. The sampling procedure was carried out in the study using the purposive sampling technique, namely the technique of determining samples with specific considerations (Sugiyono, 2016, p. 126). The criteria used as the basis for selecting sample members in this study were L.P.D.s with healthy and pretty healthy categories, totaling 71 L.P.D.s. Meanwhile, the respondents of the study in each L.P.D. were the Head of L.P.D., L.P.D. Treasurer and Credit Section, while the number of respondents was 213 research respondents. The data collection method used in this study was through distributing questionnaires. The data analysis technique in this study uses the structural equation modeling (S.E.M.) method based on partial least squares (P.L.S.).

Table 1. List of L.P.D.s in Badung Regency Healthy and Fairly Healthy Category

No	Nama LPD	No	Nama LPD
1	Seminyak	37	Sempidi
2	Tegal	38	Padangluwih
3	Padonan	39	Dalung
4	<u>Munggu</u>	40	Tandeg
5	Darmasaba	41	Kekeran
6	Penarungan	42	Sibang Gede
7	Blahkiuh	43	Sading
8	Mengwitani	44	Banjar Sayan
9	Jagapati	45	Gerih
10	Buduk	46	Lambing SK
11	Sedang	47	Dukuh Moncos
12	Kwanji	48	Tangeb
13	Kuwum	49	Angantaka
14	Kutaraga	50	Sembung Sobangan
15	Lukluk	51	Lambing M
16	Taman	52	Petang
17	Anggungan Mengwi	53	Pangsan
18	Selat	54	<u>Balangan</u>
19	Sembung	55	Baturning
20	Samu	56	<u>Punggul</u>
21	Pelaga	57	Cemagi
22	Kekeran Abiansemal	58	Samuan
23	Jempeng	59	Cengkok
24	Sigaran	60	Bindu
25	Cemenggon	61	Batulantang
26	Kerta	62	<u>Sidan</u>
27	Sandakan	63	<u>Sogsogan</u>
28	Angantiga	64	Perang
29	<u>Bon</u>	65	Pande



No	Nama LPD	No	Nama LPD
30	Belok	66	Jempanang
31	Lawak	67	Beringkit
32	Legian	68	Tinggan
33	Canggu	69	Sekarmukti
34	Mengwi	70	Tiyingan
35	Pererenan	71	Lipah
36	Sibang Kaja		

RESULT AND DISCUSSION

Table 2. Hypothesis Test Results

Influence Between Variables	Path coefficient	P-value	Direction of Hypothesis	Detail
X1->Y	-0.003	0.008	Significant negative	H ₁ Accepted
X1*X2->Y	-0.088	0.001	Strengthen	H ₂ Accepted

Sumber: Data processed (2024)

The Influence of Internal Control System on the Tendency of Accounting Fraud in Village Credit Institutions (L.P.D.) in Badung Regency. The statistical test results show that the internal control system has a negative and significant effect on the tendency of accounting fraud in Village Credit Institutions (L.P.D.) in Badung Regency. This is indicated by a significance value of 0.008, which is smaller than the specified level of significance ($\alpha = 0.05$) and has a path coefficient value of -0.003, so the first hypothesis is accepted. An effective internal control system is essential in reducing fraud, especially in financial institutions such as Village Credit Institutions (L.P.D.) in Badung Regency. The following explains how each dimension of the internal control system influences the tendency of fraud in L.P.D. in Badung Regency. The first dimension is the control environment, which includes policies, ethics, and organizational culture. When the control environment in L.P.D. in Badung Regency is robust, there are high values of integrity and commitment to good governance. This will reduce the likelihood of fraud because a robust control environment can reduce the space for dishonest practices. Next is the risk assessment dimension. A good risk assessment helps L.P.D. identify and manage potential risks that can lead to fraud. Risk assessment allows L.P.D. to detect vulnerable points where fraud may occur so that preventive measures can be taken immediately. By understanding the risks, L.P.D. can implement specific control measures to minimize the possibility of fraud, such as monitoring high-risk transactions or implementing regular audits. If the risk assessment is carried out correctly, the risk of fraud will be reduced, hurting the likelihood of fraud. The third dimension is control activities, such as segregation of duties, authorization, reconciliation, and access control, which are crucial in preventing fraud. By dividing responsibilities in financial management, no individual has full access to manipulate or commit fraud. These control activities significantly reduce the opportunity for fraud because each process is monitored and must go through tiered approvals. The fourth dimension is information and communication. A practical information and communication system ensures that relevant data is available on time for sound decision-making. Transparently distributed information throughout the organization ensures that all financial activities are known to the relevant parties, making fraud easier to detect. Open communication channels allow employees to report irregularities or fraud without fear, creating an environment where fraud cannot be covered up. When information and communication are



reasonable, any irregularities will be revealed more quickly, reducing the potential for fraud. The last is the monitoring dimension (Sanjayani et al., 2024). Good monitoring hurts the tendency of fraud because effective monitoring ensures that the internal controls that have been implemented are running well and as expected. Consistent monitoring allows any potential fraud to be prevented or detected before it reaches a more severe level.

The internal control system is essential in preventing and detecting fraud, including in the Village Credit Institution (L.P.D.). The negative and significant influence of the internal control system on the tendency of fraud means that the better the internal control system implemented, the smaller the tendency of fraud. A robust internal control system creates strict monitoring procedures, such as effective separation of duties and accounting controls. With apparent supervision, the opportunity for individuals to commit fraud will be reduced because they know their actions will be checked periodically. In addition, a sound internal control system has a mechanism to detect signs of fraud early on, for example, through effective internal audits, transparent financial reports, and routine monitoring. This early detection allows fraudulent acts to be prevented before they reach a larger scale. Of the five internal control indicators, each element plays a vital role in reducing the tendency of fraud in the Badung Regency L.P.D. With a robust control environment, careful risk assessment, practical control activities, transparent information, and continuous monitoring, the tendency of fraud will be significantly suppressed. Reasonable control creates a mechanism that narrows the gap for fraud, thus hurting the opportunity for fraud to occur in the L.P.D. The more adequate the internal control system in the control environment, risk assessment, control activities, information and communication and internal control monitoring, the more it can increase fraud prevention (Laksmi & Sujana, 2019). The results of this study are by previous studies by Dewi et al. (2017), Widiutami et al. (2017), Padmini et al. (2017), Putra et al. (2018), Laksmi and Sujana (2019), Dewi and Damayanthi (2019), and Nitimiani and Suardika (2020) which state that the internal control system hurts the tendency of accounting fraud.

Individual Integrity Level Moderates the Effect of Internal Control System on the Tendency of Accounting Fraud in Village Credit Institutions (L.P.D.) in Badung Regency. The statistical test results show that the level of individual integrity strengthens the negative influence of the internal control system on the tendency of accounting fraud in Village Credit Institutions (L.P.D.) in Badung Regency. This is indicated by a significance value of 0.001, which is smaller than the set significance level ($\alpha = 0.05$) and has a coefficient value of -0.088, so the second hypothesis is accepted. The level of individual integrity strengthens the negative influence of the internal control system on the tendency of accounting fraud in Village Credit Institutions (L.P.D.) in Badung Regency because individual integrity and internal control systems are two critical elements that support each other in maintaining good governance and preventing fraud. Individual integrity is the main foundation of ethical and honest behavior. Someone with high integrity tends to comply with the rules and internal control systems well, even if the control system is imperfect. Conversely, if an individual's integrity is low, they may find ways to circumvent or avoid internal controls, regardless of how tight the controls are.

Furthermore, a robust internal control system prevents fraud, but its effectiveness depends on the individual's intentions. If individuals within the L.P.D. have high integrity, the intention to commit fraud will be much smaller. An internal control system implemented in an environment where integrity is high will be more effective in preventing fraud because control and ethical values support each other. Individuals with high integrity tend to comply with applicable procedures and rules. In the context of the L.P.D., they will have more respect for the internal control system and implement it properly. Thus, the opportunity for manipulation or deception of the system becomes



much smaller. In addition, internal control systems often rely on formal supervision such as audits and reviews. However, individual integrity allows for self-monitoring. Individuals with high integrity will monitor themselves and their colleagues to ensure they work according to the rules and ethical standards.

The relationship between the internal control system and the level of individual integrity is a powerful combination of system and character. The internal control system is a formal mechanism to maintain order and transparency in the organization's operations. However, its effectiveness is greatly influenced by the character of the individual running the system. Integrity strengthens the negative influence of the control system on fraud because the combination of formal control and the character of honest and responsible individuals creates double protection against fraud. The level of individual integrity strengthens the negative influence of the internal control system on the tendency of accounting fraud in L.P.D.s in Badung Regency because integrity functions as a moral and ethical reinforcement that supports the control system's effectiveness. Individuals with high integrity will not only comply with internal controls but will also add layers of protection through ethical behavior, self-monitoring, and rejection of fraud. Therefore, combining individual integrity and reasonable internal control will significantly reduce fraud in financial institutions such as L.P.D.s. The high level of integrity individuals possess can prevent fraud in every agency or organization because integrity requires a person to be honest, transparent, brave, wise and responsible (Dewi et al., 2017). Integrity requires a person to be honest and transparent, brave, wise and responsible.

CONCLUSION

Based on the results of the analysis and discussion that have been carried out, it can be concluded that The internal control system has a negative and significant effect on the tendency of fraud in L.P.D.s in Badung Regency. This result means that the better the internal control system is implemented, the smaller the tendency for fraud. A robust internal control system creates strict monitoring procedures, such as separation of duties and adequate accounting controls. With apparent supervision, the opportunity for individuals to commit fraud will be reduced because they know their actions will be checked periodically.

The level of individual integrity strengthens the negative effect of the internal control system on the tendency of fraud in L.P.D.s in Badung Regency. This is because integrity is a moral and ethical reinforcement supporting the control system's effectiveness. Individuals with high integrity will not only comply with internal controls but will also add layers of protection through ethical behavior, self-monitoring, and rejection of fraud. Therefore, combining individual integrity and reasonable internal control will significantly reduce fraud in financial institutions such as L.P.D.s.

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