ECOSIA | International Conference
Institut Teknologi dan Bisnis Asia Malang
Indonesia, 10 December 2025

Internal Control, Internal Audit and the Prevention of Deviant Practices in Rural Banks: The Role of Corporate Governance

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Abstract

Introduction/Main Objectives: This study examines the effects of internal control and internal audit on the prevention of deviant practices in Rural Banks (Bank Perekonomian Rakyat/BPR) in Bengkulu Province, Indonesia, while assessing the role of Good Corporate Governance (GCG) within the governance framework.

Background Problems: Deviant practices remain a critical issue in rural banking institutions, raising questions about the effectiveness of internal control, internal audit, and governance mechanisms in preventing such practices and clarifying the mediating role of GCG.

Research Methods: A quantitative approach was employed. Data were collected through questionnaires distributed to 103 respondents consisting of management personnel and operational employees of BPRs. The data were analyzed using Structural Equation Modeling–Partial Least Squares (SEM-PLS).

Findings/Results: The results indicate that internal control and internal audit have positive and significant effects on the prevention of deviant practices. Both variables also significantly influence the implementation of Good Corporate Governance. However, GCG does not have a significant direct effect on the prevention of deviant practices and does not mediate the relationship between internal control, internal audit, and deviant practice prevention.

Conclusion: The study concludes that in rural banking institutions, the prevention of deviant practices is driven more by operational control and assurance mechanisms than by formal governance structures, highlighting limitations of GCG as a mediating mechanism in small-scale financial institutions.

Keywords: internal control; internal audit; corporate governance; deviant practices; rural banks.

Introduction

Rural Banks (Bank Perekonomian Rakyat/BPR) play a strategic role in promoting financial inclusion and supporting micro, small, and medium-sized enterprises (MSMEs), particularly in regions underserved by commercial banks. As financial intermediaries, BPRs mobilize public funds and channel them into productive credit, thereby contributing directly to local economic development. Despite their relatively small scale, BPRs face substantial operational and governance risks due to limited organizational resources, concentrated decision-making authority, and close relationships between management and customers.

In recent years, the Indonesian financial services authority has identified various cases of internal misconduct and operational irregularities in BPRs, including unauthorized credit approvals, manipulation of financial records, and misuse of customer funds. Such incidents demonstrate that deviant practices in rural banking institutions are not merely incidental but reflect systemic weaknesses in internal control, audit functions, and governance oversight. These conditions pose significant risks not only to financial stability but also to public trust, which is essential for the sustainability of rural banks.

Prior studies have emphasized the importance of internal control and internal audit as key mechanisms for preventing fraud and operational misconduct in financial institutions. Effective internal control systems limit opportunities for deviant behavior through segregation of duties, authorization procedures, and continuous monitoring, while internal audit functions provide independent assurance regarding compliance and control effectiveness. At the same time, Good Corporate Governance (GCG) has been promoted by regulators as a comprehensive framework to enhance accountability, transparency, and oversight in banking institutions, including BPRs.

However, empirical findings regarding the role of corporate governance in fraud prevention remain inconsistent. While several studies report a significant effect of GCG on reducing fraudulent behavior, others suggest that governance mechanisms may not directly influence operational misconduct, particularly in smaller financial institutions where governance structures are more formal than functional. Moreover, limited empirical evidence exists on whether corporate governance acts as an effective mediating mechanism between internal control, internal audit, and the prevention of deviant practices in rural banking contexts.

This study addresses this gap by empirically examining the relationships between internal control, internal audit, Good Corporate Governance, and the prevention of deviant practices in BPRs operating in Bengkulu Province. By applying a Structural Equation Modeling approach, this research aims to clarify whether governance mechanisms function as an operational conduit or merely as a strategic oversight framework in preventing deviant practices. The findings are expected to contribute to both governance theory and practical policy discussions on strengthening risk management and control systems in rural banking institutions.

Internal Control, Internal Audit, and the Prevention of Deviant Practices

Internal control refers to a systematic process designed to provide reasonable assurance regarding the achievement of organizational objectives related to operational effectiveness, reliability of financial reporting, and compliance with regulations. In banking institutions, internal control mechanisms are essential for limiting discretionary behavior, reducing information asymmetry, and minimizing opportunities for misconduct. Effective internal control systems emphasize segregation of duties, authorization procedures, documentation, and continuous monitoring, which collectively contribute to the prevention of deviant practices.

Internal audit complements internal control by providing independent assurance on the adequacy and effectiveness of control systems. Through audit planning, risk-based assessments, and follow-up of audit findings, internal auditors play a preventive role by identifying weaknesses before they escalate into material misconduct. In the context of rural banks, where organizational structures are relatively simple and decision-making authority is often concentrated, the role of internal audit becomes particularly critical in reinforcing operational discipline and compliance.

Prior empirical studies consistently report that strong internal control and effective internal audit functions are associated with lower levels of fraud and operational irregularities. Accordingly, this study posits that internal control and internal audit directly contribute to the prevention of deviant practices in Rural Banks.

Corporate Governance and Deviant Practice Prevention

Good Corporate Governance (GCG) represents a framework of principles and structures aimed at ensuring accountability, transparency, responsibility, independence, and fairness within organizations. In the banking sector, governance mechanisms—such as board oversight and supervisory functions—are expected to mitigate agency problems and align managerial behavior with organizational and stakeholder interests.

While several studies suggest that effective corporate governance can reduce the likelihood of fraud and misconduct, empirical findings remain mixed, particularly in small-scale financial institutions. In rural banks, governance structures are often formalized to comply with regulatory requirements, yet their influence on daily operational behavior may be limited. This condition raises questions regarding the extent to which corporate governance mechanisms can directly affect the prevention of deviant practices, as opposed to functioning primarily as strategic oversight tools.

Despite these inconsistencies, governance theory suggests that corporate governance should play a role in shaping organizational behavior by strengthening oversight and accountability. Therefore, this study examines whether Good Corporate Governance directly influences the prevention of deviant practices in rural banking institutions.

Research Hypotheses and Conceptual Framework

Drawing upon internal control theory, audit assurance literature, and corporate governance frameworks, this study proposes a research model in which internal control and internal audit influence the prevention of deviant practices both directly and indirectly through Good Corporate Governance. Internal control and internal audit are expected to strengthen governance mechanisms, which may enhance oversight and reduce opportunities for misconduct.

Based on this theoretical reasoning, the study hypothesizes that internal control and internal audit positively influence Good Corporate Governance, and that both mechanisms directly contribute to the prevention of deviant practices. Furthermore, Good Corporate Governance is examined as a potential mediating mechanism linking internal control and internal audit to the prevention of deviant practices. The conceptual framework reflecting these relationships forms the basis for the empirical analysis conducted using Structural Equation Modeling–Partial Least Squares (SEM-PLS).

Research Methods

Research Design

This study employs a quantitative research design using a survey approach to examine the relationships between internal control, internal audit, Good Corporate Governance, and the prevention of deviant practices in Rural Banks (Bank Perekonomian Rakyat/BPR) in Bengkulu Province, Indonesia. A cross-sectional design was applied, with data collected at a single point in time to capture respondents' perceptions regarding control, audit, governance, and deviant practice prevention within their institutions.

Population and Sample

The population of this study comprises management personnel and operational employees of BPRs operating in Bengkulu Province. Respondents were selected based on their involvement in operational processes, control activities, audit functions, or governance-related responsibilities. Using a purposive sampling technique, a total of **103 valid responses** were obtained and included in the analysis. This sample size is considered adequate for Partial Least Squares–Structural Equation Modeling (PLS-SEM), which is suitable for predictive analysis and models with relatively small samples.

Data Collection

Primary data were collected through structured questionnaires distributed directly to respondents. The questionnaire items were developed based on established literature and adapted to the context of rural banking. Responses were measured using a five-point Likert scale ranging from 1 ("strongly disagree") to 5 ("strongly agree"). To ensure clarity and relevance, the questionnaire was reviewed prior to distribution.

Measurement of Variables

Internal control was measured using indicators reflecting control environment, risk assessment, control activities, information and communication, and monitoring. Internal audit was measured through indicators capturing independence, competence, objectivity, and audit effectiveness. Good Corporate Governance was assessed based on principles of transparency, accountability, responsibility, independence, and fairness. The prevention of deviant practices was measured through indicators related to fraud prevention, compliance with procedures, and deterrence of misconduct.

All constructs were modeled as reflective variables in the PLS-SEM analysis.

Data Analysis Technique

Data analysis was conducted using Structural Equation Modeling–Partial Least Squares (SEM-PLS). The analysis followed a two-stage approach. First, the measurement model was evaluated by assessing indicator reliability, internal consistency reliability, convergent validity, and discriminant validity. Second, the structural model was assessed by examining path coefficients, coefficient of determination (R^2), and significance levels obtained through bootstrapping procedures.

SEM-PLS was selected due to its suitability for exploratory and predictive research, its robustness to non-normal data distributions, and its ability to handle complex models with relatively small sample sizes.

Results

Respondent Profile

A total of 103 valid questionnaires were collected and analyzed in this study. The respondents consisted of management personnel and operational employees of Rural Banks (BPR) in Bengkulu Province who were directly involved in operational activities, internal control processes, audit functions, or governance-related responsibilities. This composition ensured that respondents possessed adequate knowledge and experience relevant to the variables examined in this study.

Measurement Model Evaluation

The measurement model was evaluated to assess the reliability and validity of the constructs used in this study. Indicator reliability was examined through outer loading values, internal consistency reliability was assessed using Composite Reliability and Cronbach's Alpha, while convergent validity was evaluated using Average Variance Extracted (AVE).

The results indicate that all constructs achieved acceptable levels of reliability, with Composite Reliability values exceeding the recommended threshold of 0.70. Convergent validity was also confirmed, as the AVE values for all constructs were above the minimum criterion of 0.50. These findings suggest that the indicators adequately represent their respective latent constructs.

Discriminant validity was assessed to ensure that each construct was empirically distinct from the others. The evaluation results demonstrate that the constructs satisfy the discriminant validity criteria, indicating that each variable measures a unique concept within the research model.

Structural Model Evaluation

The structural model was evaluated by examining the coefficient of determination (R^2) and the path coefficients between constructs. The R^2 values indicate the model's explanatory power in predicting endogenous variables.

The results show that internal control and internal audit jointly explain a substantial proportion of variance in Good Corporate Governance. In addition, internal control, internal audit, and Good Corporate Governance collectively explain the variance in the prevention of deviant practices. These findings indicate that the proposed model demonstrates adequate predictive relevance in the context of rural banking institutions.

Hypothesis Testing

Hypothesis testing was conducted by analyzing the path coefficients and their significance levels obtained through the bootstrapping procedure. The results reveal that internal control has a positive and significant effect on Good Corporate Governance. Similarly, internal audit is found to have a positive and significant effect on Good Corporate Governance.

Furthermore, internal control and internal audit both exhibit positive and significant effects on the prevention of deviant practices. In contrast, Good Corporate Governance does not show a significant direct effect on the prevention of deviant practices. Additionally, the indirect effects indicate that Good Corporate Governance does not mediate the relationship between internal control, internal audit, and the prevention of deviant practices.

Overall, the results provide empirical support for the direct effects of internal control and internal audit, while the hypothesized mediating role of Good Corporate Governance is not supported.

Discussion

This study investigates the relationships between internal control, internal audit, Good Corporate Governance, and the prevention of deviant practices in Rural Banks (BPR) in Bengkulu Province. The discussion focuses on interpreting the empirical findings in light of existing theories and prior empirical studies, while considering the specific characteristics of rural banking institutions.

The results demonstrate that internal control has a positive and significant effect on the prevention of deviant practices. This finding confirms the central role of operational control mechanisms in limiting opportunities for misconduct within financial institutions. Effective internal control systems, characterized by segregation of duties, authorization procedures, and continuous monitoring, reduce discretionary behavior and enhance compliance with established procedures. In the context of BPRs, where organizational structures are relatively small and operational activities are closely interconnected, internal control serves as a primary line of defense against deviant practices.

Similarly, the findings indicate that internal audit significantly contributes to the prevention of deviant practices. This result highlights the importance of independent assurance functions in identifying control weaknesses and potential irregularities before they escalate into serious misconduct. Internal audit not only detects deviations from procedures but also reinforces a culture of accountability and compliance. This finding aligns with prior studies emphasizing the preventive role of internal audit in strengthening organizational integrity and reducing fraud risk.

The study also finds that internal control and internal audit have positive and significant effects on Good Corporate Governance. This suggests that effective operational control and assurance mechanisms support the implementation of governance principles by enhancing transparency, accountability, and oversight. In rural banking institutions, internal control and audit functions provide critical information and assurance that enable governance structures to function more effectively. These findings support the view that governance quality is, to a considerable extent, shaped by the strength of underlying control and audit mechanisms.

In contrast, the results show that Good Corporate Governance does not have a significant direct effect on the prevention of deviant practices. This finding diverges from several prior studies conducted in larger banking institutions and corporations, which report a significant governance–fraud prevention relationship. The difference may be explained by the contextual characteristics of rural banks, where governance mechanisms are often implemented as formal structures to meet regulatory requirements but may not directly influence day-to-day operational behavior. As a result, governance functions tend to operate at a strategic and oversight level rather than as instruments of operational control.

Furthermore, the study finds that Good Corporate Governance does not mediate the relationship between internal control, internal audit, and the prevention of deviant practices. This indicates that the influence of internal control and internal audit on deviant practice prevention is primarily direct and does not depend on governance mechanisms as an intervening pathway. In rural banks, the effectiveness of fraud prevention appears to be driven by the immediate application of control and audit processes rather than by governance structures that function as supervisory frameworks.

Taken together, these findings suggest that, within the context of rural banking institutions, operational control and assurance mechanisms play a more decisive role in preventing deviant practices than formal governance structures. While Good Corporate Governance remains important for ensuring accountability and strategic oversight, its role in directly influencing operational misconduct may be limited. This highlights the importance of contextualizing governance theories and recognizing that the effectiveness of governance mechanisms may vary across institutional settings and organizational scales.

Conclusion

This study examined the influence of internal control and internal audit on preventing deviant practices in Rural Banks (BPRs) in Bengkulu Province, within the framework of Good Corporate Governance (GCG). Using SEM-PLS analysis, the findings revealed that both internal control and internal audit have positive and significant effects on preventing misconduct. Operational control mechanisms and assurance functions effectively reduce opportunities for irregularities by reinforcing compliance and monitoring.

Furthermore, internal control and internal audit were found to positively strengthen the implementation of GCG. This indicates that governance quality in BPRs is supported by robust control and audit practices, which enhance transparency, accountability, and oversight. However, GCG itself does not have a significant direct effect on preventing deviant practices and does not mediate the relationship between internal control, internal audit, and fraud prevention.

The study concludes that fraud prevention in BPRs is primarily driven by the direct effectiveness of internal control systems and internal audit functions rather than by the formal implementation of governance structures. In this context, GCG serves more as a strategic and supervisory framework than as an operational mechanism for controlling daily behavior.

Theoretically, this research contributes to governance and internal control literature by showing that the effectiveness of governance mechanisms is context-dependent. In small-scale financial institutions such as BPRs, operational control and audit functions exert stronger influence on fraud prevention than formal governance frameworks. The absence of a mediating role for GCG highlights the need to distinguish between strategic oversight and operational control in governance theory.

Practically, the findings suggest that BPR management should prioritize strengthening internal control systems and enhancing internal audit functions in terms of independence, competence, and organizational support. While GCG remains essential for strategic accountability, it must be complemented by strong operational controls to achieve effective fraud prevention. Regulators and stakeholders are encouraged to balance formal governance compliance with substantive improvements in control and audit practices to reduce fraud risks meaningfully.

Acknowledgement

The author would like to express sincere gratitude to all parties who contributed to the completion of this study. Appreciation is extended to the management and employees of Rural Banks (Bank Perekonomian Rakyat) in Bengkulu Province for their cooperation and willingness to participate in this research. The author also thanks academic supervisors and colleagues for their valuable guidance, insights, and constructive feedback throughout the research process. Finally, appreciation is given to all individuals and institutions whose support made this study possible.

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