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Assessment of the Effectiveness of Internal Control Systems for Checking Financial Fraud in Commercial Banks in Akwa Ibom State

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Abstract

With an increase in accounting fraud in financial institutions in Nigeria, it becomes necessary to assess the efficacy of Internal Control Systems (ICS)to check for different kinds of fraud. Three broad categories of fraud are identified for the study. These are internal, external and mixed fraud. Three specific objectives, research questions and hypotheses were formed from the types of fraud identified. Specifically, the study examined if internal control systems do not significantly predict internal, external and mixed fraud. The survey design was used in the study with a sample size of 102 consisting of operations personnel of commercial banks operating in Uyo, Akwa Ibom State. The researchers made instrument was used for data collection. The study employed both primary and secondary sources of data. The primary data was accessed through questionnaire. The data was collected through administered questionnaires and were coded for analysis. The researcher personally administered the questionnaire to the respondents. On the spot filling and return was used. However, not all the questionnaires were retrieved after a period of two weeks. The data generated were analysed using descriptive statistics (frequencies, Mean and standard deviation) to answer the research questions while in testing the null hypotheses at .05 alpha level, the regression analysis was employed. The findings of the study indicate that internal control systems significantly predict internal, external and mixed fraud. Based on the findings, it was recommended that bank management should exhibit exemplary leadership and conducts that do not encourage fraudulent activities.

Key Words: *internal control system, financial fraud, financial institutions, accountants,*

Introduction

Internal control systems is perceived to have evolved in response to certain emerging fraud related cases in Nigeria . Notably, the scandals that recently rocked the financial industry in Nigeria, where bank executives are culpable in fraud related cases. The increasing sophistication of financial fraud according to Kennedy and Anyaduba (2013) requires that financial institutions add tools necessary to bring about the successful investigation and prosecution of those individuals involved in criminal activities., while also safeguarding financial operations and banks from fraud related cases. The best instrument used to check and guard against fraud is the internal control system. This has become the first line of action for most financial institutions battling financial fraud. Internal control systems (ICS) can be described as the whole system of control, financial and otherwise established by management

in order to carry on the business of the enterprises in an orderly and efficient manner. ICS as a system embedded in the organization, operating in the same environment as the fraud itself and serving as an effective, formidable adversary to the fraud scheme becomes a vital instrument and organ of the organization for checking frauds and safeguarding the organization. It involves the control environment and control procedure, all the policy and procedure adopted by the directors and management of an entity to assist in achieving their objectives, including adherence to internal policies, the safe-guarding of assets, the prevention and detection of fraud and error as well as the completeness and accuracy of records, with the timely preparation of reliable financial information (Benjamin, 2001).
The most widely used definition is that of the Committee of Sponsoring Organizations of the Treadway Commission (COSO,ICIF, 1994): a process, effected by an entity's board of directors, management, and other personnel, designed to provide reasonable assurance regarding the achievement of objectives in the
following categories: Effectiveness and efficiency of operations, reliability of financial reporting, compliance with applicable laws and regulations. (COSO, ICIF, 1994).

Fraud, on the other hand, can be defined as an act of deliberate deception with the aim of securing a personal benefit by taking advantages of other. Also, it could simply be put as the misappropriation, theft or embezzlement of corporate assets in a particular economic environment in the simplest thinking" it is also known as "stealing by tricks" (Achibong, 1993). It is the trusted and valued employee who generally commits business fraud. When frauds are discovered, there is often shock and disbelief that they could have committed such an act. The perpetrator of business fraud could be "the person next door." This person is likely to be a married male with a family, religious affiliation, and above average education (Russell and Norvig, 2003).

Internal control systems operate at different levels of effectiveness. Therefore, ascertain the effectiveness of an ICS will require an assessment of the five components of an ICS which includes Control Environment, Risk Assessment, Information and Communication, and Monitoring should ensure that they are present and functioning well. Effective controls provide reasonable assurance regarding the accomplishment of established objectives (COSO, 2013) Financial problems experienced in recent times have demonstrated that in some organizations mostly in financial institutions, risk-management and internal control practices were ineffective in checking fraud. Fraudsters generally identifies the loopholes in the control procedures (weak internal controls) and then they compare the rewards of fraud perpetration against the risk or penalties if they are apprehended (Khanna and Arora, 2009). Many employees in bank or financial institutions have taken advantage of weak internal controls to commit fraud. Weak internal controls have contributed to large losses for some banks and failures of others arising from fraudulent activities (Hartman, 2014).

The EFCC Act (2004) attempts to capture the variety of economic and financial crimes found either within or outside the organization. The salient issues in EFCC Act (2004) definition include "violent, criminal and illicit activities committed with the objective of earning wealth illegally… in a manner that violates existing legislation… and these include any form of fraud, narcotic drug, trafficking, money laundering, embezzlement, bribery, looting and any form of corrupt malpractices and child labour, illegal oil bunkering and illegal mining, tax evasion, foreign exchange malpractice including counterfeiting, currency, theft of intellectual property and piracy, open market abuse, dumping of toxic waste and prohibited goods, etc. This definition is all-embracing and conceivably includes financial crimes in corporate organization and those discussed by provision authors (William, 2005 and Khan, 2005).

There are different ways of which authorities have classified fraud depending on their perspectives and the criteria used. Karwai (2002) and Ajie and Ezi (2000) are of the view that financial fraud in organizations vary widely in nature, character and method of operation in general. Fraud may be classified into two broad ways: nature of fraudsters and method employed in carrying out the fraud. On the basis of the nature of the fraudsters, fraud may be categorized into three groups, namely; internal, external and mixed frauds. Internal fraud relates to those committed by members of staff and directors of the organizations while external fraud is committed by persons not connected with the organization and mixed fraud involves outsiders colluding with the staff and directors of the organization. Karwai (2002) reported that the identification of the causes of fraud is very difficult. He stated that modern day organizations frauds usually involve a complex web of conspiracy and deception that often mask the actual cause.

Internal Frauds are not only the most frequent occurring, but by far the highest in terms of number than the type involving both staff and outsiders (NDIC, 2005).There are three types of fraud committed wholly by persons and organization external to the bank that is, people and organizations other than or without the involvement of the bank staff, persons such as these could be bank customers or those who do not do business with these banks such as; over invoicing; Advance fee fraud; and Loan fraud (Omachonu, and Ndulor 1998; Idowu, 2009). Mixed frauds are cases of fraud that occur when bank staff connive with clients or outsiders to defraud the bank. Quite often, according to NDIC, (2005), signature of customers are forged by non-customers with the active connivance of staff who in most cases provide the specimen signature cards, where forgeries are not perfected, arrangements are made with staff to beat the signature verification process.

Statement of the Problem

It is essential for financial institutions in Nigeria to have a robust internal audit department to ensure that accounting systems provide an efficient means of recording and reporting financial transactions, providing management information and protecting the company's asset from fraud and misappropriation (Achibong,1993). Failure to have functional and up-to-date ICS could lead to undetected fraud cases and by extension, leakages in the system that could be detrimental to financial productivity as well as the image of the financial institution. The cost of fraud to a business is difficult to estimate, this is because not all fraud cases are discovered, not all uncovered fraud is reported. More so, civil or criminal action is not always pursued. Therefore, the main thrust of this study is to examine whether the internal control systems in banking sector in Nigeria is effective in fraud detection or not.

Research Questions

The following research questions were stated to guide the study:

1. How effective are internal control systems (ICS) in detecting internal fraud?
2. How effective are internal control systems (ICS) in detecting external fraud?
3. How effective are internal control systems (ICS) in detecting mixed fraud?

Methodology

This study was carried out in Uyo metropolis of Akwa Ibom State. A descriptive survey design was employed for the study. The population of the study comprised 189 operational personnel of commercial banks operating in Uyo, Akwa Ibom State. The simple random sampling technique was employed in the s sample to select a sample size of 102, consisting of operations personnel of commercial banks operating in Uyo, Akwa Ibom State. The researcher made instrument was used for data collection. The study employed both primary and secondary sources of data. The primary data was accessed through personal interviews, observation and questionnaire. The secondary data was accessed through review of relevant literature for the study. The data was collected through administered questionnaires and were coded for analysis. The researcher personally administered the questionnaire to the respondents. On the spot filling and return was used. However, not all the questionnaires were retrieved after a period of two weeks. The data generated were analysed using descriptive statistics (frequencies, Mean and standard deviation) to answer the research questions while in testing the null hypotheses at .05 alpha level, the regression analysis was employed.

Presentation of Findings

Research Question 1: how effective are internal control systems (ICS) in detecting internal fraud?

Table 1: Mean and Standard Deviation Scores on effectiveness of ICS in detecting Internal Fraud

S/N	***How well do ICS check for the following activities***	**N**	*ess of IC* **Mean** $\bar{x}$	**Std dev**	**Remarks**
1	Unofficial borrowing	102	3.52	0.95	VGE
2	Over invoicing	102	3.93	0.36	VGE
3	Unauthorized stamps	102	3.62	0.80	VGE
4	Fictitious transactions	102	3.13	0.87	GE
5	Committing	102	3.87	0.39	VGE
6	Fraudulent use of document	102	3.25	1.23	GE
7	Cash on hand converted to personal use	102	3.95	0.29	VGE
8	Premature writing off of assets	102	3.97	0.18	VGE
9	Ghost workers	102	3.80	0.40	VGE
10	Figures falsification	102	3.98	1.10	VGE
11	**Grand Mean**	102	3.60	0.66	VGE

GE- Great Extent, VGE: Very Great Extent

Table 1 show the summary of the item analysis of the effectiveness is ICS in detecting internal fraud. The result shows that all the items have Mean responses above 3.0, the cut-off Mean, indicating that the respondents had positive view of ICS in detecting internal fraud. The Grand Mean of the total set gives a value of 3.60; this means that ICS are effective in detecting internal fraud to a very great extent.

Research Question 2: How effective are internal control systems (ICS) in detecting external fraud?

Table 2: Mean and Standard Deviation Scores on effectiveness of ICS in detecting External Fraud

S/N	*How well do ICS check for the following activities*	N	*ess of IC.* Mean $\bar{x}$	Std dev	Remarks
1	Over invoicing	102	3.72	0.55	VGE
2	Advance fee fraud	102	3.73	0.26	VGE
3	Loan fraud	102	3.72	0.80	VGE
4	**Grand Mean**	**102**	**3.72**		**VGE**

VGE: Very Great Extent

Table 2 shows the summary of the item analysis of the effectiveness is ICS in detecting external fraud. The result shows that all the items have Mean responses above 3.0, the cut-off Mean, indicating that the respondents had positive view of ICS in detecting external fraud. The Grand Mean of the total set gives a value of 3.72; this means that ICS are effective in detecting external fraud to a very great extent.

Research Question 3: how effective are internal control systems (ICS) in detecting mixed fraud?

Table 2: Mean and Standard Deviation Scores on effectiveness of ICS in detecting mixed Fraud

S/N	*How well do ICS check for the following activities*	N	*ess of IC.* Mean $\bar{x}$	Std dev	Remarks
1	Concealing inadequate business operation performances	102	3.00	1.09	GE
2	Concealing prohibited business activities	102	3.78	0.42	VGE
3	Management fraud	102	3.00	1.09	GE
4	Employee Fraud	102	3.83	0.38	VGE
5	Employee/customer Fraud	102	3.22	0.87	GE
6	Computer fraud	102	3.98	1.13	VGE
7	Counterfeit securities	102	3.38	0.90	GE
8	**Grand Mean**	**102**	**3.31**		**GE**

GE- Great Extent, VGE: Very Great Extent

Table 3 shows the summary of the item analysis of the effectiveness is ICS in detecting mixed fraud. The result shows that all the items have Mean responses above 3.0, the cut-off Mean, indicating that the respondents had positive view of ICS in detecting mixed fraud. The Grand Mean of the total set gives a value of 3.31; this means that ICS are effective in detecting mixed fraud to a great extent.

Null Hypotheses

H_{o1}: internal control systems do not significantly predict internal fraud
H_1: internal control systems significantly predict internal fraud

Table 4: Regression test for how ICS predict internal fraud

Model		Sum of Squares	df	Mean Square	Fcal	Fcrit.	Decision
1	Regression	105.540	1	105.540	4.22	3.984	Reject Ho
	Residual	684.163	66	25			
	Total	789.703	67				

r=0.66, R^2=0.34, @=.05

Table 4 shows the summary of the regression table for the significant test of how ICS Predict internal fraud control. The result shows that the calculated F-vale is 4.22. At 1 and 66 degree of freedom and .05 alpha level, the critical f-value is 3.984. Since the Fcal is greater than the fcrit, the null hypothesis is rejected. Thus, internal control systems significantly predict internal fraud. The coefficient of determination value (R^2) gives a value of 0.34, indicating that the only 34% of changes in internal fraud is traceable to ICS.

H_{o2}: internal control systems do not significantly predict external fraud
H_2: internal control systems significantly predict external fraud

Table 5: Regression test for how ICS Predict external fraud control

Model		Sum of Squares	df	Mean Square	Fcal	Fcrit.	Decision
1	Regression	194.142	1	194.142	9.71	3.984	Reject Ho
	Residual	595.561	66	20			
	Total	789.703	67				

r=0.557, R^2=0.311, @=.05

Table 5 shows the summary of the regression table for the significant test of how ICS Predict external fraud control. The result shows that the calculated F-vale is 9.71. At 1 and 66 degree of freedom and .05 alpha level, the critical f-value is 3.984. Since the Fcal is greater than the fcrit, the null hypothesis is rejected. Thus, internal control systems significantly predict external fraud control. The coefficient of determination value (R^2) gives a value of 0.311, indicating that the only 31.1% of changes in external fraud is traceable to ICS.

H_{o3}: internal control systems do not significantly predict mixed fraud
H_3: internal control systems significantly predict mixed fraud

Table 6: Regression test for how ICS Predict mixed fraud control

Model		Sum of Squares	df	Mean Square	Fcal	Fcrit	Decision
1	Regression	29.750	1	29.750	5.95	3.984	Reject Ho
	Residual	759.953	66	5			
	Total	789.703	67				

r= -0.194, R^2=0.18, @=.05

Table 6 shows the summary of the regression table for the significant test of how ICS Predict mixed fraud control. The result shows that the calculated F-vale is 5.95. At 1 and 66 degree of freedom and .05 alpha level, the critical f-value is 3.984. Since the Fcal is greater than the fcrit, the null hypothesis is rejected. Thus, internal control systems significantly predict mixed fraud control. The coefficient of determination value (R^2) gives a value of 0.18, indicating that the only 18% of changes in mixed fraud is traceable to ICS.

Discussion of Findings

Internal Control Systems and internal Fraud Control

The findings of the study reveal that the respondents had positive view of ICS in detecting internal fraud. The Grand Mean of the total set gives a value of 3.60; this means that ICS are effective in detecting internal fraud to a very great extent. The corresponding hypothesis test reveals that internal control systems significantly predict internal fraud control. The coefficient of determination value (R^2) gives a value of 0.34, indicating that the only 34% of changes in internal fraud is traceable to ICS.

There are different ways of which authorities have classified fraud depending on their perspectives and the criteria used. Internal frauds are fraud committed among the member staff of the bank. According to NDIC, (2005), internal Frauds are not only the most frequent occurring, but by far the highest in terms of number than the type involving both staff and outsiders. This findings is in line with Ali (2013), financial problems experienced in recent time have demonstrated that in some organizations mostly in financial institutions, risk-management and internal control practices were ineffective or imperfect. According to the reports on the interview carried on the management leaders of businesses in various organizations it was realized that majority of them did not understand the internal risks they were exposed to.

Internal Control Systems and External Fraud Control

The result of the analysis shows that all the items have Mean responses above 3.0, the cut-off Mean, indicating that the respondents had positive view of ICS in detecting external fraud. The Grand Mean of the total set gives a value of 3.72; this means that ICS are effective in detecting external fraud to a very great extent. The hypothesis indicates that internal control systems significantly predict external fraud control. The coefficient of determination value (R^2) gives a value of 0.311, indicating that the only 31.1% of changes in external fraud is traceable to ICS. External Fraud are three types of fraud committed wholly by persons and organization external to the bank that is, people and organizations other than or without the involvement of the bank staff, persons such as these could be bank customers or those who do not do business with these banks such as; over invoicing; advanced fee fraud and Loan fraud. This findings is corroborated by Omachonu, and Ndulor (1998) which found that generally, advance fee fraud is perpetrated in the following ways: - Schemes ostensibly for the disbursement of money for mills; Contract frauds; Purchase of real estates and Transfer of funds.

Internal Control Systems and Mixed Fraud Control

Findings of the study shows that Grand Mean of the total set gives a value of 3.31; this means that ICS are effective in detecting mixed fraud to a great extent. The hypothesis shows that internal control systems significantly predict mixed fraud control. The coefficient of determination value (R^2) gives a value of 0.18, indicating that the only 18% of changes in mixed fraud is traceable to ICS. Mixed Fraud occurs when bank staff collude with outsiders (clients) to defraud the bank. Management Fraud essentially refers to frauds committed by bank employees in top echelon that is, top management level staffs that are aimed largely at deceiving the shareholders and to a considerable extent, auditors and the regulatory authorities through deliberate presentation of false financial statement – the key device of perpetration. Employee fraud refers to fraud committed by employees below management position. As distinguished from management fraud, employee fraud does not involve alternations or misrepresentation of financial statements or information but the outright misappropriation of assets of the bank or the alternation of individual instruments such as cheques, drafts, for their personal advantages.

This findings is line with Tunji (2013), which found that previously many organizations focused on financial reporting controls until many more financial crises arose. These crises showed that many, of the risks that affected organizations were from other areas other than financial reporting including operations and external circumstances. Therefore, risk management and related ICS need to include a wider perspective, considering that organizations are affected by internal and external variables, some variables from the external environment are beyond the control of the organization. Therefore effective risk management and internal control should be an important part of responsibility of management at every level of an organization and across all operations to reduce risks

Conclusion

The cost of fraud to a business is difficult to estimate because not all fraud and abuse is discovered, not all uncovered fraud is reported, and civil or criminal action is not always pursued. From the analysis of data and results of the study, it is concluded that ICS are effective in checking internal, external and mixed fraud to a great extent. Related to the above is the fact that fraud will be difficult to eradicate completely.

Recommendation

Based on the findings of the study, the following recommendations are made

1. Adequate remuneration and motivation- Banks should strive to remunerate their workers adequately to enable them to meet their basic needs, ensuring that they pay competitive salaries. This should serve as appropriate motivator, alongside other welfare issues such as promotion, giving staffers a sense of belonging so as to prevent segregation or alienation.
2. Exemplary leadership- Bank's management should exhibit exemplary leadership and conducts that do not encourage fraudulent activities.
3. Source documents and authorization for all entries -Ensuring that all entry besides being adequately supported by source documents must be appropriately authorized and approved by different staff before being posted into the day's transactions.

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