Evaluating Internal Control System as Preventive Measure of Fraud in the Nigerian Banking Sector

Author's Details

[1] **AJALA Oladayo Ayorinde-**Department of Management and Accounting,Ladoke Akintola University of Technology, Ogbomoso[2] **AMUDA Toyin-**Department of Management and Accounting,Ladoke Akintola University of Technology, Ogbomoso [3] **ARULOGUN Leye-**Department of Management and Accounting,Ladoke Akintola University of Technology, Ogbomoso

ABSTRACT

This study evaluated Internal Control System as preventive measure of fraud in the Nigerian banking sector. The objective was to identity whether this has actually achieved the desired result for which it was purposed, especially, in the popular Nigerian banks. To this end, the study was carried out by purposely collecting data from five Nigerian Commercial banks. The data were collected from bank audited and published financial statements and were analyzed with the use of Product Moment Correlation Coefficient and regression analysis. The findings revealed that Internal Control System has significantly prevented and curbed frauds in Nigerian banks. That bad corporate governance was responsible for proper designing of Internal Control System and that Internal Control System has led to increase in the corporate performance of Nigerian banks. Based on the findings, it was recommended that the management of every bank should create and establish a standard Internal Control System, strong enough to stand against the wiles of fraud in order to promote continuity of operations and to ensure the liquidity or solvency and going concern concept of the banks.

Keywords: Internal Control System, Banks, Fraud, Corporate Governance, Corporate Performance.

INTRODUCTION

Banking institutions occupy a central position in the nations' financial system and are essential agents in the development process of the economy. By intermediating between the surplus and deficit spending units, banks increase the quantum of National Saving and investments and hence national output. By granting credits, banks create money, thus influencing the level of money supply which is an essential item in the growth of national income as it determines the level of economics activities in the country (Etuk, 2011).

Bank are central to the payment system by facilitating economic transactions between various national and international economic units and by so doing, encourage and promote trade, commercial and industry.

The banking sector plays a very significant role in the development of any economy (Adeyemo, 2012). Banks in most economies are the principal depositories of the public monetary savings, the nerve centre of the payment system, the vessel endowed with the ability of money creation and allocation of financial resource and conduct through which monetary and credit policies are implemented (Idolor,2010 and Akindele, 2011). The success of monetary policy, to a large extent, depends on the health of the banking institutions through which the policies are implemented (Adeyemo, 2012). Whatever problems which militate against the proper functioning of the banking sector will invariably have multiplier effect on the others sector of the economy. This is one of the reasons it is essential to quickly diagnose any factor which may hamper the smooth functioning of the banking sector and urgently address such issues.

However, for banks to be able to function effectively and contribute meaningfully to the development of a country the industry must be stable, save and bound. And for these conditions to be obtained there must be a sound accounting system which is occasioned by an Internal Control System. In view of the economic growth in companies' size and complexities proper management of modern business understandings is not possible unless the have an effective system of internal control.

A system of effective internal control is a critical component of bank management and a foundation for the safe and bound operation of banking organization (Andrew, 2008). A system of strong internal controls can help to ensure tat the goals and objectives of a banking organization will be met, that the bank will achieve long term protitability targets and maintain reliable financial and managerial reporting. Such a system can also help to ensure that the bank will comply with laws and regulations as well as policies, plans, internal rules and procedures and decrease the right of unexpected losses or damage to the Bank's reputation.

The need for the internal control system in the organizations, especially banks cannot be undermined, due to the fact that the banking sector, which has a crucial role to play in the economics development of a nation, is now being characterized by macro economic

instability, slow growth in real economics activities, corruption and the risk of fraud.

There are two essential components of an internal. Internal control system namely; prevent controls (these are controls that prevent errors) and detect controls (these control that detect error and fraud which have occurred).

Internal Control System therefore is an essential pre-requisite for an efficient and effective management of any organization including banks, which is the main focus of this study. .

Statement of the Problem

Internal control system is considered to the essential in accounting system as this will enhance the effectiveness and efficiency of the management of an enterprise. An effective and efficient internal control system ensures that all recorded transaction are; real properly valued, recorded, timely correctly classified, correctly summarized and correctly posted. However, whether of not internal control system has helped the management in having a bound accounting system, particularly in the areas of ‘prevent controls and defect control’ for which most organizations are facing remained debatable and controversial.

Therefore this study is aimed at verifying the conception that an effective and efficient internal control system is the best control measure for preventing and detecting fraud, especially in the banking sector.

In the light of the above the following research questions were raised.

i Does internal control system as a preventive measure has significantly curbed fraud in Nigeria banking sector?

ii Does bad corporate governance responsible for the use of internal control system in the Nigerian banking sector?

iii What are the effects of internal control system on the corporate performance of Nigeria banking sector?

The hypotheses that were tested in the course of this research are stated below as:

i. Internal control system as a preventive measure has not significantly curbed fraud in Nigerian banking sector
ii. Bad corporate governance is not responsible for the use of internal control system in the Nigerian banking sector
iii. Internal control system has significant effect on corporate performance of Nigerian banking sector.

LITERATURE REVIEW

The Nigerian Banking industry which is regulated by the central Bank of Nigeria is made up of; deposit money banks referred to as commercial banks, development finance institutions and other financial institutions which include: microfinance banks finance companies bureau de changes, discount houses and primary mortgage institutions.

By 1980s there was liberalization in the licensing of new banks in Nigeria and most of the banks were under capitalized with weak internal control in place. This led to the collapse of most of these to CBN (2005), as at the end of 2002 there were 90 licensed insured banks, 282 licensed primary mortgage institutions and six Development Finance Institutions.

In 2004, the CBN came out with a circular demanding that all commercial banks in the country must increase their capital Base to a minimum of N25 billion. This led to massive merger acquisition and consolidation in the banking industry. With improved capital base, the banks are expected to perform better and affect the real sector positively. Achebe (2008), the Nigerian banking industry grew stronger in 2007 as indicated b the various performance measures. The industry showed capacity to finance real sector activities with substantial credit flow to the core private sector with this the challenge to the internal control system became enormous. These have had salutary effects in the form of restoring confidence in the banking sector and reducing interest rate the death of credit to the real sector of the economy persisted.

Additionally, the competition in the industry and the increased application of Information and Communication Technology (ICT) has led to development of new banking products which are ICT based. This has resulted in a shift from cash based transactions and this improved the efficiency in fraud determination.

The Concept of Internal Control

The structure of modern banking system and the high expectation from the investors and society at large has called for a more tightened internal control system. Internal control has been various defined. According to Princeton (2008) internal control is a process effected b an organization structure, work and authority flours people and management information system, designed to help the organization accomplish specific goal or objective from the definition, the objective of any internal control should be directed towards the attainment of the organization objective.

An efficient internal control system involved a clear definition and separation of duties for various employers of groups within a company. The intent separating the duties is to protect against fraud, waste abuse and

mismanagement of resource. Effective internal control helps to assure the accuracy of reports to management and the various supervising bodies (in the case of banks). According to Asuquo (2005), internal control is made up of internal checks, internal audit, accounting controls and other forms of controls such as budgetary and physical control. The COSO framework defines internal control as a process, effected by an entity's board of directors, management and other personnel designed to provide reasonable assurance regarding the achievement of objective in the following categories; effectiveness and efficiency of operation, reliability of financial reporting and compliance with applicable laws and regulations.

Internal controls are polices procedures practices and organization structure implemented to provide reasonable assurance that an organization's business objectives will be achieved and undesired right events will be prevented or detected and corrected, based on either compliance or management initiated concern (Awe,2005).

From these definitions, it can be deduced that internal control comprises the plan of an organization and all of the coordinate methods and measures adopted within it, to safeguard its assets, check the accuracy and reliability of its accounting data, promote operational efficiency and encourage adherence to prescribed managerial policies. Internal control objectives are channeled towards ensuring adherence to managerial policies and achieving organizational goal in general.

Classification of Internal Control

ICAN (2006) categorized control into three major classifications.

Preventive controls: These are control that predict potential problem before they occur and make adjustments. They also prevent an error omission or malicious act from occurring. Examples of preventive controls include using well-designed documents to prevent errors, establishing suitable procedures for authorization of transactions. Employ only qualified personnel

Detective controls: These controls are designed to detect and report the occurrence of an omission, error or a malicious act. Examples of detective controls include duplicate checking of calculations. Periodic performance reporting with variance error message over tape labels Hash totals counter cheques post-due account reports.

Corrective controls: These control help to minimize the impact of a threat, identify the cause of a problem, correct errors arising from the problem. They also correct problems discovered by detective controls and modify the processing system(s) to minimize future occurrence of the problem. Examples of corrective controls are: contigency planning, back up procedures, rerun procedures.

A system of effective internal control is a critical component of bank management and a foundation for the safe and sound operation of banking organizations. A system of strong internal control can help to ensure that goals and objectives of a banking organization will be met, that the bank will achieve long term profitability targets and maintain reliable financial and managerial reporting. Such a system can also help to ensure that the bank will comply with laws and regulations as well as policies, plans, internal rules and procedures and decrease the risks of unexpected losses or damage to the bank's reputations.

The Concept of Fraud

Fraud has been a widely defined in literature by scholars and experts. Idowu (2009) defines fraud as the intentional misrepresentation, concealment or omission of the truth for the purpose of deception/manipulation to the financial detriment of an individual or an organization (such as a bank) which also includes embezzlement, theft or any attempt to steal or unlawfully obtain, misuse or harm the asset of the bank.

According to the ICAN study pack (2006), fraud consists of both the use of deception to obtain illegal financial advantage and intentional misrepresentation, affecting the financial statements by the one or more individuals among management, employees or third parties. Fraud in its effects reduces the assets and increases the liability of any company. In the case of banks this may result in the loss of potential customers or crisis of confidence of banking public and in the long run end up in another failed bank situation.

From the above, the term fraud may be said to be as an intentional misrepresentation of financial information by one or more individuals among management employees or third parties. From whichever perspective fraud is looked at, it is simply a deceitful and dishonest act, which involves taking a property unlawfully from its owner without his/ her knowledge, permission or consents or to misstate a situation knowingly or by negligence.

This issue of fraud is a conventional phenomenon in the national life. In the government and private sectors, it is the order of the day. In the banks, fraud is on the increase. Companies are failing every day through the activities of fraudsters.

Classification of Fraud

Within the scope of this study attempts shall be made to critical examine the two broad schemes of frauds. Fraud is classified into two and are:

1. Management fraud
2. Employee fraud

Management Fraud

According to Fakunle (2006), management fraud often involves the manipulation of the records and the account, typically by the enterprise's senior officer with a new to benefiting in come indirect way. An example is obtaining finance under false pretences or concealing a material, worsening off the company's true position i.e. window dressing.

Management fraud is usually perpetrated by the management staff of an organization, which includes director, general managers, managing directors etc. The classes of victims of management frauds are investors and creditors and the instrument of perpetration is financial statement.

The essence of management fraud most times is to attract more shareholders to come and invest in the organization. It is also perpetuated, so that organization will be in better position of obtaining loans from banks because a good statement will show a health look, hence it will be a good collateral security.

Employee Fraud

This is also known as non-management fraud. These are frauds perpetrated by the employees of an organization. It usually involves falsification of some kind, like false documents, lying, exceeding authority or violating an employer's policies, embezzlement of company's funds, usually of cash or other assets. It consists of three phases, which are; the fraudulent act, the conversion of the money or property to the fraudsters and the cover-up. Employee frauds are more likely to be encountered where internal controls are weak. Other types of employees frauds according to Awe (2005) are as follows; fictitious payment of supplies, wages fraud (payroll fraud).

It is important to note that all these form of employee fraud are perpetrated, so that the perpetrators will have an undue benefit form all the irregularities made, as embedded in the definition of fraud

Causes of Bank Frauds

There are many identified causes of fraud in banks. They vary from institutional to economical, social, psychological, legal and even infrastructural causes. The immediate causative agents of frauds in general as provided by Ogbunka (2002) are as follows: availability of opportunity to perpetrate frauds and forgeries, human greed, avarice, instability, increasing incidence of unemployment, job insecurity, increasing financial burden on individuals, societal expectations, inadequate training of man power, risk on the fraudsters may below or none, poor/weak management control, monitoring and supervision, weak internal control system of the bank.

Of a truth there are many causes of bank frauds but weak internal control system stands as the major cause of frauds in banks. It is therefore, expedient that adequate, efficient and effective internal control system be installed in every bank in order to reduce this disaster called fraud.

Effects of Fraud on Nigerian Banks

Fraud is perhaps the most fatal of all risks confronting banks. The enormity of bank fraud in Nigeria can be inferred from its value, volume and actual loss. A good number of banks' frauds never get reported to the appropriate authority, rather they are suppressed partly because of the personalities involved or because of concern over the negative image effect that disclosure may cause if information is leaked to the banking public. The banks' customers may lose confidence in the bank and this could cause a set back in the growth of the bank in particular.

It also leaders to a diminishing effect in the asset quality of banks. The problem is more dangerous when companied by insider loan abuses. Indeed, the first generation of liquidated banks by NDIC was largely a consequence of frauds perpetrated through insider loan abuses. If this problem is not adequately handled, it could lead to distress and bank failures.

Fraud can increase the operating cost of a bank because of the added cost of installing the necessary machinery for its prevention, detection and protection of assets. Moreover, devoting valuable time to safeguarding its assets from fraudulent men distracts management. Overall, this unproductive diversion of resources always reduces outputs and lead to low profits which in turn could retard the growth of the bank.

Fraud leads to loss of money, which belongs to either the bank or customers. Such losses may be absorbed by the profits for the affected trading period and this consequently reduces the amount of profit, which would have been available for distribution to shareholders. Losses from fraud which are absorbed to equity capital of the bank impairs the bank's financial health and constraints its ability to extend loans and advances for profitable operations. In extreme cases, rampant and large incidents of fraud could lead to a bank's failure.

METHODOLOGY

In carrying out empirical investigation this study to actually measure (statistically) the significance of internal control system as a preventive measure of fraud in the banking sector, the authors purposely selected five banks for survey (i.e Access bank, Diamond bank, First bank of Nigeria, United bank of Africa and Wema Bank). Besides the survey study which was carried out by the use of primary data (questionnaire) the authors

went ahead to examine and analyze the book of these selected banks. Data (secondary) were extracted from the financial record of the bank for analyses by considering financial records of five years covering the period from year 2006 to year 2010. However, the study relied heavily on secondary data from academic journals, textbooks, magazines, newspapers, companies' annual reports and internal source. Furthermore, it was more objective to analysis data from the published account of the company to eliminate personal opinion, this will to a large extent guarantee the validity and reliability of empirical data and further analysis.

The formulated hypotheses were tested with the statistical techniques of Person Product Moment Correlation coefficient and simple linear regression equation of the form:

Y=a+bx+μ

Where: y= dependent variable (fraud, bad corporate governance and corporate performance

a= intercept parameter

b=slope parameter

x=independent variable (internal control system)

μ=stochastic error term

RESULT and DISCUSSION

The first hypothesis presents the effect of internal control system on curbing fraud in Nigerian banking sector. The results as presented in the tables 1,2 and 3 revealed that calculated t-statistics $(t = 6.764)$ for parameter internal control system is greater that tabulated t −statistics at 0.05 level of significance. The regression equation also revealed that internal control system accounted for 8.463 unit for every decrease in fraud in Nigerian banking sector. The coefficient of determination (R^2) 0.920 indicating that 92% of variation in fraud decrease is caused by variation internal control system. The remaining 8% unexplained variable is largely due to variation in other variation outside the regression model which is otherwise included in the stochastic error term. The relationship between fraud and internal control is strongly high positive and statistically significant at $0.05\ level\ (r = 0.954, p < 0.05)$. The overall regression model is statistically significant in terms of its overall goodness of fit$(f = 47.024, p < 0.05)$. As a result of this the study accepts the alternation hypothesis meaning that internal control system as a preventive measure has signification curbed fraud in Nigerian banking sector.

Table 1 Model Summary

Model	R	R Square	Adjusted R Square
1	0.959	0.920	0.899

a. Predictor: (Constant) internal control system

b. Department variable: Fraud

Table 2 Coefficients

Model	Under standard coefficient		Standard coefficient		
	Beta	std Error	Beta	T	Sig
(constant) Internal control	23397.18	52013.66		0.449	0.001
Fraud	8.463	1.251	0.959	6.764	0.002

Dependent variable: Fraud

Table 3 ANOVA

	Model	Sum of square	Df	Mean Square	F	Sig

1	Regression Residual	20090.194	1	20090.194	47.024	0.000
		9826.339	23	427.232		
	Total	29.916.533	24			

a. Predictor: (Constant) internal control system

b. Dependent variable: Fraud

The second hypothesis was presented in the tables 4, 5 and 6. The result measured whether bad corporate governance was responsible for the compulsory designing of internal control system in Nigerian banking sector. The result revealed that, calculated t - statistics $(t = 5.864, P < 0.05)$ was greater than tabulated t= statistics at 0.05 level of significance. The coefficient of determination(R^2) was 0.896 which implied that 89% of the variation in bad governance was caused by variation internal control system. The remaining 11% unexplained variation in caused by other variable outside the regression model which are otherwise include in the stochastic error term. The relationship between bad corporate governance and internal control system is strong and positive and statistically significant at 0.05 alpha level $(r = 0.947, P < 0.05)$. Also, the regression model is statistically signification in terms of its overall goodness of fit$(F = 25.706, P < 0.05)$. Hence, the alternative hypothesis was accepted. This implies that bad corporate governance was actually responsible for the use of internal control system in the Nigerian banking sector.

Table 4 Model Summary

Model	R	R Square	Adjusted R Square
2	0.947	0.896	0.869

a. Predictor: (Constant) internal control system

b. Dependent variable: Bad Corporate Governance

Table 5 Coefficients

Model	Under standard coefficient		Standard coefficient		
	Beta	std Error	Beta	T	Sig
(constant)	181482.5	131102.0		1.384	0.003
Internal control Bad Corporate Governance	7.175	1.223	0.947	5.864	0.000

Dependent variable: Bad Corporate Governance

Table 6 ANOVA

2	Model	Sum of Square	Df	Mean Square	F	Sig
	Regression Residual	110955.182	1	110955.182	25.706	0.000
		99274.511	23	4316.283		

	Total	210229.693	24			

a. Predictor: (Constant) internal control system
b. Dependent variable: Bad Corporate Governance

Hypothesis three as revealed in the tables 7, 8 and 9 showed the result of effect of internal control system on corporate performance. The result revealed that, calculated $t - statistics\,(t = 5.423, P < 0.05)$ was greater than tabulated t-statistics at 0.05 level of significance. The coefficient of determination (R^2) was 0.659 which implied that 66% of the variation in corporate governance was caused by variation in internal control system. The remaining 34% unexplained variation is caused by other variable outside the regression model which is included in the stochastic error team. The relationship between corporate performance and internal control system is strong and positive and statistically significant at 0.05alpha level$(r = 0.812, P < 0.05)$. Also, the regression model is statistically significant in terms of its overall goodness of fit$(F = 23.651, P < 0.05)$. Hence, the alternative hypothesis was accepted. The implication of this is that internal control system has significant effect on corporate performance of Nigerian banking sector.

Table 7 Model Summary

Model	R	R Square	Adjusted R Square
3	0.812	0.659	0.635

a. Predictor: (Constant) internal control system
b. Dependent variable: Corporate Performance

Table 8 Coefficients

Model	Under standard coefficient		Standard coefficient		
	Beta	std Error	Beta	T	Sig
(constant) Internal control	201245.3	172112.2		1.621	0.001
Corporate Performance	6.153	1.241	0.812	5.423	0.002

Dependent variable: Corporate Performance

Table 9 ANOVA

3	Model	Sum of Square	Df	Mean Square	F	Sig
	Regression	12043.241	1	12043.241	23.651	0.000
	Residual	11711.672	23	509.203		
	Total	23754.913	24			

a. Predictor: (Constant) internal control system

Dependent variable: Corporate Performance

CONCLUSION and RECOMMENDATIONS

The paper evaluated the effect of internal control system as a preventive measure of curbing fraud in the Nigerian banking sector. The study was necessitated be the fact that bank fraud are now becoming a global phenomenal and that fraud in

general, inflicts untold hardship or bank owners, customers and family members as most banks failures are associated with large scale frauds. The prevention and defection of frauds are basically the responsibility of the management, through the establishment of an effective and efficient internal control system.

The study revealed that internal control design has gone a long way in curbing menace of frauds in Nigerian banking sector and as a result of this it has led to increase in corporate performance of the banking sector. Conclusively, the important of the internal control department of any organization especially banks cannot be undermined.

The study therefore recommended that the management of every bank should create and establish a standard internal control system, strong enough to stand against the wiles of fraud in order to promote continuity of operations and to ensure the liquidity, solvency and going concern concept of the banks

Finally, there should also be continuous improvement in internal control techniques and tactics. It is only a good internal control that can guarantee the continuous existence and profitability of the Nigerian banks.

REFERENCES

Achebe I.N (2008) *Auditing and Investigation.* Owerri, Bon Publication

Adeyemo K . A. (2012) *Fraud in Nigerian Banks: Nature, Deep Seated Causes, Aftermaths and Probable Remedies,* Mediterranean Journal of Social Sciences 3(2) pp 279-289

Akindele R. I (2011) *Fraud as a Negative Catalyst in the Nigerian Banking Industry*, Journal of Emerging Trends in Economics and Management Sciences 2 (5) pp 357-363

Andrew E. U. (2008) *Management Accounting Theory and Practice* Uyo: Otuekong Associates.

Annual Reports of Bank (2006-2010) Access, Diamond, FBN, UBA and Wema

Asuquo, P.E. (2005), *Bank Frauds: A look at the Nigerian Banking Clearing System* ICAN News, Published by ICAN, vol. 14, No 1 Jan/May

Awe, O.I. (2005) *The Theory and Practice of Auditing* 2nd Edn. Gilgal Creations and Publication, Lagos.

CBN (2005), Central Bank of Nigeria Annual Report and Statement of Accounts

Etuk I. C. (2011). *Evalvation of Internal Control System of Banks in Nigeria:* Dissertation Submitted to St Clemnts University for Doctor of Philosophy (PhD)

Fakunle B.(2006) *Audit Companion,* 2nd Edn.pp 172-296

ICAN (Institute of Chartered Accountants of Nigeria) 2006. Financial Reporting and Audit Practice pp:206 ISBN 978-382 42-8-7

Idolor E.J (2010), *Bank Fraud in Nigeria: Underlying Causes, Effects and Possible Remedies,* African Journal of Accounting, Economics, Finance and Banking Research 6(6) pp62

Idowu A. (2009) *An Assessment of Fraud and its Management in Nigeria Commercial Banks*: European Journal of Social Sciences, 10(4) pp 628-640

Ogbunka, N.M. (2002), *Risk and Internal Control Management in Financial Institutions,* pp:187-188

Priceton A. (2008) www.wordnet.princeton.edu.perl/webun