

EFFECT OF INTERNAL SYSTEM ON EMPLOYEE FRAUD IN MANUFACTURING COMPANIES IN ILORIN METROPOLIS

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Abstract

Fraud prevention has become an issue that some manufacturing companies find themselves faced with. Internal control is the tool which companies hope to adopt in combating employee fraud. The main objective of this study was to examine the impact of internal control system on employee fraud in manufacturing companies in Ilorin Metropolis. The ordered logit regression method was adopted in testing the viability of the hypotheses put forward. It was concluded that internal control has an impact on fraud prevention. Findings from the study showed that human resource policies, managerial accountability and management override of control all have a positive effect on fraud prevention in manufacturing companies in Ilorin Metropolis. It was recommended that the human resource (HR) department should follow due process when hiring, promoting and compensating staff and that internal control guideline should be based on principles instead of laws.

Keywords: *Fraud, Management, Companies and Managerial Accountability.*

Introduction

The safety of assets is a major concern for investors and stakeholders of companies, both in public and private institutions. This is because they transfer their control rights to the managers, who act in the best interest of the principal. This separation of ownership from control however, implies a loss of effective control by shareholders over managerial decision which brings about such concerns for their investments (Oguda, Odhiambo & John, 2015). These concerns are not however unwarranted, as such separation of ownership from control increases the likelihood of fraud occurrence. Fraudulent activities have a devastating effect on a company and as a result, companies need to adopt an effective mechanism to curb or prevent the occurrence of such activities. It is therefore important that good governance and accountability practices are adopted to achieve the organizational goal of safeguarding shareholders assets and wealth maximization.

However, an effective internal control cannot help an entity achieve all these objectives. It can only provide management with information about the entity's progress, or lack of it, toward their achievement. A wide range of research has established that effective internal control system has a positive and significant effect on fraud prevention. However, according to the Committee of Sponsoring Organizations of the Treadway Commission (COSO, 2013), internal control system can only be considered effective if its components are present and effective for operations, financial reporting and compliance. The top management is saddled with the responsibility of ensuring that internal control system is adequate. Therefore, the attitude of such top management will determine the success of the internal control system.

Literature Review

Fraud

Adeniji (2012) describes fraud as an intentional act by one or more individuals among management, employees or third party which is capable of resulting in a misrepresentation of financial statements. Fraud may involve: manipulation, falsification or alteration of records or documents; misappropriation of asset; suppression or omission of the effects of transaction from records or documents; recording transactions without substance and misapplication of accounting policies.

Chakrabarty (2013) defines fraud as any behaviour by which one person intends to obtain a dishonest advantage over another where the person makes an illicit gain while the other party incurs a loss. Sommer (2014) also defines fraud as any illegal act characterized by deceit or concealment or violation of trust which do not directly depend on the use of violence, perpetrated in firms to obtain money, property, or services; to avoid payment or loss of services; or to secure personal or business advantage.

Internal Control System

Internal control is the gamut of measures that seek to detect errors, frauds and irregularities, to ensure that all transactions are correctly processed and ensure that all assets are safeguarded through restrictions of access to authorized persons only. It enables work to be performed by a person and any omission or error can be traced to that person and to make the work of auditors easier (Adetiloye, 2016).

The Committee of Sponsoring Organizations of the Treadway Commission (COSO, 2013) defines internal control as a process affected by an entity's board of directors, management and other personnel designed to provide reasonable assurance regarding the achievement of objectives relating to operation, reporting and compliance.

Management Override of Control

Management override of control as used in ISA 240 refers to the ability of management and/or those charged with governance to manipulate accounting records and prepare fraudulent financial statements by overriding these controls, even when the controls might otherwise appear to be operating effectively. Due to the fact that management is primarily responsible for the design, implementation and maintenance of internal control, the entity is exposed to the risk of management overriding control when the powerful incentive to meet accounting objectives is

combined with the opportunity to override control, senior management may engage in fraudulent activities.

Managerial Accountability

Management is under an obligation to account for its decisions and actions, including the ones related to managing funds to those who appointed them or delegated to them powers and responsibilities. Helen, Kelvin, Mike and Alison (1999) posited that while accountability by public companies was essential, the emphasis on accountability has obscured business prosperity, the most important aspect of corporate performance. They recognized that a good internal control system allows boards of directors to be free to drive their companies forward, but exercise that freedom within a framework of effective accountability.

Theoretical Framework and Hypothesis Development

This study is underpinned by the Committee of Sponsoring Organizations of the Treadway Commission framework (COSO, 2013). The framework highlighted five integrated components which include: control activities, control environment, monitoring activities, information and communication, and risk assessment. The focus of this study is on control environment where the tone is set at the top for effective internal control. This study argues that the increasing rate of employee fraud despite a wide range of research establishing that effective internal control system has a positive and significant effect on fraud is due to inadequate attention to non financial controls. Internal control is a whole system of control, financial and non-financial, put forward by management to achieve its objectives. Sommer, (2014) but past researches on internal control system have focused on financial controls. The primary responsibility for the design, implementation and maintenance of internal control lies with the management and that exposes the entity to the risk of management overriding control when the powerful incentive to meet accounting objectives is combined with the opportunity to override control, senior management may engage in fraudulent activities. This study therefore hypothesis that

H₀: Management override of control has no effect on fraud prevention in manufacturing companies in Ilorin Metropolis.

Human resource policies are organizational activities directed at managing the pool of human capital and ensuring that capital is directed towards the fulfilment of organizational goals (Patrick, Gary, & Abigail, 1993).The board of directors and senior management establish the tone at the top regarding the importance of internal control including expected standard of conduct. a bad and ineffective policies provide rationalization for employee to commit fraud. This study therefore hypothesis that

H₀: Human resource policies have no effect on fraud prevention in manufacturing companies in Ilorin Metropolis.

An effective internal control system allows boards of directors to be free to drive their companies forward, but exercise that freedom within a framework of effective accountability. The fact that management is under an obligation to account for its decisions put them in a position to be responsible for employee fraud whether that are involved or not. This study therefore hypothesis that

H₀: Managerial accountability has no effect on fraud prevention in manufacturing companies in Ilorin Metropolis.

Empirical Framework

Kirsty and Nava (2008) examined the quality of Internal Control Procedures (ICP) to determine whether or not it had a moderating effect on the relationship between perception of organizational justice and employee fraud and to also assess the relationship between ICP and some organizational factors. Primary data was used to test the quality of internal control procedures. Logistic Regression as well as Multiple Regression analysis was employed in this research and findings using Logistic Regression revealed that ICP had a moderating effect on the relationship between perception of organizational justice and employee fraud. The Multiple Regression analysis also showed that ICP quality is significantly positive to three key organizational factors; corporate ethical environment, internal audit activities and existence of risk management training (RMT).

In a research titled; “An empirical analysis of the relation between the board of directors composition and financial statement fraud” by Mark (1996), where he examine the relationship between board of directors’ composition and the occurrence of financial statement fraud, it was confirmed that the hypothesis that the proportion of outside members on the board of directors is lower for firms experiencing financial statement fraud compared to no fraud firms. For this study, the Logic Cross-Sectional Regression Analysis was used because the dependent variable ‘fraud’ was dichotomous.

Paul, Colin and Robyn (2008) in their work “Internal audit, alternative internal audit structures and the level of misappropriation of assets fraud” assessed whether organizations with internal audit function were more likely to detect and self-report fraud than those without internal audit. The Man-Whitney Analysis of Covariance was employed to arrive at the conclusion that organizations with an internal audit function were most likely to detect and self-report fraud through misappropriation of assets than those that do not.

Adetiloye, Olokoyo and Taiwo (2016) in their work on fraud prevention and internal control in the Nigerian banking industry examined the determinant of fraud prevention and internal control system on bank performance and the determinant that can be effective in the management and control of financial fraud against deposit money banks. Primary and secondary source of data was used and the Ordinary Least Square Regression method was used to analyse data. The findings revealed that internal control was effective on fraud control.

Germann and Manasseh (2017) in their paper, “internal control in small and medium scale enterprises” aimed at identifying the key internal control component that may be lacking within SMEs used a sample size of 27 SMEs in Broadway and Arawa Street of Matamata, New Zealand. Data collected was analyzed using Regression Analysis and findings revealed that some possible areas of concern in their internal control system included the changing of passwords, requiring more than one signature for authorization and the lack of disaster recovery plan. Ogudaet al., (2015) carried out a study to examine the effect of internal control on fraud detection and prevention in Kakamega country. The aim of the study was to establish the effect of internal control on fraud detection in the district treasury in Kakamega country. Both

descriptive and inferential statistics was used to analyse the data collected using regression analysis and findings showed that a significantly positive relationship existed between internal control and fraud detection and prevention in sub county treasuries in Kakamega country.

Saleh (2016) examined the effect of internal control on fraud prevention of listed manufacturing industries in Nigeria. Both primary and secondary source of data was adopted. The primary data collection techniques used was questionnaire, interview and observation and the data in the study was analysed using Chi-square and Anova analysis technique. He concluded that internal control had much effect on the number of fraud witnessed in the manufacturing industries in Nigeria.

Idogei, Josiah, and Onomuhara (2017) in their paper “Internal control as a basis for preventing, detection and eradication of fraud in banks in Nigeria” examined the possible ways which internal control had affected fraud prevention, detection and eradication. Using a combination of descriptive and inferential statistics, the study found that internal audit quality and internal audit independence have a significant positive impact on financial fraud detection.

Methodology
Research Design

A descriptive research design is employed in order to satisfy the researcher’s curiosity and desire for better understanding of the topic. A descriptive survey is employed to help obtain information from the selected sample. The findings from this survey are used to represent the population as a whole.

The data collected in this study was analysed using Ordered Logit Regression method. The hypotheses were also tested with this method. The relationship among the study’s variables is captured as:

$$FP = f (HRP, MOC, MAB)$$

Model specification is as follows:

$$FP = \alpha + \beta_1HRP + \beta_2MOC + \beta_3MAB+ \mu$$

Where:

FP = Fraud Prevention

HRP = Human Resource Policies

MOC = Management Override of Control

MAB = Managerial Accountability

μ = Stochastic error term to account for other factors that could result in fraud

Discussion of Findings

Result of Analysis

Table 1: Ordered Logit Estimates for Fraud Prevention

Variable	Coefficient	Std. Error	Z-stat	Prob
Human Resource Policies	1.012531	0.385802	2.624484	0.0087*
Management Override of Control	0.574109	0.280852	2.044166	0.0409**
Managerial Accountability	0.804274	0.385712	-2.085171	0.0371**

Pseudo R ²	0.051354
LR-chi	16.26544
Prob (chi2)	0.001000

Source: Field Survey, (2018).

Note: *, ** denotes statistically significant at 1% and 5% significance level respectively. Table 1 presents the ordered logit regression results for the investigation of the effect of internal control system on fraud prevention in manufacturing companies in Ilorin Metropolis. Ordered logit regression was estimated with fraud prevention (FP) as the dependent variable and human resource policies (HRP), management override of control (MOC) and managerial accountability (MAB) as the independent variable. The result shows that all the independent variables are positively related to fraud prevention. This means that the better the implementation of these variables, the more the likelihood of high fraud prevention in manufacturing companies in Ilorin Metropolis. Also, the results indicate that the independent variable HRP is significant at 1% while MOC and MAB are both significant at 5%. This is shown by the standard error of the coefficients of the variables 1.012531, 0.574109, 0.804274. Coefficient of a variable is said to be significant if the standard error is less than half of the value of the coefficient.

Conclusion

The main objective of this study was to ascertain the effect of internal control system on fraud prevention in manufacturing companies in Ilorin Metropolis. This study achieved this objective by first breaking down internal control system into three variables; human resource policies, managerial accountability and management override of control, and then analysing these variables using Ordered Logistic Regression (Logit).

The results of the analysis of human resource policies on fraud prevention using ordered logit regression shows that human resource policies has a significantly positive effect on fraud control in manufacturing companies in Ilorin Metropolis. The results of the analysis of managerial accountability on fraud prevention using ordered logit regression shows that managerial accountability has a significantly positive effect on fraud control in manufacturing companies in Ilorin Metropolis.

The results of the analysis of management override of control on fraud prevention using ordered logit regression shows that management override of control has a significantly positive effect on fraud control in manufacturing companies in Ilorin Metropolis. The internal control system can be used as a tool for fraud prevention in manufacturing companies in Ilorin Metropolis.

Recommendations

Based on the findings, the following recommendations are made:

1. The human resource (HR) department should follow due process when hiring, promoting and compensating staff.
2. Internal control guidelines should be based on principles instead of laws.

3. The duties of each employee should be adequately segregated with each staff being accountable for his duties. The power to make strategic decisions should not be vested in the hands of one person.

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