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Internal Audit and Employee Fraud in Manufacturing Companies in Ilorin Metropolis

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Abstract

This paper investigates the effect internal audit and Employee Fraud in manufacturing companies in Ilorin Metropolis. 'Simple random sampling technique' of the probability sampling method was used in selecting the manufacturing companies. Primary data was used in the course of this study. The data was generated using a well-structured Likert's scale questionnaire. In specific terms, the study assess the effectiveness of internal control system in manufacturing companies in Ilorin Metropolis, examine the effect of internal audit on employee fraud in manufacturing companies in Ilorin Metropolis, examine the effect of management override of control on fraud prevention in manufacturing companies in Ilorin Metropolis and examine the effect of human resource policies on fraud prevention in manufacturing companies in Ilorin Metropolis. Findings from the study show that human resource policies have a positive effect on fraud prevention in manufacturing companies in Ilorin Metropolis. The overall significance of the 5% alpha level which led to the conclusion that internal audit has positive relationship with employee fraud in manufacturing companies in Ilorin metropolis.

Keywords: *Internal Audit, Employees Fraud, Manufacturing Companies*

Introduction

Even though fraud is acknowledged as a vice in both developed and developing nations, there are national differences in the extent, origins, and impacts of fraud on corporate performance. Nwakwo (2013) a successful fraud has the power to destroy years' worth of savings for shareholders and bring an organization to its complete demise. Adeniji (2004). Fraud is described as "an intentional act resulting in a misrepresentation of financial statement by one or more individuals among management, employees, or third parties." Fraudulent activities include embezzlement, theft, and any attempt to obtain, abuse, or harm an entity's assets without authorization. The management of the entity bears the task of instituting a control system to facilitate the orderly and efficient operation of the enterprise, thereby impeding and identifying instances of fraud. These control mechanisms are commonly known as internal control systems.

"The entire system of control, financial or otherwise established by management in order to carry on the business of the enterprise in an orderly and efficient manner, ensure adherence to management policies, safeguard the assets, and secure the completeness and accuracy of the accounting records as far as possible" is how the auditing practice committee defined internal control system in their guidelines. While internal controls cannot completely eradicate errors and inconsistencies, it is anticipated that they will notify management of any issues so that they can be addressed before they become more serious ones. Nevertheless, in order to give management some confidence regarding its efficacy, the existing internal control system needs to be periodically assessed. The components of an internal control system must be present and work well for operations, financial reporting, and compliance for the system to be deemed effective. It is the duty of the board of directors and its audit committee to ensure that the organization has an appropriate internal control system. This duty entails deciding how thoroughly internal controls are assessed, with internal and external auditors participating in the assessments. This is so that the managers, who work in the principal's best interest, can assume control over them. However, this division of ownership and control suggests that shareholders will no longer have effective control over managerial choices, which raises serious issues for their investments (Oguda, *et al*, 2015).

An effective internal control system has a positive and notable impact on preventing fraud, as numerous studies have shown. An internal control system, however, may only be considered successful if all of its component pieces are present and functional for compliance, financial reporting, and operations, according to the Committee of Sponsoring Organizations of the Treadway Commission (COSO, 2013). It is the duty of upper management to guarantee that the internal control system is sufficient. Consequently, the effectiveness of the internal control system will depend on the mindset of this upper management. One of the monitoring tasks that such management is supposed to implement is internal auditing, which verifies the efficacy of internal control systems. Even though internal auditors are meant to work independently, they are still employees of the company, and the culture of control at the top has a big impact on how well they perform their jobs. Since the control environment involves senior management's control consciousness, it serves as the cornerstone for all other internal control components. It is concerning that most organizations' top management implemented internal control systems in order to abide by the directives of external regulators. To make money, they arbitrarily override these restrictions. Since employees who successfully generate profits are rewarded even if they fail to address the issues raised by internal audit, recruiting and promotion practices are in line with revenue. The majority of employees in Nigeria are under pressure due to the country's current economic situation, and internal auditors' poor oversight of internal control systems presents opportunities while top management's overriding control to generate revenue may serve as justification for employees of the company to commit fraud. This study's main goal is to investigate effect on the relationship between internal audit and Employee Fraud in manufacturing companies in Ilorin Metropolis. The specific objectives are to;

i. To assess the effectiveness of internal control system in manufacturing companies in Ilorin Metropolis.

ii. To examine the effect of internal audit on employee fraud in manufacturing companies in Ilorin Metropolis.

iii. To examine the effect of management override of control on fraud prevention in manufacturing companies in Ilorin Metropolis.

iv. To examine the effect of human resource policies on fraud prevention in manufacturing companies in Ilorin Metropolis.

The number of attempts to quantify employee fraud using multidimensional indices is few and insufficient. Lack of a comprehensive indicator capable of gathering fraud data, taking demand-side and supply-side data into account, and using a statistically sound weighting scheme. This study makes an effort to bridge this gap. Therefore, this study will attempt to fairly represent their perspectives through empirical investigation.

Conceptual Framework

Concept of Fraud

According to (2016), fraud is defined as a deliberate action by one or more management, staff, or outside parties that has the potential to cause financial statements to be falsely represented. Manipulation, fabrication, or change of records or documents; asset theft; suppression or omission of transaction impacts from records or documents; documentation of transactions devoid of content; and improper application of accounting rules are some examples of fraud.

According to Chakrabarty (2013), fraud is any action taken with the intention of giving one person an unfair advantage over another, resulting in the one making an illegal profit while the other suffers a loss.

Fraud is also defined by the Institute of Professional Practices Framework (Sommer, 2014) as any unlawful act committed in a business to obtain money, property, or services; to avoid payment or loss of services; or to secure personal or business advantage. This definition does not directly depend on the use of violence. Despite the differences between the aforementioned definitions, they all generally emphasize that fraud is the intentional distortion of reality in order to obtain an advantage.

There are two types of fraud: external and inside. Internal fraud starts inside a company and is carried out by staff members, either those in lesser positions or those burdened with management. External fraud refers to any plan in which the offender is not an officer, manager, employee, or owner of the organization; it is committed by outsiders (Krambia-Kapardis, 2002).

Internal Control System

Internal control encompasses a range of methods aimed at identifying mistakes, fraudulent activities, and anomalies, guaranteeing accurate processing of all transactions, and protecting assets by limiting access to authorized individuals only. It makes it possible for an individual to complete work and to be held accountable for any mistakes or omissions, as well as simplifying the task of auditors (Aguotu, 2002).

Management Override of Control

According to ISA 240, "management override of control" refers to the power held by management and/or those in charge of governance to circumvent controls, even when they seem to be working well, in order to alter accounting records and create false financial statements.
The entity is exposed to the risk of management overriding control because management is primarily in charge of the design, implementation, and upkeep of internal control. When senior management has the opportunity to override control and is highly motivated to meet accounting objectives, fraud may occur.

Human Resource Policies

Human resource policies are organizational actions aimed at managing the pool of human capital and guaranteeing that capital is directed towards the accomplishment of organizational goals. Human resource resources are the pool of human capital under the control of the firm in a direct employment relationship (Patrick, *et al* 2012).

Theoretical Review

Fraud Triangle

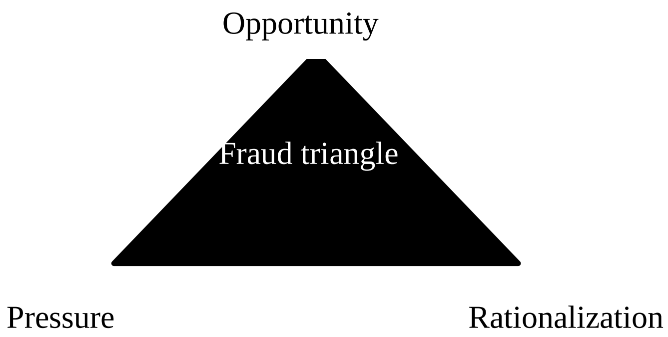
This study was underpinned by a theory pounded by Albrecht *et al.*, (1984) as cited in Kirsty and Nava (2008) proposed that fraud occurs when there is:

a. Incentive to commit fraud;

b. Rationalisation for justifying fraudulent behaviour; and

c. Opportunity to commit fraud.

These three situational factors are collectively referred to as the 'fraud triangle'.



Fraud triangle

"Opportunity" refers to a systemic flaw in which an employee has the authority or capability to specifically enable fraud. This is the fraud triangle's most important component. Most businesses unintentionally provide dishonest workers a chance to perpetrate fraud by implementing lax controls including inadequate supervision and a lack of task segregation. The term "pressure," which is often used to refer to an incentive, describes how an employee may be motivated to commit fraud for a number of reasons, including personal financial strain or greed. Although few workers would seize the chance to conduct fraud, applying additional pressure might persuade an honest worker. Workplace pressure can sometimes manifest as the desire to meet deadlines for deposits or meet profit goals at any costs. According to Kirsty and Nava (2008), the third aspect, known as "rationalization," refers to the rationalization of dishonest behavior as a result of a worker's lack of moral character or for other reasons.

EMPIRICAL FRAMEWORK

In order to ascertain if Internal Control Procedures (ICP) had a moderating influence on the relationship between employee fraud and the perception of organizational justice, Kirsty and Nava (2008) looked at the quality of ICP. They also evaluated the relationship between ICP and certain organizational characteristics. To evaluate the efficacy of internal control protocols, primary data was employed. This study used both multiple regression analysis and logistic regressions. The results of the logistic regression analysis showed that the association between employee fraud and the perception of organizational justice was moderated by ICP.

The hypothesis that the percentage of outside members on the board of directors is lower for firms experiencing financial statement fraud compared to firms that do not experience fraud was confirmed by Beasley (1996) in "An empirical analysis of the relation between the board of directors composition and financial statement fraud," which examined the relationship between the composition of the board and the occurrence of financial statement fraud. Because the dependent variable "fraud" was dichotomous, the Logic Cross-Sectional Regression Analysis was employed for this investigation.

In their study on internal control and fraud prevention in the Nigerian banking sector, Adetiloye, *et al* (2016) looked at the factors that influence internal control and fraud prevention system performance as well as factors that can be useful in managing and controlling financial fraud against deposit money banks. Data were analyzed using the Ordinary Least Square Regression approach using both primary and secondary sources. The results showed that internal control had a positive impact on reducing fraud.

Saleh (2016) investigated how internal control affected Nigeria's listed manufacturing industries' ability to prevent fraud. It was decided to use both primary and secondary data sources. Chi-square and Anova analysis approaches were utilized to analyze the data from the study, with questionnaires, interviews, and observation serving as the main methods of data collection. He came to the conclusion that internal control had a significant impact on the amount of fraud that was observed in Nigeria's manufacturing sectors.

Germann and Manasseh (2017) employed a sample size of 27 SMEs in Broadway and Arawa Street of Matamata, New Zealand, in their study, "Internal control in small and medium scale enterprises," which sought to uncover the critical internal control component that may be absent within SMEs. Regression analysis was used to examine the data, and the results showed that the lack of a disaster recovery plan, the need for multiple signatures for authorization, and the frequent changing of passwords were some potential areas of concern in their internal control system.

In their 2017 work "Internal control as a basis for preventing, detection, and eradication of fraud in banks in Nigeria," Omonyemen, *et al* investigated the potential influences that internal control may have had on fraud prevention, detection, and eradication. The study discovered that internal audit independence and quality significantly improve financial fraud detection using a combination of descriptive and inferential statistics.

Methodology

Model Specification

This study adopted a sample size of fifteen (15) manufacturing companies in Ilorin. Ten (10) questionnaires were distributed among the staffs of each of the selected companies. The choice of the sample size is due to the financial and time constraints in distributing and collecting questionnaires amongst the manufacturing companies in Ilorin. ‘Simple random sampling technique’ of the probability sampling method was used in selecting the manufacturing companies. Primary data was used in the course of this study. The data was generated using a well-structured Likert’s scale questionnaire.

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

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

Model specification is as follows:

$FP = \alpha + \beta_1 HRP + \beta_2 MOC + \beta_3 MAB + \mu$

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

RESULT AND INTERPRETATION

A total of 150 questionnaires were issued to the target population, of which 141 questionnaires were gotten back from the respondents. This represents 94% of the total questionnaires. According to Mugenda and Mugenda (1999), a response rate of 50% is adequate for analysis and reporting; a rate of 60% is good and a response rate of 70% and over is excellent. This means that the response rate for this study was excellent and will be enough for data analysis and interpretation. This is as indicated in the table below:

Table 1: Response Rate

Response rate	Frequency	Percentage
Response	141	94.0
Non response	9	6.00
Total	**150**	**100**

Source: Field Survey, (2024).

Gender of Respondents

The aim of determining the respondents' gender is to ascertain the distribution of sex amongst respondent.

Table 2: Gender of Respondents

Gender		Frequency	Percentage
	Male	67	44.7
Valid	Female	74	49.3
	Total	**141**	**92.4**
Missing	System	9	6.00
Total		**150**	**100.0**

Source: Field Survey, (2024).

The findings of the study are as shown in table 2 above. It was evident that majority of the respondents were female which represented 49.3% while 44.7% were male. The remaining 6.0% account for the missing questionnaires. It may therefore be inferred that females are the most dominant gender in the manufacturing companies of Ilorin metropolis.

Age Bracket of the Respondents

The aim of collecting data as regards the age bracket of the respondents is to determine if the respondents were old enough to provide valid responses to the questions asked in the questionnaire.

Table 3: Age Bracket of the Respondents

Age Bracket		Frequency	Percentage
	Below 25 years	55	36.7
Valid	26 – 40 years	58	38.7
	Above 40 years	28	18.6

	Total	141	94.0
Missing	System	9	6.00
Total		**150**	**100.0**

Source: Field Survey, (2024).

Table 3 above indicates that 55 of the respondents were below the age of 25 years which constitutes 36.7% of total respondents. 58 of the respondents were between the age of 26 – 40 years and this constituted 38.7% of total respondents. 28 of the respondents were above the age 40 years, which constituted 18.6% of total respondents, while the remaining 6% accounts for the missing questionnaires. The findings therefore implies to a reasonably extent that the respondents were old enough to provide valuable responses pertaining to the research topic.

Educational Qualification of the Respondents

The educational qualification of respondents was taken into consideration so as to give reliability about the information provided by them.

Table 4: Educational Qualification of the Respondents

Educational Qualification		**Frequency**	**Percentage**
Valid	O'Level	24	16.0
	OND/HND	41	27.3
	B.Sc.	60	40.0
	M.Sc.	15	10.0
	PhD	1	0.7
	Total	141	94.0
Missing	System	9	6.00
Total		**150**	**100.0**

Source: Field Survey, (2024).

Analysis of findings in table 4 above indicates that 24 respondents obtained O' Level certificates which constituted 16% of total respondents. 41 respondents obtained OND/HND certificate, constituting 27.3% of the total respondents. 60 respondents obtained B.Sc. certificate which constituted 40% of total respondents. 15 respondents representing 10% of the total respondents had M.Sc. as their highest educational qualification while 1 respondent who constituted 0.7% of the total respondents had PhD certificate as a highest educational qualification, the remaining 6% accounts for the missing questionnaires.

Table 5: 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, (2024).

Note: *, ** denotes statistically significant at 1% and 5% significance level respectively.

Table 5 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.

It is worthy of note that the pseudo R^2 in the ordered logit regression models does not capture the extent of the variation in the dependent variable explained by the independent variables. Therefore, the pseudo R^2 is not used as a measure of fitness of the model as it is in ordinary least square models. The fitness statistic used in these models is the Log Ration (LR) chi-square statistics reported along with the coefficient estimates in the table 5. A model is considered to have a good fit when the P-value of the LR statistics is less than the traditional levels (1%, 5% and 10%) of significance used in social and management sciences. Otherwise, the fitness of the model is said to be bad. The Log Ration statistics of the ordered logit regression models presented in table 5 is 16.26544 with P-value of 0.00100. This shows that all the models have a good fit and their results are valid and plausible for tenable policy inferences.

Conclusion and recommendation

The study comes to the conclusion that industrial enterprises in Ilorin Metropolis can prevent fraud by implementing internal control systems.

Therefore the study recommended that

i. The human resource (HR) department should follow due process when hiring, promoting and compensating staff.

ii. Internal control guidelines should be based on principles instead of laws.

iii. Duties of each employee should be adequately segregated and 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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