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USE OF CONTROL ACTIVITIES IN FRAUD CONTROL IN FINANCIAL INSTITUTIONS

A CASE OF FINANCIAL INSTITUTIONS IN MERU TOWN, KENYA

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Abstract

The purpose of the study was to establish the relationship between Control Activities and Fraud Control in Financial Institutions (Banks and Microfinance Institutions). Control Activities analyzed were Internal Checks and Segregation of Duties. The researchers set study objectives and hypotheses that assisted in establishing the relationship that was required. The research study was conducted using both quantitative and qualitative approaches. Stratified random sampling was used and data was collected using Questionnaires from the managers and supervisors, in various financial institutions of Meru town, Kenya. A sample of 84 respondents from a population of 106 was used for this study. Data was analyzed through SPSS using Chi square and Descriptive statistics. In analyzing the selected control activities it was found there were enhanced internal checks that involved peer review and verifications of transactions to reduce chances of forgery, also it was revealed that proper segregation of duties and job rotation have been embraced to increase transparency. In conclusion Research study found that there are continuous checks to ensure controls are working well. The study established a significant relationship between control activities and fraud control.

Keywords: Fraud, Control Activities, Internal Checks, Segregation of Duties, Kenya

INTRODUCTION

Fraud has been defined as, “Fraud in relation to affairs of a company or anybody corporate, includes any act, omission, concealment of any fact or abuse of position committed by any person or any other person with the connivance in any manner, with intent to deceive, to gain undue advantage from, or to injure the interests of, the company or its shareholders or its creditors or any other person, whether or not there is any wrongful gain or wrongful loss” (PWC, 2013).

Globalization, technology advancement and other factors, have led to increased cases of fraud. These fraud activities can often be difficult to detect due to their technological complexity, especially in financial institutions where there are a lot of challenges and large amount of resources are used to identify and eliminate fraud (Akelelo, 2014).

According to study by Apoorva (2007), Banking Fraud posed threat to Indian Economy. Bank fraud increased by 38.5% between 2004 and 2005, this mostly involved Cyber Crime. According to the study was paramount that occurrence of such frauds should be minimized.

Global consulting firm Deloitte in East Africa, carried out a crime survey which indicated that East African banks lost approximately KHS 4.89 billions to fraud in one and a half years that ended in June 2012 due insiders’ collusion with fraudsters. Most of these frauds were disseminated using the electronic systems that were introduced in banks to increase clearance of paper cheques (the Guardian Reporter, 2012). To address the electronic fraud, the Central Banks of East Africa announced plans to complement the East African banking systems. The harmonization was expected to create integrated regional financial institutions to enable them to develop proper integrated mechanisms for fighting vices like fraud, improve credit management system and other service and also improve efficiency in operations. However the synchronization of the systems alone cannot fully curb fraud problem in banks, control activities may enhanced to improve this (Mwaura and Thiong’o, 2013). A control activities as component of Internal Control System allows the financial institutions to foresee prospective problems which may causes financial losses through fraud, thereby prevent or reduce future losses (Hayali, Dinc, Sarili, Secil and Aysel, 2013).

Banking Fraud Investigations Department (BFID), in its report indicated that Kenya’s banking system has become vulnerable to fraud. In the report by BFID, banking fraud in Kenya had increased by more than three times in the third quarter of 2010 (Nyakarimi $ Karwirwa, 2015. In 2010, Kenyan banks lost approximately USD 27.5 million) mostly through cheques and bank transfer frauds. Majority of these frauds were perpetrated by employees (Akelelo, 2014). Nyakarimi and Karwirwa (2015), in their study indicated that in month of December 2013 alone, 33 financial institutions in the country reported loss of nearly Sh500 million through fraud. This

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was attributed to the facts that banks sometimes prefer internal disciplinary mechanism in cases involving employees' theft, which does little to curb fraud problem.

In recent past Kenya, has witnessed bank failure due to widespread banking fraud. Chase bank was a recent bank to fail in April this year. Chase bank failure was attributed to accounting surrounding the bank's Islamic assets and governance problem. Governance problem lead to the directors to award themselves huge loans fraudulently (Piskadlo, 2016).

Hoffman in his study as quoted by Akelelo (2014), indicated that some of challenges faced in curbing fraud in financial institutions include weak internal controls, employee collusion, overriding of controls, and lack of segregation of duties. These can often be aggravated by corrupt political systems and weaknesses in the regulatory and institutional frameworks put in place. In some cases, politicians may meddle in the operations of financial institutions, inadequate laws to prosecute fraud and weak institutions that are required to deal with fraud.

Commission of Sponsoring Organization (COSO) explained control activities are actions, supported by policies and procedures that, when carried out properly and in a timely manner, manage or reduce risks (COSO, 2013). They are established to prevent or minimize risks of problems occurrence. The management should establish appropriate control activities and employees expectations in performing these activities. Control activities are performed at all levels and at various stages of the business processes (Mathew, 2011).

Control activities include approvals, authorizations, verifications, reconciliations, reviews of performance, security of assets, segregation of duties, and controls over information systems. Implementation of control activities should be done, conscientiously, thoughtfully and consistently. Focus should be on conditions to which the policy is directed. It is also important that unusual conditions identified as a result of performing control activities be investigated and appropriate corrective action be taken (Suny University, 2012).

Statement of the Problem

Banking frauds in Kenya has been on the rise, the recent cases reported are of Chase and Imperial banks. Akelelo (2014) in her study indicated the failure to curb fraud is attributed to overriding the controls, weak internal controls, lack of segregation of duties among other factors. Nyakarimi and Karwirwa (2015) also in their study pinpointed that fraud in Kenya is rampant and Kenya's rating is low as far as dealing fraud menace is concerned. They attributed this to weak ethical practices, management policies, integrity issues, lack of proper evaluation mechanisms of procedures and policies among others. The above studies did not focus on specific control activities that may be applied to address the issue of fraud in financial institutions. This study

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therefore focused on use control activities specifically internal checks and segregation of duties to control fraud in financial institutions.

Purpose of the Study

The purpose of this study was to establish the relationship between control activities and fraud control in financial institutions

Research Objectives

The study focused on use of control activities in fraud control. The study was guided by the following objectives;

i) To determine how internal checks control fraud in financial institutions

ii) To establish how segregation of duties can help in fraud control in financial institutions

Hypothesis

H_{01}: there is no relationship between internal checks and fraud control

H_{02}: there is no relationship between segregation of duties and fraud control

Scope of the Study

The study focused on a number of branches of different deposit taking financial institutions in Meru town, this is mainly due to the fact most of the financial institutions are concentrated in these area.

THEORETICAL FRAMEWORK

Fraud Management Lifecycle Theory by Wesley Wilhelm (2004)

Fraud management lifecycle is a network where each stage is a sum of entities that are made up of interrelated, interdependent and independent actions, operations and functions that help in fraud control (Njenga and Osiema, 2013)

Wilhelm (2004) in his study noted that effective management of the Fraud Management Lifecycle starts with understanding or defining the stages in the lifecycle. If there is no awareness and understanding on lifecycle of fraud, fraud management professionals are unlikely to communicate effectively with each other, with the stakeholders in industries, and within their respective businesses. The Fraud Management Lifecycle is made up of eight stages;

First stage is deterrence is the first stage, it is characterized by actions and activities intended to stop or prevent fraud before it is attempted. This means deterrence is meant to

discourage even the attempt at fraud. Deterrence is achieved through creating fear of consequences or difficulty of perpetration, to turn aside, discourage or prevent fraudulent activity from being attempted (Kimani, 2011).

Second stage is prevention stage activities are intended to prevent the fraud from occurring or to safeguard the organization and its processes against fraud. The ability of prevention to stop losses through fraud from occurring and stopping fraudulent activity from continuing is an important aspect. The latter activities are more mitigating activities. Prevention, when understood from a security perspective, can be thought of as hardening the target. Deploying protective procedures, processes, systems, and verifications, that make fraud harder to commit prevents fraud. Prevention activities are intended to make fraud more difficult to commit (Wilhelm, 2004).

Detection is the third and it includes three activities which are connected in the fraud arena: fraud testing, fraud attempts, and fraud successes. The point of deviation is that not all fraud attempts are successful and that not all perceived fraud attempts are intended to be successful. Thus, detection in the fraud arena should ensure revelation of the existence of fraud testing, fraud attempts, and successful frauds (Wilhelm, 2004). Fourth stage involves mitigation of fraud, by definition mitigation in fraud is to stop a fraudster from going on with fraud or completing their fraudulent activities, to reduce their chances of success. Mitigation activities can take place immediately or may be delayed for some time. The faster mitigation activities can be undertaken, the will be the results (Khan, 2008). Mitigation in fraud focuses on actions that are intended to reduce the extent of the fraud, the amount of the associated fraud losses, and the effort and expense required to recover or correct the impact of the fraudulent activity (Wilhelm, 2004). This last goal is especially important when identity theft and the resulting identity fraud are involved. The faster the fraud activity is detected and mitigation activities initiated, the less time, effort, and expense will have to be invested in correcting the consumer's credit record.

The fifth stage is analysis which involves activities to identify and understand losses incurred despite the deterrence, detection, prevention, and mitigation stage activities. Analysis valuates the impact of fraud management activities upon legitimate customers. The product or service cost structures should be assessed and understood to ensure that the appropriate priority of work.

Analysts give feedback to mitigation concerning the performance measurements of activities to fully act on detection alerts to reduce the losses from fraud activities. Analysis provides the investigators with information to understand the environment well and assess their investigative activities and success (Khan, 2008). (6)Fraud policy is a statement that assists the

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employees to understand fraud, the organization's attitude towards fraud and the action to take in case of fraud perpetration suspicion (Australian National Audit Office, 2011). Njenga and Osiema (2013) in their research stated that policy to address fraud should seek to balance deterrent value, loss reduction, sales volume, operational scalability and cost effectiveness.

Policy development involves constantly putting together all the situations which had been separated during analysis. The knowledge gained through analysis, should be combined with internal, external and interactive environmental factors in order to develop policies that address the whole, while leveraging the knowledge of the parts (Wilhelm, 2004). The investigation stage involves getting sufficient evidence and information to stop fraudulent activity, to recovery of stolen assets or returning the assets to owners and to provide sufficient information and support for the successful prosecution and conviction of the fraudsters (Njenga and Osiema, 2013).

Fraud investigations concentrates on three major areas of activity; internal investigations, external investigations and law enforcement coordination Internal investigations will focus investigations of employees, contractors, consultants or vendors while external investigations are conducted on customers, fraudsters and organized groups (Wilhelm,2004). The last stage of fraud management lifecycle is prosecution. Prosecution is defined as "the institution and conducting of legal proceedings against someone in respect of criminal charge" (Oxford dictionary). There are three major intention of prosecution in the fraud. The first is to punish the perpetrator of fraud in an attempt to prevent further fraud. Secondly, prosecution intends to establish, maintain, and enhance the reputation of the organization of discouraging fraud, so that the fraud perpetrators and those with intention of committing fraud becomes aware of it. This is accomplished by the aggressive and successful arresting and punishing fraudsters who target the organization. The third goal is to recover the stolen assets or restitution where possible (Khan, 2008).

RELATED LITERATURE

Internal Checks

Internal checks involve employees outside the immediate work area should conducting checks on transactions to ensure that they are being done with the proper authority, are being recorded properly, and are accurate. This is referred to as peer audit. They should be organized and conducted in a way that they do not disrupt the business operations to a big extent. Employees conducting peer audits should be influenced by the people being checked, this means they should be of high integrity or not known on personal level. This role should be carried on

rotational basis to reduce the chances of collusion that might develop between the fraudster and the person checking the transactions (COSO, n.d).

According to COSO's fraud control model, the internal checks may involve the following activities; (a) Reconciling separately maintained records, for instance reconciling a bank account on cash book to the bank statements(b) Comparison between physical and recorded quantities of stock or assets. (c) Adhering to accounting principles of double system. (d) Surprise checking all parts of transactions to ensure that all parts are being done appropriately by all parties involved.

Segregation of Duties

Segregating duties is an effective measure to deter commission of occupational fraud, especially if combined job rotation. About 7 out of 10 occupational frauds are committed by one person acting alone. Including other people in functions makes collusion necessary, or makes the fraud far more difficult to commit. Having to involve or avoid another person in committing a fraud discourages most would-be fraudsters. This policy increases the belief that one will be caught, and reduces the chances of committing fraud. This is an easier method of fraud control to implement (COSO, n.d).

The purpose of segregating duties is to thwart occupational fraud in the form of asset misappropriation and intentional financial misstatement. Segregation of duties can be simplified by staying focused on this purpose and enhancing practical risk assessment. Segregation of duties ensures that no employee or group of employees should be in a position to perpetrate and conceal errors or fraud in the normal course of their duties. (Stone, 2009)The lesser people involved in the transaction, the greater the opportunity for fraud. The basic internal control concept requires that different employees should be assigned different financial and accounting tasks. Segregation of duties limits the probability of loss (Capodanno, 2012).

There is need for sufficient division of duties among those who are mandated perform accounting procedures or control activities and those who are entrusted to handle assets. The steps followed in transaction processing and related activities should be designed in a way that the work of one individual is either independent or serves to check the work of another. Such arrangements reduce the risk of undetected error and reduces opportunities to misappropriate assets or conceal intentional erroneous entries in the financial statements. Segregation of duties serves as a discouragement to commit fraud and concealment of error because of the fraudster will require to involve another individual concealing the act which is difficult (Stone, 2009).

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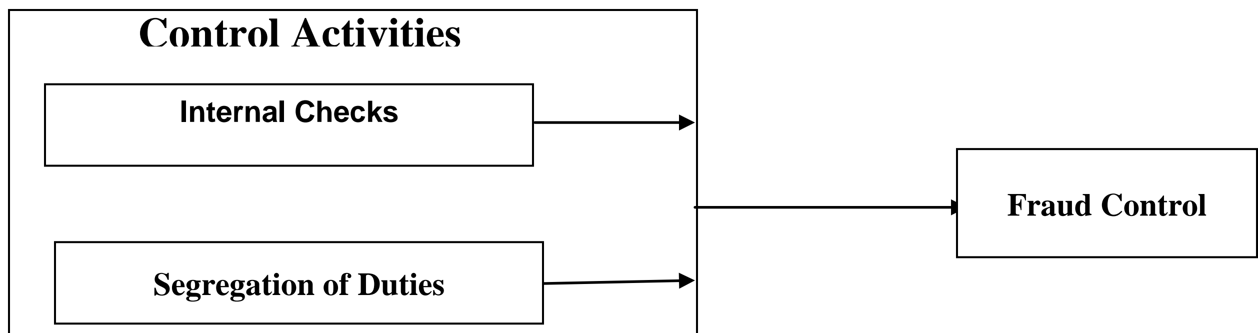
Figure 1. Conceptual Framework



METHODOLOGY

Research Design

The study used descriptive research design. Kothari (2014) stated that descriptive research design describes the state of affairs as they exist at present. He explained that the researchers has no control over variables and can only explain what happened or what is happening. This design was appropriate for the study as the researchers intended to give actual information as presented by the respondents without bias.

Target Population

The study target a total of 106 respondents who included 20 managers and 86 supervisors of various financial institutions operating in Meru town, Kenya.

Sampling Frame

The researchers' sampling frame was from managers and supervisors of financial institutions in Meru town. Sampling frame was selected in a way that it was easy to balance the representation from different financial institutions. The sample size was obtained from target population using the following formula:

Where;

$$n = \frac{N}{1+N(e)^2}$$

n= required sample size

e = level of significance taken to be 0.05

N=the population size

1=constant (Israel, 2011)

$$n = \frac{106}{1+106(0.05)2} = 84$$

Sampling Frame

Table 1

	Banks	Micro Finance Institutions	Total
Managers	14	6	20
Supervisors	60	26	86
Total	74	32	106

Data Collection Instruments

The study used the questionnaire as a tool of collecting primary data (for the first time thus original in character). The questionnaires were used as they were easy to administer and to save time. The questionnaire was designed to enable respondents to tick the appropriate answer according to their assessment based on Likert scale. The questions were designed based on the research objectives, were closed ended and required answers that were definitive to avoid confusion.

Instrument Validity and Reliability

The researcher carried out a pre-test of the questionnaire by issuing a set of questionnaires to respondents who were not part of the study to establish coherence and ease of understanding the questions. The researcher collected the answered questionnaire and carried out a post-test analysis to evaluate the responses and rectify the questionnaire where need be or where the respondents could not fully understand the questions. The researcher verified the reliability of instrument by use of reliability values (Alpha values) recommended by Cronbach who recommended analysis of each alpha value for each variable understudy which should have a value of at least 0.6 (Mohsen and Reg, 2011).The validity of the data collection instrument was done with the help of an Expert in the area who reviewed the questionnaire. He offered advice which was used for redesigning and correction of the questionnaire to facilitated at a collection. The alpha values were derived by the use of Statistical Package for Social Sciences (SPSS) and are shown in table below.

Table 2: Reliability Table

Constructs	**Cronbach Alpha Values**
Internal Checks	0.783
Segregation of Duties	0.734

Table above shows that all the variables have Alpha Values above 0.6 mark recommended by Cronbach. Therefore all the variables were reliable.

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Data Collection Procedure

Researchers sort permission from the management of organizations to carryout research through letter so frequent. The permission was granted and the researchers attached an introduction letter to the questionnaires before they were distributed to the respondents. The questionnaires were then administered through the respondents of different financial institutions. The questionnaires were collected after a maximum duration of two days for analysis.

ANALYSIS AND FINDINGS

The study was to determine how control activities in specific internal checks and segregation of duties can be used for fraud control in financial institutions. The results from the analysis of data are given in descriptive statistics with mean and standard deviation values showing the details of empirical references. The results are presented in the table below:

Table 3: Mean and Standard Deviation of Control Activities

	N	Minimum	Maximum	Mean	Std. Deviation
There is elaborate segregation of duties	*84*	*1*	*5*	*4.19*	*1.135*
There are elaborate internal checks	*84*	*2*	*5*	*4.38*	*.820*
Valid N (listwise)	*84*				

The table above gives the descriptive values of two control activities. The mean and standard deviations will be used to deduce the meanings of various statements from the respondents. The results are discussed:

There are elaborate internal checks

The study results indicated that the respondents agreed that there elaborate internal checks in various organizations, as indicated by the mean value of 4.38. Their responses do not show very diverse answers though there are variations as shown by standard deviation of 0.82. The above results show that the financial institutions regards internal checks as a way to reduce chances of fraud.

There Is Elaborate Segregation of Duties

The analysis of results in above table reveal a mean of 4.19, this imply that the respondents were in agreement with regard to segregation of duties by the responsible people. However, a standard deviation of 1.135 reveals a significant variation in the responses which could relate to

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not clearly understanding the aspect of elaborate segregation of duties or the respondents are engaged in various operations of institutions thus not keen on segregation of duties.

Hypotheses Testing

Hypothesis One

H_{01}: there is no significant relationship between internal checks and fraud control in financial institutions

H_{11}: there is significant relationship between internal checks and fraud control in financial institutions

Table 4. Hypothesis Test on Relationship between Internal Checks and Fraud Control

	Value	df	Asymp. Sig. (2-sided)
Pearson Chi-Square	134.767[a]	16	.000
Likelihood Ratio	81.200	16	.000
Linear-by-Linear Association	44.659	1	.000
N of Valid Cases	84		

The test statistics computed above (134.767[a]) is bigger than Critical chi-square value at 95 percent confidence level and sixteen (16) degrees of freedom from the table is 26.296. Since the observed Chi-square (134.767[a]) was greater than that critical chi-square (26.296), hence the null hypothesis that there is no significant relationship between internal checks and fraud control in financial institutions is rejected. Therefore we accept alternative hypothesis and conclude that there is significant relationship between internal checks and fraud control in financial institutions.

Hypothesis Two

H_{02}: there is no significant relationship between segregation of duties and fraud control in financial institutions

H_{12}: there is significant relationship between segregation of duties and fraud control in financial institutions

Table 5. Hypothesis Test on Relationship between Segregation of Duties and Fraud Control

	Value	df	Asymp. Sig. (2-sided)
Pearson Chi-Square	177.393[a]	16	.000
Likelihood Ratio	135.349	16	.000
Linear-by-Linear Association	65.101	1	.000
N of Valid Cases	84		

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The test statistics computed above (177.393[a]) is bigger than Critical chi-square value at 95 percent confidence level and sixteen (16) degrees of freedom from the table is 26.296. Since the observed Chi-square (177.393[a]) was greater than that critical chi-square (26.296), hence the null hypothesis that there is no significant relationship between control activities and fraud control in financial institutions is rejected. Therefore we accept alternative hypothesis and conclude that there is significant relationship between control activities and fraud control in financial institutions.

SUMMARY OF FINDINGS

The purpose of this study was to establish the relationship between control activities (specifically Internal Checks and Segregation of Duties) and fraud control financial institutions (Banks and Microfinance Institutions). Researchers developed research objectives and hypotheses based of the two major control activities. From the data collection instrument (questionnaire) it was revealed that majority of the respondents (96%) agreed that there were aware of the existence of control activities in their organization. Eight out of ten of all respondents indicated that control activities employed are veryeffective, 15%indicatedthatinternalcontrolsare moderate and the rest were in different. The question on the ability of control activities to address the problem of fraud, 65% strongly agreed, 29.8%agreed, 5% were indifferent to the assertion while the rest strongly disagreed.

The study established there is significant relationship between Control Activities and fraud control. The test was based on two control activities; Internal Checks and Segregation of Duties. The relationship between these two control activities and fraud control Chi square test. Details of the results from the test revealed that the control activities have significant relationship with fraud control. The test statistics was as follows (χ^2= 134.767, P = 0.0001) and (χ^2= 177.393, P = 0.0001) for internal checks and segregation of duties respectively. The Chi square test values obtained above fell in the rejection regions when compared with critical values at respective degrees of freedom. Likewise the p-values were less than the test value of 0.05.

CONCLUSION

Based on the findings of the study, it is concluded that the Control Activities (Internal Checks and Segregation of Duties) established by various financial institutions are able to control fraud as supported by the study. However, based on the standard deviation reflected by the study was big which clearly shows that the respondents had very diverse opinion on the segregation of duties. Based on that observation, it would be of paramount importance for the custodians of

controls in these financial institutions to put in place policies that will spell out clearly to all employees their roles and duties within the organization in order to address completely the fraud menace. The final conclusion of this study is that there is significant relationship between Control Activities (Internal Checks and Segregation of Duties) and fraud control in financial institution in Meru town, Kenya.

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