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AN EMPIRICAL ANALYSIS OF FRAUD PREVENTION AND PROFITABILITY

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ABSTRACT

The study focusses on fraud prevention as a dimension of audit function on business profitability, effectiveness and efficiency as measures of performance. Primary and secondary data were collected, sample size was randomly selected thirty two listed manufacturing companies from different sectors of the economy. Pearson Product Moment Correlation powered by Statistical package for social sciences and QSR-NVIVO software used in the data analysis. The study finds that the influence of fraud prevention is more positive and very significant on business profitability, than on effectiveness and business efficiency, which appear to have weak influence in the sample manufacturing companies in India. Conclusively, the more stringent fraud prevention measures tend to be, the more businesses will achieve higher growth in terms of profitability. It is recommended that firms should improve on the fraud prevention mechanism to track all dubious tendencies to avoid being defrauded.

KEYWORDS: Efficiency, Fraud Prevention, Operational Effectiveness and Profitability.

INTRODUCTION

A short definition of fraud as outlined in Black's law dictionary is an act of international deception dishonesty perpetrated by one or more individuals generally for financial gains. According to Robertson (1976) fraud is any deception practiced to cheat or deceive another to his own detriment or to the detriment of any other, or to cause another loss or injury, while the perpetrator has a clear knowledge of his deliberate falsehood, deception or advantage over the innocent and unsuspecting victim.

These two definitions establish the fact that the person perpetrating the fraud action is fully aware of his/her action. Companies put polices and procedure in place. An employee committing fraud circumvent those policies and procedures (Sander, 2015). An employee committing fraud is not making a mistake but deliberately circumventing the system.

The employee uses various methods to conceal his/her actions. Lies are told, documents are falsified, transaction recordings are misrepresented, internal controls are abused (Sunder 2015). Occupational fraud is very difficult to detect. Accountants and auditors have often been exalted to be the leaders in fraud prevention by employing their skills in designing control systems.

Control systems limit trust, limit employees' initiatives and in the extreme can strangulate business organizations with bureaucracy (Hamiltion &Gabriel, 2014). Measures aimed at fraud prevention could include dual control, operational manual, lending limits, reporting system, micro-filming etc.

In view of the serious threat posed by fraud in business performance and existence, it is possible that the absence of an adequate response to the threat arises, because the instinct for business survival encourages management of organizations to anticipate that change, the process by which the future invade existence, is much less profound than is actually the case. Many corporate management shun the practice of reporting fraud to the public, in order to protect their image and goodwill and to win the confidence of investors (Adebayo, 2006).

There have been research investigations on fraud from detection and prevention perspectives. The scholarly contributions abound on performance, but not very much regarding business performance measures of operational effectiveness and efficiency in terms of resource utilization is available in the knowledge repository. The pertinent question to be addressed in this investigation is to what extent does fraud prevention influence business performance?

LITERATURE REVIEW

Political and public office holders, board members, management and employees should lead by example in ensuring opposition to fraud and ensuring adherence to rules, regulations and codes of conduct, more so, that all procedures and practices are beyond reproach. Employees and members of the public are important elements, in the opposition against fraud and are positively encouraged, to raise alarm as part of its responsibilities, organizations are required to authorize its internal audit unit to investigate activities suspected of involving fraud. Its audit manual is required to provide adequate coverage of the risk of fraud and also to reflect the requirement for audit staff to be properly and regularly trained.

Managers at all levels in an organization are primarily responsible for fraud prevention and detection. They are required to conduct fraud risk analysis on an ongoing basis in their areas of responsibility, owing to take appropriate counter measures to limit that risk to a minimum level.

The cost effective approach should be adopted in the implementation of internal process control measures. Managers at all levels should basically perform their responsibilities in fraud prevention and detection through the development and maintenance of adequate and effective systems of internal control, which comprise the plan of organization and all of the co-ordinate methods and measures adopted within an organization to safeguard its assets, check the accuracy and reliability of its data and information, promote operational efficiency, and encourage adherence to prescribed managerial policies.

The institute of Cost and Management Accountants (ICMA) argued that, although it is extensively difficult to establish a theoretical framework for causes of fraud, three distinct factors seen to be very instrumental to giving rise to opportunities for the occurrence of fraud. They are: situational pressures, existence of lapses for fraud to flourish and personal characteristics. This tends to be prevalent particularly when there is job dissatisfaction, personal financial difficulties, pressure from fellow employees, friends and relations. These appear to subject the individual(s) to financial pressure and susceptibility to defraud.

The other situation that can create lapses for fraud to flourish include, lack of proper or adequate control supervision, close work relations, inadequate communication rules of conduct and irregular working hours. The individual personal characteristics (indecent character) which presupposes improper act, can lead to fraudulent practices (Ojaide 2000). The formula introduced in organization would assist managers to determine optimum mix of internal audit, resource allocation and penalties for violators. The developments of fraudster have remained unabated and fresh discoveries are regularly made of more sophisticated ways of perpetrating their deals (Ebhodaghe 1996).

Hotten (1993) made a critical examination of the fraud phenomenon of the Victorian age. He cited Thatcher's call in the early 1980's for a return to Victorian values that heralded an outbreak of corruption strongly reminiscent of that age. It had been observed that Victorian frauds had soured the image of businessmen in the minds of the people. The individual revolution and the consequent emergence of sophisticated financial and legal networks led to expanded chances or avenue for fraud to thrive. While discussing internal audit function, Nwankwo(1991) described fraud as a complex universal phenomenon. Political, economic, social, cultural and attitudinal factors combine in contributing to its incidence. Its effects are cumulative and circular, and they extend beyond the boundaries of nations and states (Adekanya and Ojie-Ogbebe 2007). The information deduced from a study carried out by United States of America Congressional Committee, found that out of about seventy five commercial banks failure between 1980 and 1983, 61% involved criminal misconduct by insiders. For instance, citation for fraud comprised 63% of the total number of identified causes of banks failure (Nwankwo 1991). It has been observed that, it behoves on the internal auditor to detect fraudulent behaviours which involve high level managers, against the backdrop of preservation of integrity, responsibility and accountability required of them by virtue of their terms of assignment, duties, status and position in an organization (Nwanjo, 2005).

For instance, Govindarajan and Anthony (1995) observed that, often times, managers manipulate figures, so as to report the attainment of the organization's budgeted profitability, thereby falsefully placing that organization in a favourable position. The application of such device is recording, as revenue in the current period, goods that had not actually been shipped or supplied to customers in that given period. In some other situations, managers manipulate figures, achieving result of performance exceeding the budget, in which scenario, certain revenue transactions may be omitted in management report. When considered that reporting a high profit may lead to an increase in the budget amount in the succeeding periods.

Some of us are aware of the biggest corporate fraud probed in South Korea. Daewoo went down in 1999 with eighty billion US dollar ($80 billion) debt, (BBC News, 2005). This debt arose from improper accounting and insider dealings with banks and government officials by the Chief Executive Officer, Kim Woo Choong. He directed his executives to inflate assets values to acquire bank loan between 1996 and 1997. He equally smuggled $3.2billion US dollars overseas.

Integrity and ethical values are the product of an entity's ethical and behavioral standards and how they are communicated and reinforced in practice. They include management actions to remove or reduce incentives and temptations that might prompt personnel to engage in dishonest, illegal, or unethical acts. They also include the communication of entity's values and behavioural standards to personnel through policy statements and codes of conduct.

There appears to be absence of discipline, fortitude and integrity on the part of internal auditors to always stand up to the intimidation by senior management, For example, when pressured with threats of replacement or enticed by financial rewards, internal auditors are on record to easily accommodate and compromise on questionable accounting practices. Even though they were aware that such practices did offend the generally accepted accounting principles (Akpa 2007).

Drucker(1986), in course of outlining the path to integrity for Managers argued that, the final proof of Management sincerity and seriousness is uncompromising emphasis on integrity of character. From the foregoing statements, it can be said that internal auditor and managers of organization possesses high value of rating in terms of integrity and ethical standards of practice. Thus, it appears may contribute to sound business performance, when set targets are met within the stipulated period. The organization over time may witness accelerated growth in all spheres of its operation, within the particular industrial sub-sector. The operational environment and the overall economy may experience considerable improvement.

The internal auditor's primary responsibility is not to investigate, detect or prevent fraud and other irregularities. It was stated by Justice Lopes (1896) in the case of Kingston Cotton Mill Company. *"An auditor is a watchdog and not a blood hound, He is not bound to approach his* *work with suspicion. He is entitled to rely on the representations of trusted officers of the Company".*

These trusted officers are the top management, the directors of finance, administration, engineering etc. and their subordinate managers. The way organizations are operated in this twenty first century, the judgment of Justice Lopes would have been different. It is expected of the internal auditors to possess basic knowledge of the requirement of a business transaction, to make for effectiveness and efficiency in the discharge of responsibilities. The internal auditors should also have courage to intervene from the points of expedience. The ideal situation is when the transaction detail is made available to the internal auditor, which is hardly ever so. Furthermore, the interventionist should be fair, firm, frank, objective and articulate in order to earn the respect of the various contributors to the business process. To ensure effectiveness on the part of the internal auditor, independence should be guaranteed.

Oziegbe (2001) while arguing on business profitability and efficiency in corporations, noted that fraud refers to intentional distortion of financial statements or other records which are carried out, to conceal the misappropriation of assets or otherwise for gain.

Managers of organizations have failed to internalize the norm of not applying funds for purpose other than their intended use. Perhaps, the indiscretions are not only symptomatic of large financial abuses, but contributes in encouraging malpractices and maladjustments in business operations. Recently, it was declared that auditors aid wastages, corruption and distress in the financial system. It was submitted that auditors' job had become that of post-mortem book examiners and that their inability in the publicly-owned companies to live up to their responsibility, aided waste and corruption in some organizations. What was regrettable as declared is the fact that it was possible for company executives in position of trust to embezzle huge sums of money, despite the presence and operation of internal auditors, who were there to prevent fraud.

The focus has always been on prevention through the necessary internal control measures, put in place by the internal audit department of organizations, the traditional process controls applicable to business organization are usually employed, to ensure profitability effectiveness and efficiency. The investigation of fraud came about in the year 1770, when there was widespread or large scale fraud reported in the South Sea bubble company, which outraged public outcry in the United States of America. Then, auditors were appointed to investigate the fraud.

The experienced non-executive directors and effective audit committees can play an important role, in maintaining the integrity of an organization's policies and procedures and can also help to ensure that proper perspectives are maintained, in circumstances where operating management, are under undue pressure to produce results. In the same vein, a strong internal audit function with a reporting line to every senior member of management, a board member if possible, who would also have some overall responsibility for systems and their security is an important link in the chain of an organization's fraud prevention strategies. Having extensively reviewed literature, the following hypotheses is derived :

HA7: Fraud prevention has a significant relationship with business profitability.

HA8: Fraud prevention has a significant relationship with business effectiveness.

HA9: Fraud prevention has a significant relationship with business efficiency.

METHODOLOGY

The study adopted the correlational survey method. Thirty two listed companies from the different sectors of the economy were sampled. The research instrument used was tested for validity and reliability. For Reliability test, an alpha () coefficient of 0.8 was obtained with the help of SPSS version 20. Pearson Product Moment correlation (PPMC) was used to test the stated hypotheses so as to investigate the relationship between Fraud Prevention and Business Performance. Qualitative analysis was carried out using the QSR NVIVO statistical software package.

RESULTS

Table 1. Correlation Analysis of Fraud Prevention and Profitability

Correlations

Variables	Statistics	FRAUD PREVENTION	PROFITABILITY
FRAUD PREVENTION	Pearson Correlation	1	.393*
	Sig. (2-tailed)		.043
	N	32	32
PROFITABILITY	Pearson Correlation	.393*	1
	Sig. (2-tailed)	.043	
	N	32	32

* Correlation is significant at the 0.05 level (2.tailed)

The correlation coefficient r = 0.393* as shown in the above table implies that the relatively strong relationship exist between fraud prevention and profitability. The correlation coefficient is positive showing that increase in fraud prevention, increased profitability in the studied organizations. The correlation is however significant at 0.05 level of significant (PV = 0.043)

From the foregoing, the hypothesis is accepted which states that "fraud prevention has a significant relationship with business profitability".

Table 2. Correlation analysis of fraud prevention and effectiveness

Correlations

Variables	Statistics	FRAUD PREVENTION	PROFITABILITY
FRAUD PREVENTION	Pearson Correlation	1	.194
	Sig. (2-tailed)		.288
	N	32	32
EFFECTIVENESS	Pearson Correlation	.194	1
	Sig. (2-tailed)	.288	
	N	32	32

The correlation coefficient r = 0.194 as shown in the table above shows that a weak relationship exist between fraud prevention and business effectiveness. It also shows that increase in fraud prevention increases effectiveness and relationship is statistically insignificant. (PV = 0.288) the probability value is greater than 0.05. More so the correlation is no flagged significant showing that it does not satisfy the SPSS explanatory scheme, therefore the hypothesis is rejected which states that "fraud prevention has a significant relationship with business effectiveness.

Table 3. Correlation analysis of fraud prevention and efficiency Correlations

Variables	Statistics	FRAUD PREVENTION	PROFITABILIT Y
FRAUD PREVENT	Pearson Correlation Sig. (2-tailed) N	1 32	.128 .484 32
EFFICIENCY	Pearson Correlation Sig. (2-tailed) N	.128 .484 32	1 32

The correlation coefficient r = 0.128 as shown in the above table shows a weak relationship between fraud prevention and efficiency. The correlation though weak, there is a positive signal showing that increase in fraud prevention increased efficiency. It is however statistically insignificant (PV =0.484). It is also not flagged significant implying that the correlation has not satisfied the SPSS explanatory scheme. Therefore, the hypothesis is rejected which states that "fraud prevention has a significant relationship with business efficiency".

In this analysis, the three hypotheses were tested relating fraud prevention to measures of business performance. The hypotheses were: HA1: fraud prevention has a significant relationship with business profitability, HA2: Fraud prevention has significant relationship with business effectiveness and HA3: fraud prevention has significant relationship with business efficiency. The results of the test show that HA1(r = 0.393) was accepted, while HA2(r = 0.194) and HA3(r = 0.128) were rejected. This shows that fraud prevention is only significantly related to business profitability, and not business effectiveness and efficiency. Given this trend, it was found that fraud prevention positively influences business profitability.

Fraud prevention exerts very significant but positive influence on business profitability. Beside the quantitative analysis, qualitative analysis was also conducted using the QSR NVIVO statistical software package. The analysis involved the transcription of the audio record interview, which was later typed in rich-text format, and then coded into the NVIVO using codes and nodes. From this analysis, the following findings were deduced: (a) Fraud prevention influences profitability; (b) The influence of fraud prevention is more positive and very significant on business profitability, than on effectiveness and business efficiency which appear to have weak influence in the selected manufacturing companies.

DISCUSSION

From the interpretation of result on the hypotheses tested on fraud prevention and measures of business performance, it was revealed that fraud prevention is significantly associated with profitability but not with effectiveness and efficiency. The issue of fraud in business organizations has drawn enormous theoretical attention some of which have support for our finding that fraud prevention positively influences profitability. Considering fraud as a wrongful and non violent act with the intent to deceive and cheat, Radburn (1982) argued that fraud is an illegal activity which principally involves deceit, misrepresentation, concealment, manipulation, breach of trust, subterfuge or illegal circumvention. Also, our finding has much support from the argument of ICMA that the frequency of occurrences of fraud in any establishment tends to be detrimental to the long-term and short-term survival, and growth of the organization. Therefore, if it is not handled with due care and urgency, it could lead to corporate failure. When this is viewed on the background of our finding, it further implies that the prevention of fraud is a conscious attempt to protect the profit, survival, and growth objectives of business, since fraudulent act is against the achievement of these goals.

Therefore, our finding corresponds with that of United States of America congressional committee reported in Adekanya and Ojie-Ogbebe (2007) that out of seventy-five commercial banks failure between 1980 and 1983, 61% are traceable to criminal misconduct (fraudulent activities) by insiders. In the same regard, Nwankwo (1991) argued that fraud comprises 63% of total number of identified causes of bank failure.

It is quite indicative in our finding that fraud prevention is a guard to achieving profitability. From the foregoing, it is logical to conclude that, the more stringent fraud prevention activities and measures tend to be the more profitability is assured in the organization.

In terms of justification, the study is of immense significance to scholars in the field from the theoretical point of view, shareholders and practitioners will also benefit from the practical angle. It is imperative to empirically determine the influence fraud prevention exerts on corporate performance. Since, cases of business failure are prevalent and cases of embezzlement are often reported in private and public sectors of the economy. The theoretical and empirical knowledge generated will serve as a guide in preventing fraud occurrence in the sample manufacturing companies.

CONCLUSION

Despite the best effort of those responsible for preventing fraud one inevitable reality remains, fraud takes place. Fraud prevention and detection are related concepts. Prevention encompasses policies, procedure, training and communication while detection involves activities and programmes designed to identify fraud. This study has established that the frequency of occurrence of fraud in any establishment tends to be detrimental to the long-term short-term survival and growth of the organization. When this is viewed on the background of our findings, it implies that the prevention of fraud is a conscious attempt to protect the profit, survival and growth objectives of business since fraudulent act is against the achievements of these goals. The more stringent fraud prevention measures tend to be the more business will achieve higher performance in terms of profitability.

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