

**The role of effective internal control
on the detection and prevention of
Fraud in Egyptian commercial banks.**

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Abstract

Effective Internal Control has been an important topic in Accounting. Its linkage to fraud prevention and detection has always been an area of interest for audits and managers.

In this study, the relationship between Effective internal control and detection and prevention of fraud in Egyptian commercial banks has been addressed.

Data was gathered using a self-administered structured questionnaire.

The data was analyzed using SPSS to test the relationship between Effective internal control and detection and prevention of fraud in commercial banks given to managers, internal auditors and members of audit committee of the Egyptian banking sector.

The findings revealed that effective Internal Control have a significant positive effect in detecting and preventing of fraud in Egyptian commercial banks .

The study further reveals that there a significant positive relationship between the Control Environment, Control Activities, Risk Assessment, Information , Communication and Monitoring and Detecting and preventing of fraud in Egyptian commercial banks .

1.1 General Background:

The banking sector plays a major role in any economy. The economic crises in the Asian countries emphasized the importance of corporate governance. The corporate governance of commercial banks is more important than other industries. Poor corporate governance in commercial banks can drive the market to lose confidence in the ability of a bank then it leads to economic crisis in any country and lead to a systemic risk. In contrast, good corporate governance in any commercial bank strengthens property rights; minimize transaction cost and the cost of capital, and leads to capital market development. Corporate governance reforms are of great significance for developing countries to gain a sustained effort to attract Foreign Direct

Investment and Foreign Portfolio Management, and to mobilize greater saving through capital market (Adnan et al., 2011 cited in Ravi P. and Martin H. 2013)

Banking has a diversified and essential financial activity which is no longer limited or restricted within the geographic boundary of any country in the world. Since its activity involves high risk, the issue of effective internal control system, corporate governance, transparency, accountability has become significant and major issues to ensure smooth performance of the banking industry throughout the world. In many banks internal control is identified with internal audit; the scope of internal control is not limited to audit work. It is an integral part of the daily activity of a bank, which on its own identifies the risks associated with the process and adopts a measure to mitigate the same. Internal Audit on the other hand is a part of Internal Control system which encourages the control system through regular review. (García-Marco & Robles-Fernández, 2008 cited in Ravi P. and Martin H. 2013)

Commercial bank's internal controls to protect the assets of the bank safety integrity, and guard against financial risks, ensuring the authenticity of the reliability of accounting data, improving efficiency, the implementation of the various senior managers to develop management policies to ensure the achievement of business objectives to develop and implement organizational planning and the various departments and personnel within the constraints and coordination with each other a series of systems, measures, procedures and. The purpose is to ensure that a bank's business according to the bank's management policies at the most reasonable way to ensure business standardization will be a variety of risk management within the narrowest scope to achieve their business objectives. (Claessens & Fan, 2002 cited in Ravi P. and Martin H. 2013)

Fraud is an ever-present threat to the effective utilization of resources and hence will always be an important concern of management (Brink and Witt, 1982 cited in Ravi P. and Martin H. 2013).

Fraud identification should precede any preventive measure as the success of any measure will be largely dependent on the knowledge of the nature and

type as well as frequency of fraud, the causes and methods of the frauds and the potentials and prospects of some of them occurring in the bank. The volume, types and concentration of the bank business operations will be the function of internal control System. Internal checks are operational controls; which are built into the banking system to simplify the Processing of entries in order to ensure prompt services to help in minimizing errors and to act as insurance against collusion. Also, the external auditors who examine the books of the banks to determine its truth and fairness have their own part too. This is known as statutory audit which is called for by the law (Ogwuma, 1998 cited in Idowu A., Adedokun T. Oyewole. 2013)

Crosse and Hempel (1973) and Canhil M el al (2002) cited in Idowu A., Adedokun T. Oyewole. (2013) that the five major types of fraud perpetrated in the banking industry. These include:

1) "Borrowing" from the till. This usually starts out with borrowing a few naira, which are returned.

Overtime, the sums involved increase and the willingness and ability to 'repay' declines.

2) Forgeries of customers' signature to withdraw from his/her account.

3) Transfer from customers account to collaborators account.

4) Granting of loans to fictitious borrowers.

5) Granting of loans without adequate information and security from the borrower.

Fraud has attracted the attention for scholars, investigators, auditing and accounting associations, and government agencies, nationally and internationally. Fraud's many definitions include those given below.

Prosser (1971) stated the major elements of fraud as follows:

- 1) False representation of a material fact;
- 2) Representation made with knowledge of its falsity;
- 3) A person acts in the representation; and
- 4) The person acting is damaged by his/her reliance.

Fraud detection is essential to fraud prevention, as when their fraudulent acts will be detected with ease, the fraudsters will think twice before doing it by making reference to the statement that “the best deterrent is the certainty of detection” (Nwankwo, 1991).

1.2 Research Problem:

The focus of this study is to provide evidence bearing on the nature and factors leading to ineffective management in bank, also it actually evaluates the effect of Fraud and finally shows internal control as a basis to prevention and detection of fraud.

In addition, this study attempts to investigate the relationship between effective internal control and fraud detection and prevention in commercial banks.

1.3 Research Questions:

- 1) What are causes of the increasing rate of fraud in banks?
- 2) What are the effects or damage has fraud caused banks?
- 3) How to prevent fraud in the very initial stages?
- 4) What are the development ideas and suggestions to improve internal control?
- 5) What Kind of relationship exists between detection and prevention of Fraud and internal Control system?
- 6) What is the impact of internal control in the prevention and detection of fraud in banks?
- 7) Is Lack of good internal control system considering a major role of Fraud in commercial Banks?

1.4 Research Objectives:

The objective of this project is to through light on the relation between effective internal control system and fraud in commercial bank and discusses several theories of auditing, internal control system and Fraud.

The usefulness of this study entitled effective internal control as a basis for prevention detection of fraud cannot be over whole the researcher was motive into embarking on this study because of the positives result accruable from an adequate internally control organization. Equally the result of this study would be immense benefit to numerous groups of persons such as Auditors, External Examiners, Managers, the Accounting and banking professions, Regulatory bodies of banks and other operators in the banking system.

It will be relevant to analyze and recommend directive, preventive and curative measure to check fraud and distress in banks. Indeed internal control machinery when installed can do this, Also recruitment not based on sentiments but on personal integrity will prevent recruitment of greedy people in bank

1.5 Research Importance:

A study, such as the one conducted here, is recommended by experts in the field of accounting.

This study has practical implications for accounting practitioners, internal auditors, and fraud examiners.

It provides precious information on what fraud detection and prevention method work best, and suggests the most effective method to be used in the banking sector.

According to Some studies and researches have showed the ability of internal auditors to perform fraud related work. Internal auditors achieved a high level of consensus in their financial statement fraud risk ratings suggesting that internal auditors are as aware as external auditors of where fraud is likely to be detected (Apostolou, Hassell, Webber and Sumners 2001).

Literature Review and Hypothesis development:

2.1. Literature Review:

Fraud, according to Webster's New World Dictionary, is the "intentional deception to cause a person to give up property or some lawful right." The Association of Fraud Examiners' (1999) Report to the Nation on Occupational Fraud and Abuse further defines occupational fraud and abuse as "the use of one's occupation for personal enrichment through the deliberate misuse or misapplication of employing an organization's resources or assets." A third definition comes from the Federal Bureau of Investigation. It defines fraud as "the fraudulent conversion and obtaining of money or property by false pretenses: included are larcenies by bailee and bad checks, except forgeries and counterfeiting" (FBI 1984:342). The common thread among these definitions is that fraud is a deliberate deception for the gratification of an individual or group. Fraud requires a theft, often accompanied by concealment of the theft, and the translation of the stolen assets or resources into personal assets or resources.

2.1 History of fraud

The history of fraud shows an evolution in the complexity of today's fraud ranked from the most famous to the most ambiguous. For further details, a document called "Fraud Museum" on the ACFE (Association of Certified Fraud Examiners) site provides lot of old books that cites ancient fraud cases that have questioned the fairness of the financial statements.

One of the first financial statement frauds was perpetrated by the South Sea Company (1711-1727) and nearly bankrupted England. In 1719, the company proposed a scheme by which it would take on the entire national debt of the United Kingdom in exchange for government bonds. By fraudulently hyping the value of the stock, the price rose from £128 per share to over £1,000 before the company collapsed, bringing financial ruin to thousands of investors, including members of Parliament. (Fraud Museum 2006, By ACFE)

The notorious fraudster Ivar Kreuger claims the first piece in the Fraud Museum collection. Known as the "Swedish Match King," Krueger engaged in a large number of frauds in the early 20th century including embezzlement, the use of shell companies, transferring debt to subsidiaries, and even counterfeiting \$142 million worth of Italian bonds. After his schemes began to collapse, Kreuger committed suicide in 1932 leaving a note that said, "I'm too tired to continue." (Fraud Museum 2006, By ACFE)

Financial historians generally agree that the infamous stock market crash of 1929 actually began with a chain of events surrounding the bankruptcy of this flamboyant English financier. On Sept. 20, 1929, it was revealed that Hatry had forged \$67 million in municipal bonds to cover his debts.

As a consequence, many of his shareholders had to fortify themselves by selling their American holdings, creating panic in the market. Less than 30

days later, the stock market crashed, causing the worse financial crisis in U.S. history. Hatry served 15 years in prison for his crimes. (Fraud Museum, 2006)

The bankruptcy of Barings in the middle of 1990, bankruptcies of Enron, Worldcom, Refco and Parmalat recently, highlighted the devastating fraud effects on business, including huge financial losses, damage of stock market, etc...

2.2 Domain of fraud

Several definitions approached the term fraud from different legal and accounting points of view, Price Waterhouse Coopers (PWC) Global Economic Crime Survey 2003 defines fraud to be (PWC Crime Survey, 2003):

"Intentional deception Action to dispossess someone sum of money, property or a legal right."

In a legal context The term 'fraud' is generally defined in the law as an intentional misrepresentation of material existing fact made by one person to another with knowledge of its falsity and for the purpose of inducing the other person to act, and upon which the other person relies with resulting injury or damage. (Lectlaw Library, www.lectlaw.com/def/f079.htm)

In this orientation, the Committee of International Auditing Standards (IAS 240) tried to clarify the term fraud:

"The term fraud indicate an intentional act committed by one or several people being a member of the management or the employees, or by third party, which ends in erroneous financial statements" (ISA 240, p.77)

Fraud has been considered by ISA as:

- a. Manipulation, falsification or alteration of accounting or documents.
- b. Misappropriation of assets.
- c. Suppression or omission of the impact of certain transactions in the accounts or documents.
- d. Registration of baseless operations.
- e. The incorrect application of closing accounts procedures:

The ACFE (Association of Certified Fraud Examiners) defines fraud as: "The use of one's occupation for personal enrichment through the deliberate misuse or misapplication of the employing organization's resources or assets." (ACFE, 2004)

It is in other words, the exploitation of an occupation for personal interest by misuse or illegal use of an entity's assets.

According to the ACFE, fraud requires the presence of four essential criteria:

- a. The clandestine nature.
- B .An activity that infringes the rights of the victim.
- C. directly or indirectly Result, a financial interest to the fraudster.
- d. The presence of a cost that will be charged to the victim.

2.3 Comparison between error and fraud

An error is a mistake committed inadvertently, it may be an oversight, a false arithmetic, or a false tax ... the measure that these faults are considered errors is intention. (ISA 240: irregularities and inaccuracies)

2.4 Types of frauds

Fraud has always existed and does not seem likely to disappear. We identify two general types of fraud: one resulted from fraudulent financial reporting violating the tax law and other from an accounting manipulation: to divert funds or deface the financial statements credibility. In both cases, there can be no fraud without motivation or pressure pushing a person or a group to use deceptive maneuvers in order to obtain an unjust or illegal advantage. (The Business, 2006)

Therefore, we can deduce the presence of both best-known existing frauds within the company and having effects on the financial statements reporting:

- 1- The fiscal fraud.
- 2- The accounting fraud.

2.4.1 The fiscal fraud.

"Fiscal fraud necessarily imply a violation of the tax law in order to escape completely or partially to tax or to obtain tax refunds illegally" (Dasses M. & Minne P., 1996)

The tax fraud is then the illegal diversion of a fiscal system to not contribute to the public responsibilities. On the contrary, the tax evasion is the legal use of weaknesses of the fiscal system to reduce the amount of tax paid. (Alex M., 2010)

2.4.2 Accounting fraud.

Accounting fraud is the manipulation and the forgery of accounts and accounting records in order to divert assets or give deceitful and unreal situation of the corporate image. This fraud has a direct effect on the financial statements which will bear the consequences of the committed frauds, and so the true image of the company, that is the purpose of an internal or external audit mission, is never highlighted. (Amadou N. Yaro, 2006)

In another approach, the possibilities of frauds within a company are very varied but they belong generally to one of the following categories:

a- Fraud and theft by misappropriation of asset

As far as companies do not have developed internal control procedures, it is often easier for employees to misappropriate the assets of the company. This type of fraud may involve "material assets" as exaggerated expenses such as the cost of restaurants, travel and entertainment or telephone communications. But the risk of "immaterial" fraud should not be underestimated. (Deloitte, 2005)

b- Fraud in the presentation of financial statements

This type of fraud is usually committed by management or the owner of the company to be financially different from the actual situation. The objectives of this maneuver can be multiple: to maximize its performance against other competitors, achieve certain financial indicators as a basis for determining objectives premiums, reduce income tax expense or reassure credit institutions with which the company negotiates loans or credit lines. (Deloitte, 2005) This type of fraud is generally done as follows:

- The non-recognition of a significant event that occurred in the accounting period.
 - The non-compliance with generally accepted accounting principles.
 - Recording fictitious sales or intentional over-or under-valuation of stocks.
- In all cases, the purpose is the same: Faking the numbers to change the reality.

c- Fraud by third parties

This type of fraud occurs mainly through the arrangements taken by the owner of the company or by the management with partners, in particular with customers or the suppliers. The most common cases are the transactions with "friendly" companies on terms that do not meet the normal market conditions or commissions received from transactions with customers or suppliers. (Deloitte, 2005)

2.5 Impacts of fraud

As the control mechanism is weak and the accounting standards are flexible, the fraudulent reporting in the financial statements and manipulated financial information will remain inevitable.

The Association of Certified Fraud Examiners (ACFE) assures that measuring the cost of occupational fraud is important, yet incredibly challenging, possible with more efforts, but the true cost is incalculable. The clandestine nature of fraud means that many cases will never be revealed, and, of those that are, the full amount of losses might not be uncovered, quantified or reported. Consequently, any measurement of occupational fraud costs will be, at best, an estimate. Nonetheless, determining such an approximation is critical to illustrate the pandemic and destructive nature of white-collar crime. (ACFE, global fraud study, 2012)

Until recently, organizations did not deploy a "proactive strategy" to fight against fraud and anticipate problems before they occur. Most of the measures were reflexive, through internal control and audits, but does not clearly included fraud.

Fraud was not recognized as a real risk for the company, partially for cultural reasons, also because it was difficult to identify the extent of its impacts. Financial scandals have reformed this situation by exposing some secrets to the public: accounting manipulations, control weaknesses, conflicts

of interest, auditor independence issues, etc... The "dark side business" appeared to the light and it was no longer possible to ignore the problem.(S. Albert et al, 1995)

Media have focused on both accounting side and managers responsibility, and minimized other aspects of fraud: embezzlement, corruption and the existence of fraudulent employees. At a time when the economy was experiencing a serious crisis of confidence, it would certainly have been too hard to show the public that the organizations were not under control.

2.5.1 Indirect financial loss

The Price waterhouse Coopers survey (PWC) reveals that 'the impacts of fraud beyond the financial loss of alteration. Other factors must be taken into consideration even if they cannot always be directly measured.(PWC survey, 2003)

The financial loss is not limited to the embezzled funds only. Indeed, how to recognize and analyze the resulting loss due to embezzlement? There is undoubtedly an exceptional charge, and the tax treatment will depend on the perpetrator of the fraud: (Sylvia F., 2006)

- By a partner: not deductible because the diversion is considered a levy
- By an employee (non-officer): deductible if committed without the knowledge of management and therefore the company
- By a manager: not deductible because the alteration was not made without the knowledge of the company.

2.5.2 Direct financial loss

Market share

Loss of market shares is the direct impact of the income loss. In fact, in an economy where the costs of returns are very tight, increase its costs by fraud, especially if it is unidentified, leads to reduce its productivity. And competitors who have mastered their risk of fraud may be in a better position in the competitive market. (Olivier Gallet, 2005)

Share price

For listed companies, the stock is very sensitive to loss rumors. Thus, when a financial fraud is suspected, there is often a collapse in shares market. For example, the share price of the giant Dutch retail 'Ahold' has dropped by 67% the day of the announcement of the overestimation of the operating income of its U.S. Foodservice subsidiary. The fraud involved at least \$ 500 million for the years 2001 to 2002. (Olivier Gallet, 2005)

Branding

The image of the organization is greatly damaged when fraud is known by the public. The loss of confidence derives from customers, suppliers,

partners and employees. For example, providers refuse to contract and deliver their products for fear that the company goes bankrupt following a fraudulent conversion. This effect is multiplied if the company had not planned a crisis procedure to react in case of fraud with a suitable communication. (Olivier Gallet, 2005)

Audit fees

Improvement standards and regulations on business complicate the work of the auditors. For example, the evaluation of the internal audit report provided by the Financial Security Act will have an impact on the number of hours and therefore auditor fees. In general, the auditors will show increased vigilance in the coming years, at least to reduce their exposure to prosecution. Knowing that if the company could establish an environment that promotes controls and transparency, it will reduce the additional work required by the auditors. (Olivier Gallet, 2005)

Litigation costs

The choice for a company to pursue a fraudster employee to justice is justified by the desire to obtain financial compensation and also to recognize the criminal offense. Some large companies can absorb the cost of fraud which they were victims and avoid ruining its image in the media. Nevertheless they decide to get a judicial order so that the fraudster cannot do it again. This is the case of groups that cannot control global hiring of their employees... If an old fraudster applies for employment, there are chances that he is hired again but if the condemnation appears in his record, a watchful human resources department identifies him. (Olivier Gallet, 2005)

2.6 Who's committing this fraud?

As the amount of fraud increases, organizations can no longer just fight it reactively. They need to be more proactive when it comes to protect them. One aspect of this is gathering as much information as possible about the perpetrators. Knowing who they are and where they come from is essential for finding out where the weaknesses are in an organization's response mechanisms and internal controls. 56% of the main perpetrator of the most serious fraud in 2011 was an internal fraudster, and 40% was an external fraudster. (PWC crime survey, 2011)

But the financial services and insurance sectors stood out, with the main perpetrator usually coming from outside the organization. This is typical in the financial services and insurance sectors, so it wasn't a surprise here. (PWC crime survey, 2011)

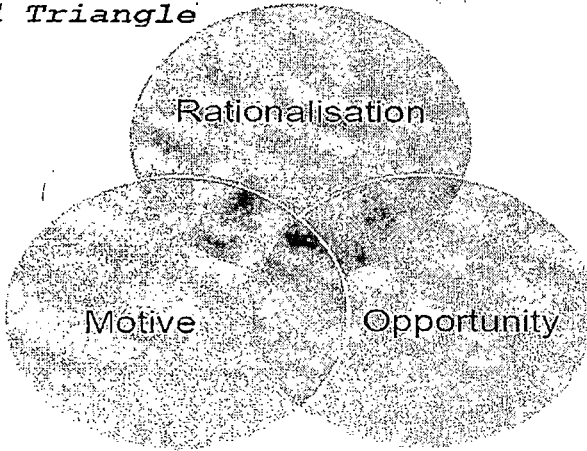
2.7 Why do people commit fraud?

From a theoretical point of view there are three important factors concerned with committing fraud: opportunity, motive, and rationalization, also known as the fraud triangle. (ACFE, 2012)

Figure

1

Fraud Triangle



Source: ACFE, Global fraud Study, 2012

Opportunity generally occurs through weaknesses in the internal controls and creates an atmosphere where fraudsters believe they are likely to be successful and undetected. Therefore companies primarily focus their prevention efforts on this aspect of the fraud triangle by enforcing certain types of controls and by implementing effective fraud risk management policies. Trust, however, though important in business often becomes the door opener for fraudsters.

Motive often develops from financial pressure resulting from a fraudster's excessive life style, or from the gap between the financial remuneration earned and the responsibility held by the individual, or pressure to meet financial targets, or the superiority complexes of the individual or basic greed.

Rationalization is the fraudster's internal dialogue that provides the self-justification for his actions. The fraudster convinces himself / herself that he /she is owed this remuneration by the employer.

2.8 The incentives of the manipulation of financial information

For any action there should be reasons and conditions should be compatible for. What kinds of reasons trigger managers to manipulate the financial information? According to surveys made, incentives of the manipulation financial information are as follows:

- 1- Influencing the shares' prices
- 2- compliance with debt covenants clauses,
- 3- managers' salaries and bonuses,
- 4- minimizing of certain costs from political or organizational reasons,
- 5- decrease of the due taxes quantum,

- 6- providing the better performance in the future for company's financial pictures.

The main benefit of the financial information is to reduce the financial cost of companies' projects. On the other hand one of the incentives of the manipulation financial information is to obtain resources with reduced financial cost. There is in literature no consensus on the incentives of the financial information manipulation. (Tak Isa, 2011)

Investigations launched after the wave of corporate scandals have shocked the world during the last decade of the past century, and finished by making some of the largest multinationals managers guilty. Those managers have been admitted being fraudster, either by inflating their profits, masking debts or hiding realized losses. This certainly leads us to wonder about the reasons and circumstances leading to such behavior.. (Ph. Michael Haddad, 2007)

2.9 Techniques of manipulation financial information

The main purpose of financial information manipulation is to deceive the investors by publishing financial statements that do not present the financial position and the performance of a company fairly. Financial information manipulation prevents decision makers from making rational decisions. So, it is of utmost importance to detect financial information manipulation and prevent it before the financial statements are made public. Researchers have developed models to predict whether the financial information manipulation occurred or not (HulisiÖğüt, RamazanAktaş, Ali Alp, M. Mete Doğanay, 2009).

Main techniques for manipulation of financial information are:

- 1- Earnings management,
- 2- Income smoothing
- 3- Creative accounting practices

There also other techniques like aggressive accounting, big bath accounting, fraudulent financial reporting and accounting errors and irregularities. Applying some of the techniques determined in the accounting standards may be acceptable but if the manager of the company exceeds accounting standards so it is called fraud in the financial information or manipulated financial information. (Tak Isa, 2011)

According to Maydew (1997), companies that are by definition profitable pay lower taxes, manipulate financial data by reducing the profit of the activities. (Maydew,1997). According to Eilifsen, Knivsfla and Sættem'e (1999), if the taxable income is related to the accounting profit, in this case we speak about an automatic security mechanism as response to the financial information's manipulation. (Eilifsen, Knivsfla and Sættem, 1999)

In order to manipulate the financial information, earning management technique is used mostly than other types to evade any sanction and not exceed the accounting standards. The three different definitions of earnings management are (Beneish, 2001):

- a. Managing earnings is the process of taking deliberate steps within the constraints of generally accepted accounting principles to bring about a desired level of reported earnings.
- b. Earnings management is a purposeful intervention in the external financial reporting process, with the intent of obtaining some private gain.
- c. Earnings management occurs when managers use judgment in financial reporting and in structuring transactions to alter financial reports to either mislead some stakeholders about the underlying economic performance of the company or to influence contractual outcomes that depend on reported accounting numbers.

2.10 Detecting Fraud

Fraudsters invariably highly suffer to conceal or remove evidence of their crimes. As companies can only report crimes that have been detected, it is not possible to judge how much fraud goes unnoticed. What we can analyze is the means by which fraud is brought to light. The results vary considerably depending on the size of the organization concerned. Within larger organizations a combination of factors are likely to be involved in the detection of an incident. (PWC, economic crime survey 2003).

Large companies most often detected fraud through their control and risk management systems. However, in many cases this was accompanied by a finding from the internal or external audit function. Smaller organizations detected a far greater proportion of economic crime through audit processes. Given the respective size of the organizations this is most likely to be via the external auditors – a worrying finding that suggests smaller companies may be placing too little attention on the development of effective controls and alternative checks and balances. (PWC, economic crime survey 2003)

Clearly, reliance on luck is not a basis for an anti-fraud regime. However, even where companies have control systems to detect economic crime, these can often be rendered ineffective by management override or collusion.

Companies need to do more in terms of:

- Assessing the real risks and vulnerabilities to fraud within the organization
- Communicating actively the company's stance on fraud and "walking the talk"
- Proactively monitoring risky areas
- Developing policies to encourage (and protect) "whistleblowers"
- Expecting the worst and being prepared – devising a robust fraud response plan. (White collar crime survey, 2003)

2.10.1 Symptoms to detect fraud

Stephen N. Getzoff , the founder and President of Business Fraud Detection Services, defines some symptoms that lead to detect a fraud (Fraud discovery, 2011):

1. Unusual Behavior

The perpetrator will often display unusual behavior, that when taken as a whole is a strong indicator of fraud. The fraudster may not ever take a vacation or call in sick in fear of being caught. He or she may not assign out work even when overloaded. Other symptoms may be changes in behavior such as increased drinking, smoking, defensiveness, and unusual irritability and suspiciousness.

2. Complaints

Frequently tips or complaints will be received which indicate that a fraudulent action is going on. Complaints have been known to be some of the best sources of fraud and should be taken seriously. Although all too often, the motives of the complainant may be suspect, the allegations usually have merit that warrant further investigation.

3. Stale Items in Reconciliations

In bank reconciliations, deposits or checks not included in the reconciliation could be indicative of theft. Missing deposits could mean the perpetrator absconded with the funds; missing checks could indicate one made out to a bogus payee.

4. Missing Documents

Documents which are unable to be located can be a red flag for fraud. Although it is expected that some documents will be misplaced, the auditor should look for explanations as to why the documents are missing, and what steps were taken to locate the requested items. All too often, the auditors will select an alternate item or allow the audited to select an alternate without determining whether or not a problem exists.

5. Excessive Credit Memos

Similar to excessive voids, this technique can be used to cover the theft of cash. A credit memo to a phony customer is written out, and the cash is taken to make total cash balance.

6. Common Names and Addresses for Refunds

Sales employees frequently make bogus refunds to customers for merchandise. The address shown for the refund is then made to the employee's address, or to the address of a friend or co-worker.

7. Adjustments to Receivables or Payables

In cases where customer payments are misappropriated, adjustments to receivables can be made to cover the shortage. Where payables are adjusted, the perpetrator can use a phony billing scheme to convert cash to his or her own use.

8. Excess Purchases

Excess purchases can be used to cover fraud in two ways:

- Fictitious payees are used to convert funds
- Excessive purchases may indicate a possible payoff of purchasing agent

9. Duplicate Payments

Duplicate payments are sometimes converted to the use of an employee. The employee may notice the duplicate payment, and then he or she may prepare a phony endorsement of the check.

10. Employee Expense Accounts

Employees frequently conceal fraud in their individual expense account reimbursements. These reimbursements should be scrutinized for reasonableness and trends, especially in the area of cash transactions on the expense account.

2.10.2 Fraud detection procedures

Corporate fraud is frequently detected by accident. This underscores the need not only for fraud prevention measures, but also for sound fraud detection analysis. Improving the probability fraud is detected can help organizations minimize fraud-related losses and preserve their hard-earned reputations.

Cendrowski Corporate Advisors (CCA) helps organizations find fraud with a variety of fraud detection control measures designed to identify areas where the "fraud triangle" factors of rationalization, pressure and opportunity may exist. Examples of these fraud detection procedures include (Cendrowski Corporate Advisors):

1- Proactive testing:

Periodically testing for anomalies in transactions can bring red flags to light before other warning signs are noticed. Moreover, when employees know that transactions are being closely monitored, they realize the opportunity for fraud is slim, nearly eliminating one of the 3 elements of the fraud triangle. These tests can help minimize fraud-related losses for the firm.

2- Proper authorization processes:

As a routine course of business, employees are typically granted the authority to authorize certain transactions, such as purchasing supplies or granting client or vendor discounts. These authorizations usually require an employee's signature or initials or their electronic equivalents, which must be

recorded as they occur and transactions must be audited regularly as a part of fraud detection.

3- Segregation of duties:

Almost 70% of occupational frauds are committed alone, according to the Committee of Sponsoring Organizations of the Treadway Commission (COSO). One person (like a trusted bookkeeper) frequently performs multiple duties in small business environments, for example. But some functions, such as the receipt and banking of money, should be done by separate individuals. Simply, including more people for the control and oversight of critical financial or inventory functions makes fraud more difficult to be committed.

4- Adequate record keeping:

Organizations should maintain paper trails – or electronic versions of them – that contain detailed documentation of transactions and information regarding all individuals involved in them.

5- Physical controls over assets and records:

Firms must protect assets as a routine part of fraud detection, not just from third-party threats, but also from employee theft, accident or unauthorized use. Examples of controls include maintaining a register of all physical assets, maintaining regular backups of electronic data, and using passwords to restrict access to computer systems and sensitive information.

6- Independent internal checks:

Companies should conduct peer audits of transactions as part of fraud detection to ensure they are being done properly, completed by the proper authority and are being recorded accurately. Peer auditors should be independent of individuals being audited.

2.11 Preventing Fraud

Fraud can cause huge consequences for the company, threaten its existence and jeopardize its reputation. In today's business world, risk increasingly exist which reveal the role of several factors capable of capturing and correcting accounting irregularities, that are the means of preventing and detecting deception.(Hussein H., 2007)

Having defined the fraud and after studying the changes in the business world surrounding the company, we will highlight the roles of:

- 1.Management
- 2.Internal audit
- 3.External audit
- 4.Internal control

in securing the financial information not forgetting to mention the most serious financial scandals.

1- Management

International Auditing Standards (ISA) affirms that "Management is responsible for the prevention and detection of irregularities and misstatements by the implementation of appropriate procedures and permanent control of accounting systems and internal control. If these systems reduce the risk of irregularities and inaccuracies, however they cannot eliminate them completely." (IAS 240)

Those in charge of enterprise management should ensure the reliability of the accounting system and the establishment of appropriate internal controls over risk management, financial control and compliance with legal requirements. Responsibility of the management of the entity is the establishment of a control system with rules and procedures to ensure, to the extent possible, the orderly and efficient behavior of operations. (PWC, Dispute Analysis & Investigation)

2- Internal control

According to Dominique P., director of price waterhouse coopers, internal control is a process designed to ensure control of the company. Its objective is to prevent errors and fraud, protect the integrity of goods and resources, sound management and proper recording of transactions. It refers to the overall system of controls that are exercised within the institution, to ensure proper accounting and financial regulatory procedures. Therefore, it ensures that decisions are made on a controlled, relevant and communicated in timely basis information. (Dominique P, crime survey 2003)

An effective internal control system (ICS) is the primary means of preventing, detecting, and correcting fraud and errors. Yet, that which constitutes an effective ICS is largely conjecture established through ex post forensics (a form of induction) performed by practitioners (Roberta Ann Barra, 2010). Internal controls alone are insufficient to fully prevent occupational fraud. Though it is important for organizations to have strategic and effective anti-fraud controls in place, internal controls will not neither prevent all fraud from occurring, nor will they detect most fraud once it begins (ACFE, 2010).

Lack of the internal control will prevent company from competing with other competitors from all over the world. First of all every company should control itself to produce reliable, accurate financial information that reflect the true financial image of the company. (Lionnel C, 1995)

The main purpose of the internal control is to protect the active assets of the company and provide reliability and accuracy of the financial information produced by the company. In the last decade, the investigations have been focused on internal control system mechanism. If the company's structure is durable it cannot send false signal to users of the financial information. Of course any good internal control system cannot detect all frauds but at least can

prevent most of the frauds in the financial statements. A weak internal control contributes to fraud. (Gerard V. 1995)

The Association of Certified Fraud Examiners (ACFE 2010) has investigated control weaknesses by asking survey respondents to identify which of several common reasons they considered to be the primary factor that allowed the fraud to occur. It is for the auditor a means of proof of reliability of data on the financial statements.

3- Internal Audit

The internal audit function in a business has a goal of reviewing, assessing the functioning, the consistency and effectiveness of the internal control. It is an independent and obligatory activity that gives an organization a degree of assurance on the control of its operations, brings advices to improve them, and helps to create added value. It helps an organization to accomplish its objectives by evaluating in a systematic and methodical approach, its processes of risk management, control and corporate control, and making proposals to strengthen their effectiveness. (French Institute of Internal Auditors and Controllers IFACI, 2005).

According to Germond and Bernalaut, internal audit " is a difficult and constructive technical review conducted by a competent and independent expert to express an opinion on the quality and reliability of the financial information presented by a company under obligation, to give at all times and in compliance with the rules of law and applicable accounting principles, an accurate image of its assets, financial condition and results." (Lionnel Collin & Gerard Velin, 1992)

In this context, the internal audit is one of the various components of an anti-fraud procedure.. The role played is more and more needed to investigate possible known cases or suspicions of fraud, and also to support prevention initiatives and participate in a more effective detection. (PWC, 2003)

4- External Audit:

The audit practice, which was first in the financial and accounting domain, and then in other business functions (operational audit), has been recently developed in a considerable manner. The external audit mission involves an occasional or periodic examination of activities of one or more organizations to help managers to improve the management and performance of these organizations. This review includes checks, value judgments and recommendations on policy, objectives, procedures, information and resources. This review is performed by independent persons, not responsible for the organization management or activities they review. Each audit mission ends by writing a report with the auditor's opinion on the fairness of financial statements.(Odooc, 1993)

Prevention responsibilities

Due to the limits on the auditor's possible role in controlling fraud, other considerations in the prevention and detection of corporate fraud should be discussed. (Barbara F. & Joseph F., 1999).

These includes:

- 1- Managerial controls,
- 2- Employee screening,
- 3- Organizational climate
- 4- Others methods.
- 5- Forensic accounting

1- Managerial Controls.

Organizations with one hundred or fewer employees have the greatest median losses per capita. The primary reason for this is because internal controls are less sophisticated and stringent in smaller organizations. So what, if any, are management's responsibilities when it comes to the prevention or detection of fraud? Management is responsible for the preparation and integrity of the financial information presented, and both company and management should maintain a system of internal controls to provide for administrative and accounting controls. All professional literature makes it clear that the responsibility of internal controls, proper reporting, and the adoption of sound accounting policies rests solely with management, not the auditors. (Barbara F. & Joseph F., 1999).

To combat the problem of fraud, a crucial element in deterring theft is strict internal controls, segregation of duties, and separation of functions. For example, simple procedures such as not letting the person writing the checks reconcile the bank statement, not letting the receiving department maintain physical inventory records, not letting the person initiating the purchase order approve the payment, and not letting the person maintaining the personnel database also issue payroll checks, may help separate incompatible functions within a business. Thus, internal controls may be strengthened and fraud deterred by separation of functions. (Jones 1996: 23).

2- Screening.

Another element to combat fraud is adequate employee screening. Although this statement might seem obvious, a good rule to follow to minimize the risk of fraud is to hire honest employees. There are many organizations specializing in pre-employment screening. These screening tests include lie detector and drug tests and fingerprinting of employees. Through adequate background checks of information on resumes and applications, an employer

can elicit significantly more information and determine if the original information is accurate. (Jones 1996: 23).

3- Organizational Climate.

A third component to deterring fraud is creating a business environment that reduces the perceived need of a pressured employee to commit fraud. This environment includes creating open and consistent communications for hiring, evaluating employee performance, and assessing employees for promotion. These factors, along with counseling programs and employee enrichment efforts, might curtail the perceived need of an employee to commit fraud. (Jones 1996: 23).

4- Others.

Finally, a few additional components to business fraud prevention include setting up a hotline whereby fellow employees can report improper conduct, having a high level employee review unopened bank statements monthly, establishing a written code of ethics, and making sure management level employees are role models. Although these additional practices may not seem important, they help establish the tone within the work environment and may help deter fraudulent activities (Jones 1996: 23).

5- Forensic accounting: a new specialization in accounting.

Within the last ten years, the alarming increase in the cost of fraud to businesses has brought attention to a specialization called "forensic accounting". (Barbara F. & Joseph F., 1999).

Forensic accounting is the integration of accounting, auditing, and special investigative skills. The goal of forensic accounting is to uncover the paper trail left by a fraud and prepare the investigation prior to presenting it to a court of law.

Forensic accountants are trained to examine financial statements and related materials for wrongdoing and analyze the reality of business situations. Former law enforcement officers, who know how to integrate their investigative skills to business, are frequently found in the ranks of forensic accountants. Many of the large accounting firms have expanded their forensic accounting departments to address an increase in deception and the criminal activities being encountered by business. The personnel hired by public accounting and law firms in their forensic accounting departments are primarily former FBI agents, accountants with additional computer expertise, former "white collar" law enforcement investigators, and business wise computer experts. (Barbara F. & Joseph F., 1999).

Forensic accountants are retained in many business situations to analyze, interpret, summarize and present financial issues and situations in an understandable and supportable manner. Examples of situations where forensic accountants might be involved are:

- 1- Analyze and investigate financial evidence
- 2- Develop computerized applications to perform analysis
- 3- Present findings through reports and exhibits
- 4- Testify in court as an expert witness.

In addition to public accounting and law firms adding forensic accounting departments, many banks and brokerage firms are now adding these departments to investigate possible frauds. Although it is not yet the norm for all businesses to have forensic accounting departments, the trend has increased considerably. (MacErlean Neasa., 1993)

The Committee of Sponsoring Organizations of the Tread way Commission (COSO, 1992; 1994), in its study on the factors that guide to fraudulent financial reporting in the early ninety's in the USA, concluded that internal controls consist of five (5) components. These are derived from the way management run the business, and are integrated with the management process. The components are:

1)The control environment: This includes factors such as integrity and ethical values, board of directors or audit committee, management philosophy and operating style, organizational structure, human resource policies and practices and assignment of authority and responsibility. Although many factors go into control environment, this component is significantly influenced by the effectiveness of the board of directors or audit committee if any. However, the effectiveness of these factors largely depends on their interaction with the internal and external auditor. This means internal auditors are essential to effective control environment.

2)Risk assessment: This is the careful assessment of factors that affect the possibility that the organization's objective will not be achieved. As we saw in the definition of internal control, management always design internal controls in order to ensure effectiveness and efficiency, reliability of financial reporting and compliance with applicable laws and regulations. As part of the internal auditor's function to ensure that these objectives are achieved, the internal auditor conducts performance review and evaluates the adequacy and effectiveness of the controls designed.

3) Information and communication system: Pertinent information must be identified, captured ad communicated in a form and time frame that enable people to carry out their responsibilities.

Information systems produce reports containing operational, financial and compliance - related information that make it possible to run and controls the business.

4) Control Activities: These are policies and procedures that help ensure management directives are carried out. Control activities occur throughout the organization, at all levels and in all functions. They include range of activities as diverse as approvals, authorizations, verifications, reconciliations, reviews of operating performance, security of asset and segregation of duties. Most of

these activities are made possible through the help of the internal audit function

5) Monitoring: This process assesses the quality of the internal control structure over time. This is because internal controls are processes; and thus may need modifications over time. This could be achieved through regular supervision and management activities such as monitoring of customer complaints as well as periodic audits by internal auditors. Internal auditors investigate and appraise internal control structure and the efficiency with which the various functions are performing their assigned duties. According to the Institute of Internal Auditors (IIA), internal auditors bring a systemic and disciplined approach to the evaluation and improvement of risk management activities and governance process through examination of internal controls and evaluation of how adequate and effective the controls are. From the above, we can say that internal controls are as effective as its components and these components are as effective as that of internal auditors.

According to Autorite Des Marches Financiers (2010), Management is entirely responsible for the establishment of internal control system. But, internal control is a matter of concern to everybody, from the governance bodies to the company's entire staff. Executive Management or the Management Board imagines the internal control system. This system has to be appropriately communicated so as to ensure application by staff. The level of involvement of Boards of Directors with regards to internal control varies from one institution to another. It is up to Executive Management or the Management Board to inform the Board (or its audit committee when there is one) of the main features of the internal control systems. If the need arises, the Board can exercise its general powers to subsequently have the controls and verifications it deems appropriate performed or take any other steps it considers suitable in the circumstances.

Internal control is therefore not limited to a set of procedures nor simply to accounting and financial processes, nor does it embrace all of the initiatives taken by the executive bodies or by management, such as defining company strategy, fixing objectives, and management decisions, and dealing with the risks or monitoring performance.

Below are the *players* in the implementation of Internal Controls.

1) Board of Directors or the Supervisory Board ("The Board")

The involvement of Boards in the execution of internal controls may differ from institution to another, the key criteria being the nature of the firm's business.

It is the duty of the Top level or Executive management to inform the Board (or its audit committee when there is one) of the main features of the internal control system. If the need arises, the Board can exercise its general powers to subsequently have the controls and verifications it deems appropriate performed, or take any other steps it considers suitable in the circumstances. When there is one, as may be the case in most foreign countries, the Audit

Committee should monitor the internal control system closely and on a regular basis.

2)Executive Management

It is up to the Executive or Top level Management to define, drive and monitor the system deemed to be the most suitable for the operations and activities of the enterprise. Within this framework, they receive regular updates concerning any problems it may encounter, its inadequacies and its application difficulties, or even any excessive demands it may be causing, and they ensure that all necessary corrective actions are undertaken.

3)Internal audit Department

Where this is instituted, it has the sole responsibility or the onus lies on this department to assess the effectiveness and the challenges of the internal control system and for making recommendations to improve it, within the scope of its audit engagements.

It raises the level of awareness and usually dispenses management training on internal control, but is not directly involved in the design or the day-to-day running of the system.

The head of this department is in most cases directly responsible the executive management on the results of his department's work.

4)Organization staff

Each member of staff concerned should possess the appropriate knowledge and information to be able to design, operate and monitor the internal control system, as applied to the objectives which have been allocated to him. This applies to operational managers who are directly involved with the internal control system but also internal controllers and financial management staff who have an important monitoring and controlling role to play. AMF (2010).

According to Barnes (1995) cited Ashu ,K.andBindu, A.(2009) pointed out that the quality training to bankers helps not only in developing job related skill but also maximizes the performance potential of bankers and provides them the sound knowledge and understanding of banking practices and principles. Imparting training is of paramount importance in this regard.

Bologna (1994) cited in Ashu ,K.andBindu, A.(2009)that the environmental factors that enhance the probability of fraud, they are: inadequate rewards; inadequate internal controls; no separation of duties or audit trails; ambiguity in job roles, duties, responsibilities, and areas of accountability; failure to counsel and take administrative action when performance levels or personal behavior fall below acceptable levels; inadequate operational review; lack of timely or periodic review, inspections, and follow-up to assure compliance with company goals, priorities, policies, procedures, and governmental regulations and failure to monitor and enforce policies on honesty and loyalty.

Calderon and Green (1994) made an analysis of 114 actual cases of corporate fraud published in the *Internal Auditor* between 1986 and November 1990. They found that limited separation of duties, false documentation, and inadequate or nonexistent control account for 60 percent of the fraud cases. Moreover, the study found that professional and managerial employees were involved in 45 percent of the cases. Based on the findings, they recommended the following:

□ To deter fraud, internal auditors should ensure that strong prevention systems based on the fundamental principles of good internal control be established and used.

□ To detect and investigate fraud, organizations must ensure the existence of strong internal audit departments with sufficient resources to pursue the increased responsibilities faced by internal auditors.

Bhasin (2007) cited in Ashu ,K.andBindu, A.(2009)that the reasons for frauds, the magnitude of frauds in Indian banks, and the manner, in which the expertise of internal auditors can be integrated, in order to detect and prevent frauds in banks. He emphasized that though the head of the branch holds the responsibility for ensuring adherence to prescribed systems and procedures, the bank's internal auditors also occupy a special position in the detection and prevention of frauds. In addition to considering the common types of fraud „signals', auditors can take several „proactive' steps to combat frauds. Checking frauds requires training, account screening, signature verification and information sharing with regulators and local authorities. One important challenge for banks. Therefore, is the examination of new technology applications for control and security issues?

Beirstaker, Brody, Pacini (2005) cited Ashu ,K.andBindu, A.(2009)proposed numerous fraud protection and detection techniques. These various techniques include fraud policies, telephone hotlines, employee reference checks, fraud vulnerabilityreviews, vendor contract reviews and sanctions, analytical reviews (financial ratio analysis), password protection, firewalls, digital analysis and other forms of software technology, and discovery sampling.

To Commercial Angels" Newsletter (2001), the best way of preventing fraud was to understand why it happened. Fraudster generally identifies loopholes in control procedures and then assess whether their potential rewards will outweigh the penalties should they be caught. A regular control is most effective for prevention of frauds and normally requires little management time or effort. Prevention of frauds starts with identification of weakness in current systems of the organization. Next the organization must improve those systems with new or better controls. The introduction and enforcement of controls will reduce the opportunities for frauds. The control warns potential fraudster that the management is actively monitoring the business and in turns deters frauds. Education, training and awareness programs are informal intervention measures that should be implemented to prevent frauds.

Ganesh and Raghurama (2008), believe that training improves the capabilities of employees by enhancing their skills, knowledge and

commitment towards their work. In the survey conducted by them, about 80 executives from Corporation Bank and Karnataka Bank Ltd of India, were requested to rate their subordinates in terms of development of their skills before and after they underwent certain commonly delivered training programs. Responses revealed that for the seventeen skills identified there was improvement in the skills statistically.

The paired t-test was applied individually for the seventeen skills, and all these skills have shown statistical significance. The seventeen skills include analytical skill, human resource skill, marketing skill, communication skill, accounting skill, credit appraisal skill, cash management skill, time management skill, inter-branch reconciliation skill, conceptual skill, information technology related skill, technical skill, role identification skill, problem solving skill, behavioral skill, risk management skill and customer service skill.

Haugen and Selin (1999) discussed the value of internal controls. Internal control system has four broad objectives: to safeguard assets of the firm, to ensure the accuracy and reliability of accounting records and information, to promote efficiency in firm's operations and to measure compliance with management prescribed policies and procedures. The effectiveness of internal controls depends largely on management's integrity. There are many other reasons for employee fraud, the more common being revenge, overwhelming personal debt, and substance abuse. Business today is very competitive, and employees often stressed. As a result, they have a feeling of being overworked, underpaid, and unappreciated. If employees are also struggling with serious personal problems, their motivation to commit fraud is very high. Adding to the situation of poor internal controls, the readily available computer technology also assists in the crime, and the opportunity to commit fraud becomes a reality.

Harris and William (2004) examined the reasons for loan frauds in banks and emphasized on due diligence program. This is a proactive approach, with each business line within the institution establishing policies and procedures for conducting due diligence investigations for both new and existing customers. They indicated that lack of an effective internal audit staff at the company, frequent turnover of management or directors, appointment of unqualified persons in key audit or finance posts, customer's reluctance to provide requested information or financial statements and fictitious or conflicting data provided by the customers are the main reasons for loan frauds. Fraud thrives when conditions are right. A "fraud-friendly environment" is characterized by lax corporate culture on the enforcement of internal controls; deficient and/or absence of requisite risk controls, staff apathy and overconfidence.

According to Howard (1984) cited in William, A.(2011), increasing attention has been paid to the methods of internal control in recent years. He argues further that not only the complexity of modern business techniques but also the increased size of business units have encouraged the adoption of methods which, whilst increasing the efficiency of the business, also act as safeguards against error or fraud. The objectives that internal controls must

meet to prevent errors and to be efficient so as to provide reasonable assurance are that:

- Recorded transactions are valid. The system should not permit the inclusion of fictitious or non-existent transactions in accounting records.
- The transactions are properly authorized. The system should ensure that transactions are properly authorized.
- Transactions are recorded. The procedures must provide controls to prevent omissions of transactions from the records.
- Transactions are properly valued. An adequate system must include procedures to avoid errors in calculating and recording transactions at various stages in the recording process.
- Transactions are properly classified. Proper account classification accounting to appropriate categories or divisions must be ensured by the system.
- Transactions are recorded at the proper time. The recording of transactions either before or after the time they took place increases the likelihood of failing to record

transactions or recording them at the wrong amount. Therefore, effective control system should ensure timely recording of transactions.

Jeffords (1992) examined 910 cases submitted to the Internal Auditor during the nine-year period from 1981-1989 to assess the specific risk factors cited in the Treadway Commission Report. Approximately 63 percent of the 910 cases are classified under the internal control risks that include: lack of regular independent checks in performance, inadequate organizational control methods, inadequate methods of communicating and enforcing the assignment of authority and responsibility; and unauthorized access and physical control of assets, records, computer programs, or data.

Sharma and Brahma (2000) have emphasized on Banker's responsibility on frauds. They indicated that bank frauds could crop up in all spheres of bank's dealing, like cheque frauds, deposit account frauds, purchase bill fraud, hypothecation fraud, loan fraud, frauds in foreign exchange transactions and inter-branch account. Major cause for perpetration of fraud is laxity in observance in laid down system and procedures by supervising staff. Unscrupulous constituents commit frauds by taking advantage of the laxity on the part of the officials in observance of time-tested safeguards established by Reserve Bank of India (RBI). The RBI has set up an investigation cell in its central office. An investigator of high and vast experience mans it. The bank team goes deep into the root cause of bank frauds and suggests exhaustive preventive measures. The RBI carries out detailed studies and researches in the commission of bank frauds and recommends innovations to prevent frauds.

The authors have further suggested that the need of the hour is not another piece of complex high-powered body of RBI, but analysis and concerted application of controls by bank management and their operational staff.

Smith (1995) offered a typology of individuals who fraud. He indicated that embezzlers are “opportunist’s type”, who quickly detects the lack of weakness in internal control and seizes the opportunity to use the deficiency to his benefit.

To deter embezzlement he recommended the following measures:

- Institute strong internal control policies, which reduce the opportunity of crime.

- Conduct an aggressive and thorough background check prior to employment.

Willson (2006) examined the causes that led to the breakdown of Barring bank, in his case study: “the collapse of Barring Banks”. The collapse resulted due to the failures in management, financial and operational controls of Baring Banks. The failures that were evident include the following areas:

- Failure in management supervision

- Lack of segregation between front and back offices of Baring Futures, Singapore.

- Insufficient actions taken by Barring’s management in response to warning signals.

- No risk management or compliance function in Singapore

- Weak financial and operational control over the activities and funding of Baring Futures Singapore at group level.

Ziegenfuss (1996) performed a study to determine the amount and type of fraud occurring in state and local government. The study revealed that the most frequently occurring types of fraud are misappropriation of assets, theft, false representation; and false invoice. The reasons for the increased fraud in state and local governments are poor management practice; economic pressure; weakened society values; people being not held responsible for their actions; and inadequate training for those responsible for fraud prevention/detection. The most often reported “red flags” are weaknesses in internal control; ignoring audit reports; inventory losses; non reliance on internal/external audit reports; not paying attention to employee comments; and actual expenses exceed those budgeted.

Table 1: Types of Bank Fraud

1. Presentation of forged cheques and Dividend warrants
2. Granting of unauthorized credits
3. Posting of fictitious credits
4. Fraudulent transfers/withdrawals from customers’ accounts
5. Cheque suppression and cash defalcation
6. Excess charges
7. Non-refund of wrong debit
8. Outright theft of money/embezzlement
9. Identity theft
10. Granting of unauthorized Loans

Source: Commercial Angles Newsletter.(2001).

According to Albrecht (1996) cited in Ashu ,K.and Bindu, A.(2009), the symptoms of poor internal controls increase the likelihood of frauds. *Internal control symptoms* include a poor control environment, lack of segregation of duties, lack of physical safeguards, lack of independent checks, lack of proper authorizations, lack of proper documents and records, the overriding of existing controls, and an inadequate accounting system.

2.2. Hypothesis Development:

Based on the review of literature the researcher hypothesizes that there's a positive relationship between Effective internal control and the detection or prevention of fraud in commercial Banks.

This hypothesis are formulated and tested in this study.

Hypothesis: There is a positive relationship between an Effective internal control and the detection and prevention of fraud in commercial Banks.

Procedures and Methodology:

3-1 Introduction:

This current study attempt to identify the relation between effective internal control and Fraud detection and prevention as a whole by analyzing data from male and female positions holding managerial positions in bank sector. This section describes the instruments used in this study, the data collection procedures, the population and sample, and the data collection techniques used to answer the research questions.

3-2 Research Population and Sample:

The population of the study consists of the Egyptian banks' managers ,internal auditors and members of auditors committee .

The research sample consists of 60 managers, internal auditors and members of audit committee distributed at five different Egyptian banks.

The chosen five Egyptian banks are: Banque Misr Liban SAL, BankMed, ,Jammal Trust Bank ,BLOM Bank and Fransabank .

Established in 1929, **Banque Misr Liban sal** is one of the oldest banks in Lebanon, predating the country's independence by nearly 17 years and listed as bank number 3 on the historical register of banks. For many decades, BML was one of the leading banks in Lebanon in terms of the size of its balance sheet, the scope of its banking activities, the spread of its branch network, and its substantial customer base that encompassed a broad segment of depositors and the top commercial and corporate clients in Lebanon and the region. BML today is poised to continue its long tradition within the Egyptian banking sector, offering a full range of corporate, commercial and retail banking services through its network of 18 branches strategically located in the major cities and regions of Lebanon, and supported by a network of ATM

machines. BML's services and products embody the latest in banking techniques, and are geared to meet the evolving requirements and expectations of its growing customer base.

BankMed is a Egyptian joint stock company, registered under Number 5261 in the Egyptian Commercial Register on August 13, 1950 and under Number 22 in the list of banks published by the Central Bank of Lebanon. The principal activities of the Bank and its subsidiaries (the Group) consist of conventional commercial and private banking through a network of 56 branches in Lebanon in addition to a branch in Cyprus, a subsidiary in Switzerland and a subsidiary in Turkey (with 27 branches). BankMed has grown to become one of Lebanon's top banks. Its market share, measured by total assets, now constitutes around 11% of the total of the Egyptian banking system. BankMed provides a broad range of retail banking, corporate, wealth management, brokerage and investment banking products and services to both individuals and companies.

Jammal Trust Bank has built a reputation for over five decades as being a commercial banking institution. It also developed a reputation for supporting both Lebanon's SME markets through commercial lending and Africa's Egyptian Diaspora through a large scale trade finance in more than one west and central African country. To enhance such ties, alongside a significant share of the Egyptian market for small business loans, the bank has set up representative offices in Nigeria and the Ivory Coast. While on the drawing board our plans for expanding JTB's African presence to cover several countries over the coming years, as well as in Europe.

BLOM BANK is a leading Egyptian bank which has repeatedly and unanimously been selected as the Best Bank in Lebanon by the most recognized regional and international institutions. Its successful business operations are based on a universal banking model which includes: Commercial Banking, Corporate Banking, Private Banking, Investment Banking, Asset Management, Retail Banking, Islamic Banking, Brokerage Services, and Insurance Products and Services. As one of the oldest established banks in Lebanon, if not the region, BLOM BANK has always been at the center of the country's banking system. Its universal banking services revolve around trust and credibility, built with its clients through long-term personal relationships, integrity, and the strong financial results that it has consistently delivered.

Fransabank Group banking and finance legacy dates back to more than nine decades of excellence supported by its very responsible role in the multi-dimensional development of the economies and communities it serves. The Group has succeeded in establishing, developing and consolidating a competitive edge that earned it a leading position amongst the Egyptian banking community and the countries into which it expanded. Today, Fransabank Group has a consolidated presence in nine countries: Lebanon,

France, Algeria, Syria, Sudan, Belarus, Cyprus, Iraq, Libya, UAE (Abu Dhabi) and soon in Africa. The Group also ranks first in terms of local branch network with 116 branches strategically spread all over the country, providing the Egyptian community with all types of banking products and services to satisfy their personal and professional banking wants and needs.

The sample used in this research are based on convenient basis .In other words this means that the sample are based on Non –Probability. Non probability holds that the members are selected on a non-random and subjective manner. The data has been collected from several locations. The demographic structure of the sample was filled by the participants, which included information about Job title ,Gender , Age, Educational Level and Experience .

3-3 Research Variables:

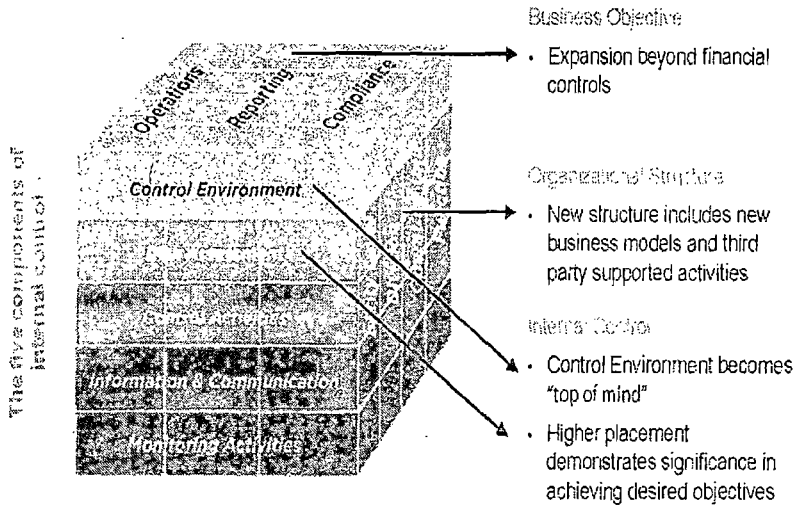
In this research the relation between effective internal control and Fraud detection and prevention is investigated. The correlation between the variables dependent and independent. This research contains independent variable and dependent variable.

The independent variable is:

Effective internal control is very important to the reliability of financial statements when the internal control system examined closely in timeliness. Internal control should be effective when examining design can extremely beneficial and is usually for Bank management and widely to financial statements. At present, all Banks have used internal controls through the formation of policies to ensure a safeguarding assets and profitable business environment especially accounting policy, management policy, and operational policy. Hence, internal control should be on a regular basis review in all aspects and insert internal controls that will strengthen the Bank and increase profitability(Skaifeetal.,2007).

According to the high internal control system efficiency, reliability of financial reporting is the only leg of the high quality of internal control efficiency system of internal control. The meaning is internal controls are important to the company's financial trustworthiness for stakeholders, investors or everyone who is using information from financial reporting for decision. In this research, internal control effectiveness refers to a sufficient and appropriate internal control that firm's system concerning of organizational specific policies, rule, and procedures designed. Internal control effectiveness will be met when the manager designs a reasonable assurance (Kahya, 2009) that can achieve company goals and objectives. Besides, internal control effectiveness is important to the entity level of the firm especially it provides reliable financial information, safeguard assets and records, encourages adherence to prescribes policies and comply with regulatory agencies (IIA, 2006)

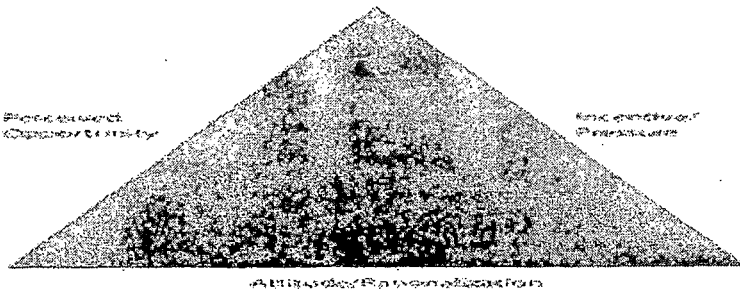
Figure2: The five components of internal control



Source:Skaifeetal.,2007

The dependent variable is:

Fraud is generally defined in the law as an *intentional misrepresentation* of material existing fact made by one person to another with knowledge of its falsity and for inducing the other person to act, and upon which the other person relies *with resulting injury or damage*. Fraud may also be made by an omission or purposeful failure to state material facts, which nondisclosure makes other statements misleading (*USLegla.com*).



Source: Skaifeetal.,2007

Figure 2: Fraud Triangle

The fraud triangle: The fraud triangle theory propounded by Donald Cressey states that every fraud has three things in common: (1) Pressure sometimes referred to as motivation and usually a “un-shareable need”; (2) Rationalization of personal ethics; and (3) Knowledge and opportunity to commit the crime.

These three factors (pressures/incentives, opportunity, and rationalization) are commonly referred to as the fraud triangle³, and when all three of those conditions are present the risk of fraud being perpetrated can increase significantly. Of those three conditions, opportunity is the one condition that can most effectively be managed to address fraud risks. This condition is principally managed by designing and implementing a control environment that prevents, detects, and deters most fraudulent behavior, whether conducted by employees, vendors, consultants, or senior management. (*USLegla.com*)

The variables could be summarized by the following table:

Table 2: Dependent and independent variables of the research

INDEPENDENT VARIABLE	DEPENDENT VARIABLE
Effective internal control	Fraud

3-4 Research Method and Data Gathering

The data for this research was collected by using a questionnaire. Interviews were conducted to fill the questionnaire for some respondents, while the other respondents took their time in answering the questions by themselves, then they returned the answers back. The respondents agreed to answer the questionnaire under the conditions of no name to be mentioned in the research.

3-5 Conceptual Frameworks for Data Analysis

This research used the Statistical Package for Social Sciences (SPSS) and different statistical techniques to test the hypothesis and answer the questions that were posed in section one as follows:

- Tabular and graphical representations of data were used in determining the major characteristics of the selected sample for the study.
- Graphical representations are used to assist correlation matrices in testing the hypothesis.

Data Analysis

4.1 Introduction:

This section presents the results from the data analyses.

First, descriptive statistics for the items are reported.

Second, test of hypothesis is done through regression analysis.

Ready statistical software was chosen to analyze the collected data. It is the Statistical Package for Social Sciences (SPSS) which is usually used in the social sciences studies: Descriptive statistics, to describe the characteristics of the sample depending on frequencies and percentages, ANOVA to measure the effects of the independent variable on the dependent variable.

4.2 Descriptive statistics

Descriptive statistics test is conducted to calculate the frequency distribution and percentage distribution in the most common form of summarizing. This test is done for the items that are answered in the questionnaires.

The demographic structure of the sample consists of the position and the bank where the respondent works and is represented by figures below.

Demographic information of respondents:

The position of the sample's participants is represented by table and figure 1. Table 3: Sample distribution by position

Frequency Distribution - Qualitative

<i>JOB TITLE</i>	<i>frequency</i>	<i>Percent</i>
MEMBER OF AUDIT COMMITTEE	6	5.0
AUDITOR	54	45.0
MANAGER	60	50.0
	120	100.0

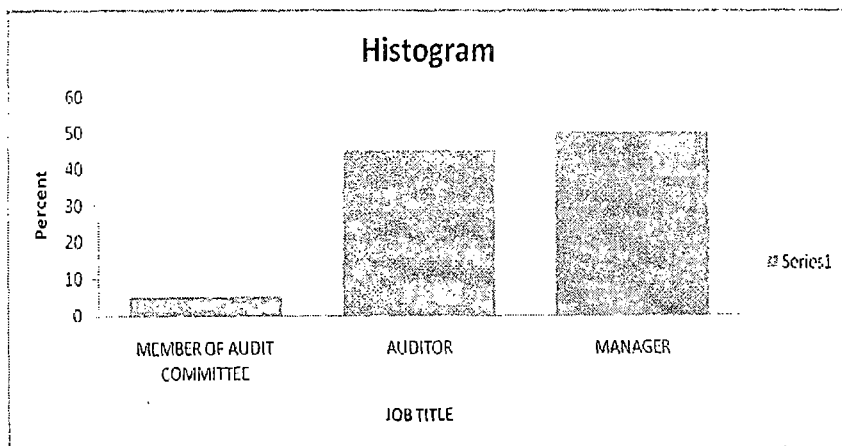


Figure 3: Sample Distribution by position

Table and figure 3 show that half of the respondents are managers (having a percentage of 50%), internal auditors constitute 45% of the sample. Whereas members of audit committee constitute 5% of the sample.

Table 4: Sample distribution by gender

Frequency Distribution – Qualitative

<i>GENDER</i>	<i>frequency</i>	<i>percent</i>
MALE	80	66.7
FEMALE	40	33.3
	120	100.0

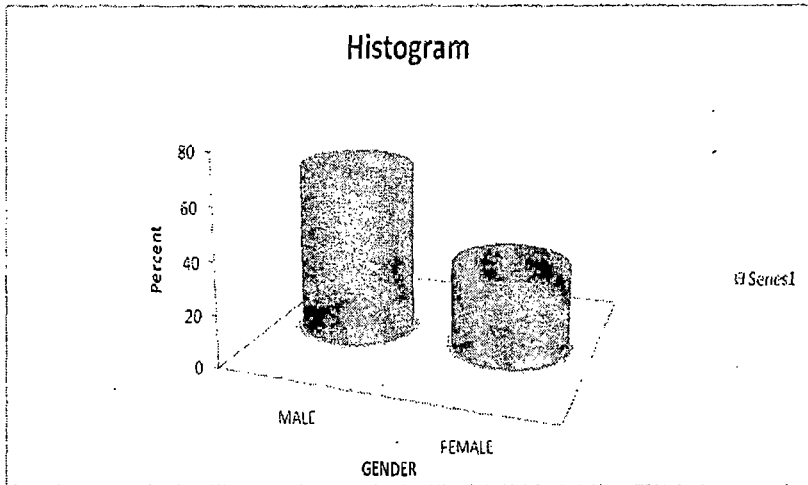


Figure 4: Sample Distribution by Gender

Table and Figure 4 show that more than half of the respondents are Male having a percentage of 67% Whereas females constitute 33% of the sample.

Table 5: Sample distribution by age

Frequency Distribution – Qualitative

<i>WHAT IS YOUR AGE?</i>		
	<i>frequency</i>	<i>percent</i>
36-45	60	50.0
46-55	54	45.0
OLDER THAN 55	6	5.0
	120	100.0

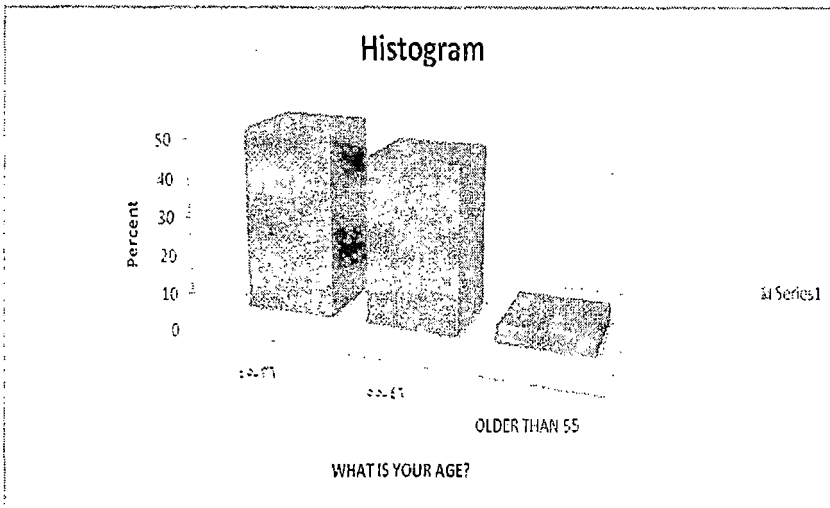


Figure 5: Sample Distribution by Age

Table and figure 5 show that half of the respondents belong to middle ages between 36-45 having a percentage of 50%. Consequently, the answers in the questionnaires could very well reflect the opinions of the middle-aged respondents.

Table 6: Sample distribution by educational level obtained

Frequency Distribution – Qualitative

EDUCATIONAL LEVEL	frequency	percent
BACHELOR DEGREE	20	16.7
MASTER DEGREE	42	35.0
BEYOND MASTERS	58	48.3
	120	100.0

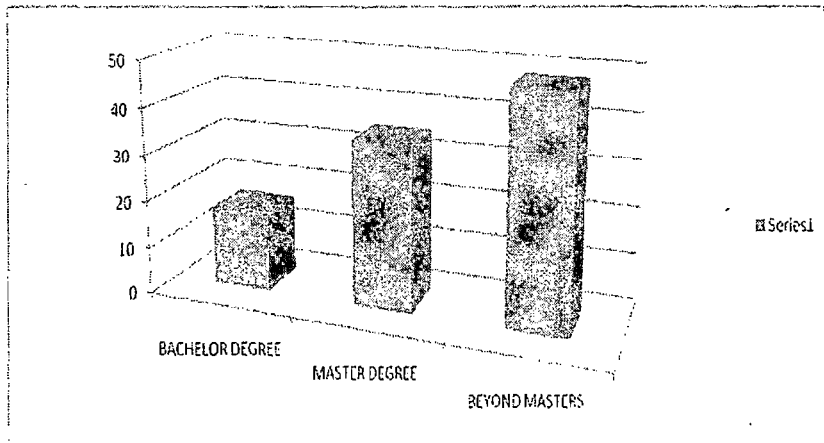


Figure 6: Sample Distribution by Educational Level obtained

Table and figure 6 show that Most of the respondents reached educational level beyond masters having a percentage of 49%. Consequently, the answers in the questionnaires could very well reflect the opinions of the highly educational respondents.

Table 7: Sample distribution by work experience

Frequency Distribution - Qualitative

HOW MANY YEARS HAVE YOU BEE WORKING AT THIS JOB?	frequency	percent
BETWEEN 3 AND 5 YEARS	1	1.7
BETWEEN 5 AND 10 YEARS	10	16.7
MORE THAN 10 YEARS	49	81.7
	60	100.0

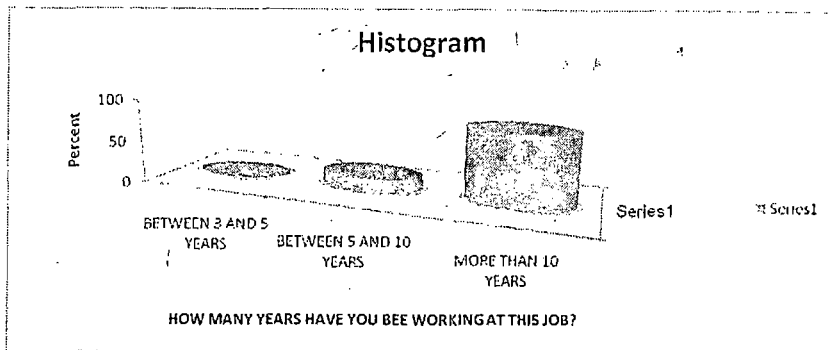


Figure 7: Sample Distribution by work experience

Table and Figure 7 show that most of the respondents have being working at banks more than ten years having a percentage of 82%. Consequently, the answers in the questionnaires could very well reflect the opinions of the highly work experienced respondents.

4.3 Testing of hypothesis:

The following section will present the research results as following:

The **hypothesis:** There is a positive relationship between an Effective internal control and the detection or prevention of fraud in commercial Banks.

Regression Analysis

<u>r²</u>	<u>0.090</u>	<u>n</u>	<u>120</u>
<u>r</u>	<u>0.300</u>	<u>k</u>	<u>1</u>
<u>Std. Error</u>	1.111	<u>Dep. Var.</u>	Fraud detection /prevention

ANOVA TABLE

Source	SS	df	MS	F	P-value
Regression	7.0615	1	7.0615	5.73	.0200
Residual	71.5385	118	1.2334		
Total	78.6000	119			

REGRESSION OUTPUT

variables	coefficients	std. error	t (df=118)	p-value	confidence interval		std. coeff.
					95% lower	95% upper	
Intercept	12.2308	5.0462	2.424	.0185	2.1298	22.3318	0.000
Effective internal control	0.2308	0.0964	2.393	.0200	0.0377	0.4238	0.300

The results of the simple regression test conducted on the following hypothesis are included in the below table.

To test **hypothesis**, The researcher used SPSS and One-Way Analysis of Variance ANOVA, it's found that there was a significant relationship between EFFECTIVE INTERNAL CONTROL and DETECTION/PREVENTION OF FRAUD in Egyptian commercial banks since the significance was 0.02 which is less **than 0.05**.

If P value is less than 0.05 this means there is a significant correlation between effective internal control and fraud detection/prevention in commercial banks.

If we need to check if the relation between these two variables is positive or negative we must check the value of R which is equal to **0.3**.i.e. R is positive

This means that there is direct relation between the two variables as X increase Y increase.

The more effective is the internal control the more the detection and prevention of fraud in commercial banks.

The coefficient of determination R square is 0.090 which means 9 % of change in effective internal control is explained by change in detection and prevention of fraud in commercial banks..

Beta is 0.578 positive number not negative so significant relations between effective internal control and fraud detection/prevention in commercial banks.

Therefore the hypothesis is supported.

Finding of hypothesis that concludes that the existence of effective internal control has positive effect on fraud detection and prevention in banks, though statistically proved to be correct, may not be true at all time, as fraud cannot be fully eliminated but can only be reduced with the aid of an efficient and effective internal control.

The hypothesis 2: There is a difference between the auditors according to their experience regarding the Effectiveness of internal control and the detection or prevention of fraud in commercial Banks

To test hypothesis, The researcher also used SPSS and Mann-Whitney Test, the sample was 54 auditors (22 auditors under 10 years, and 32 auditors greater than 10 years) it's found that there was a significant difference between experience (under 10 years, and greater than 10 years)by two variables EFFECTIVE INTERNAL CO NTROL and DETECTION/PREVENTION OF FRAUD in Egyptian commercial banks since the significance was 0.00 which is less **than 0.05**.

Mann-Whitney Test

Ranks

exp	N	Mean Rank	Sum of Ranks
Internal_1	22	11.95	263.00
Control_2	32	38.19	1222.00
Total	54		
Fraud_1	22	12.43	273.50
2	32	37.86	1211.50
Total	54		

Test Statistics^a

	Internal_Control	Fraud
Mann-Whitney U	10.000	20.500
Wilcoxon W	263.000	273.500
Z	-6.028	-5.858
Asymp. Sig. (2-tailed)	.000	.000

a. Grouping Variable: exp

Conclusion and Recommendations

This section provides a discussion of the results and draws conclusions. Recommendations for future research conclude this section

5.1 Conclusion

The relationship between effective internal control and fraud detection/prevention in commercial banks has been examined in previous studies.

By testing the hypothesis revealed that existence of effective internal control has positive effect on fraud detection and prevention in banks.

Effectiveness of Internal control has great impact on accuracy and reliability of records in Banks

Fraud being a social problem can affect the economy of a country negatively, in that it reduces the liquidity ratio of a bank involved as well as the strength and welfare of staff. It was discovered that, if fraud goes undetected or unpunished, it also affects the morale of good number of other staffs in the banks who may want to leave their employment for fear of being corrupted or implicated by fraudulent colleagues.

The most challenges of the economic environment is to combat fraudulent acts. While there may not be a feasible way to eliminate every type of fraud, audit committee and senior management have an important role in ensuring that the internal control environment and internal audit control function remain effective.

The study revealed that banks are facing a major problem which is fraud and while searching for the best method to be adapted .

The researcher found that effective internal control represented to their management but that perpetrators get sophisticated even the more and thereby increase the occurrences of fraud cases.

Adequate, effective and efficient internal control activities are capable of preventing employees from indulging in fraudulent acts if effectively complied with. It was observed during the study that, lack of adequate training and teaching of ethics to bank staff can to an extent lead to fraud.

Plato, was quoted as saying "**Good people do not need laws to tell them to act responsibly, while bad people will find a way around the laws.**"

In this case, a strong and effective internal control serves as a best method to protect any commercial bank but cannot eliminate totally the fraudulent acts.

Benjamin (2001) corroborated this by saying that, though there seems to be effective internal audit and control in operation yet the incidence of fraud and fraudulent activities are on the increase.

In view of the above findings, the study recommended that:

Bank staff should be trained and taught the ethics of the banking profession in order to minimize fraud in banks and effective control cannot eliminate totally the fraudulent acts.

The researcher found the major causes of fraud in the banking sector . Banks should also investigate the would-be staff's previous work experience and also double check with the law enforcement agencies if they had any record of wrong doings.

If the banks are able to put the aforementioned recommendations into use, it will enable them to control fraud and fraudulent activities and with an effective internal control that will guarantee renewal of public confidence, , increased profitability and fraud prevention and detection.

5.2 Recommendations for Future Research

This study provides a foundation for future research that may study the relationship of effective internal control and fraud detection and prevention in different Egyptian industries.

It is recommended to use more than one method other than effective internal control to detect and prevent fraud and to increase the sample size in an attempt to get clearer and more accurate results.

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Appendix

Questionnaire

The role of effective internal control on the detection and prevention of Fraud in commercial banks.

Dear Respondent,

This questionnaire aims at analyzing the relationship between **effective internal Control** and **Fraud prevention and detection** in commercial banks.

This questionnaire is purely conducted for academic purposes only.

The responses to this questionnaire will be kept strictly confidential.

All information given will be handled anonymously and confidentially.

I thank you in advance for your participation!

Please place an "X" in the appropriate box to rate the following items using a scale of 1-5:

1= Strongly Disagree 2= Disagree 3= Neutral 4= Agree 5= Strongly Agree

	1	2	3	4	5
1) Policies and procedures are periodically reviewed by the audit committee and management to ensure that appropriate internal controls have been established.					
2) The audit committee and management reviews the qualifications and the independence of the bank's internal auditors.					
3) Audit procedures or other control systems exist to test on a periodic basis for staff compliance with ethics policies or codes of conduct.					
4) The audit committee and management appropriately evaluate risks when the bank is planning and approving new products or activities.					

5) The audit committee and management appropriately discuss and plan for control systems when the bank is planning and approving new products or activities.					
6) The bank's audit committee and management involve internal audit staff, and other internal control staff, in the risk assessment process.					
7) Policies and procedures exist to provide that decisions are made with appropriate approvals.					
8) Processes exist to provide independent verification of a sufficient sample of transactions to ensure integrity of the decision making process.					
9) Dual controls over bank assets and separation of duties provided for in the bank's organizational structure.					
10) The bank's accounting systems properly manage and report bank transactions in accordance with the proper accounting standards.					
11) Appropriate and sufficient reports produced by the bank for the proper management and control of the bank.					
12) The audit committee reviews the results of all internal and external audits.					
13) Internal control can effectively detect Misappropriation of Funds fraud.					
14) Internal control can effectively detect Credit Card fraud					
15) Internal control can effectively detect Theft fraud.					
16) Internal control can effectively detect ATM fraud.					
17) Internal control is the best effective method in detecting fraud					
18) Internal control is the best effective method in preventing fraud					
19) Internal Audit Review is the best effective method in detecting fraud					

20) Internal Audit Review is the best effective method in preventing fraud					
21) Employee Notification is the best effective method in detecting fraud					
22) Employee Notification is the best effective method in preventing fraud					
23) External Audit Review is the best effective method in detecting fraud					
24) External Audit Review is the best effective method in preventing fraud					

III) Respondent profile:-

1) Job Title:

- Manager
 Auditor
 Member of Audit Committee

2) Gender:

- Male
 Female

3)What is your age ?

- 25- 35 [] 36 – 45
 46–55 [] Older than 55

4)Educational level obtained:

- Bachelor Degree
 Master's Degree
 beyond Masters

5)How many years have you been working at this job?

- Less than 3 years [] Between 3 and 5 years
 Between 5 and 10 years [] More than 10 years

This is the end of this questionnaire. I thank you for your cooperation!!!

Thank You for completing the questionnaire!