Effect of Internal Control Systems on Sustained Management of Frauds in Nigerian Microfinance Banks

John Nma Aliu
Department of Banking and Finance, Kaduna Polytechnic, Kaduna

Abstract

Microfinance banks policy in Nigeria was targeted at creating an environment of financial inclusion to assist small producers. This was also aimed at boosting economic growth through job creation which would lead to improved standard of living. Microfinance banks have faced series of financial crisis in various parts of the world. In Nigeria, microfinance banks are faced with problems of massive loan defaults and lack of sufficient savings mobilization. This study examined the effect of internal control systems on the management of frauds in these banks. Explanatory descriptive ex-post facto research was adopted while questionnaires and interviews were used to collect primary data. The study found that occurrences of frauds and irregularities were due largely to weaknesses in internal control systems. The study concluded that the adoption of modern technology in service delivery by the microfinance banks can improve the internal control systems. It was recommended that microfinance banks should strictly adhere to code of corporate governance in order to strengthen the control systems.

Keywords: *Sustainability, Microfinance banks, Inside abuses, Frauds and irregularities*

Corresponding Author   John Nma Aliu

Background to the Study

Internal control systems involves a total control mechanisms – financial and otherwise by which banks relate to their clients and stakeholders to improve quality of service (Unegbu, 2004). Therefore, good systems of controls ensure transparency, accountability and fairness in financial transactions and reporting. Renee and Hamid (2003) points out that internal control systems is not only limited to corporate efficiency, but it relates to a much wider range of bank's strategies and life cycle development. The negative experiences of Microfinance bank distress around the world in the recent past gives credence to the need for good internal control practices. This view was supported by Harnando and Nicholas (2006) when they pointed out that the 1990s witnessed several distresses amongst bank and failures of Microfinance Institutions (MFIs) around the world. Financial distresses of banks in most of these countries were attributed to high incidence of non-performing loans, weak management and poor credit policy. Shleifer, Andrei and Vishny (1997) assert that the sheer scale of fraud, embezzlement and graft in some failed MFBs has brought into question the reliability and effectiveness of present-day operational and compliance control mechanism and financial reporting systems.

An important aspect of internal control in banks is the quality of the bank management-especially the directors. Accordingly, leadership characteristics have great impact on their performance (Waithaka, Gakure & Wanjau, 2013). The main goal of every bank is to operate profitably in order to maintain its stability and improve performance and sustainability (impact reporting and investment standards. 2010). However, existence of high level of loan delinquency problem in the Nigerian banking industry negatively affect the level of services to SMEs (Ditcher, 2003).

The financial sector in Turkey is traditionally dominated by microfinance activities, and the industry experienced several systemic crises in the 1990s (Mordy, 2010). Turkey weathered the financial crisis far better than many countries. As a result of strong internal control systems in the banking sector, Turkey's gross domestic product (GDP) increased from $230 billion in 2002 to $740 billion in 2008 (Sanusi, 2010). In addition, Turkey's national deficit fell by 40% in the first few months of 2010. Good control mechanism promotes goodwill and confidence in the financial system. Studies show that good internal control measures leads to increased valuation, higher profit levels, increased sales growth and lower capital expenditure (Wolfgang, 2003). This view was supported by Lam, Tin and Lee (2008).

Nigerian Banking Sector

There have been various episodes of banking crisis in Nigeria. Since commercial banking business commenced in 1892, the Nigerian banking system has witnessed episodes of crisis. The first took place in the late 1930s and early l950s, mainly as a result of lack of regulation, inadequate capital, fraudulent practices and bad management (Mordy, 2010). Consequently, about 21 of the 25 indigenous banks in existence by 1954 failed, Adesina and Ayo (2010), observed that the introduction of banking ordinance of 1952, the establishment of the Central Bank of Nigeria (CBN) in 1959 as well as the Banking Act of 1962 appeared to have brought sanity into the corporate governance practices in Nigerian banking system.

However, systemic crisis resurfaced in the Nigerian banking Industry in the mid-1990s and 2000s (Mordy, 2010). Sanusi (2010), noted that the Nigerian banking crisis situation was the manifestation of a complex state of inter-related corporate governance problems including a weak policy environment, capital and management inadequacies and economic down-turn. Sanusi (2010). pointed that the banking sector in Nigeria has evolved in five stages. The first stage was the pre-existence of the Central Bank of Nigeria (1930-1959), during which several poorly-capitalized and unsupervised indigenous banks failed in their infancy. The second stage was the control regime (1960-1985), during which the Central Bank of Nigeria (CBN) ensured that only persons of honour and integrity were granted license, subject to the prescribed minimum paid up capital and in line with the provisions of Banking Act (Mordy, 2010). The third stage was the post Structural Adjustment Programme (SAP) or de-control regime (1986-2004), during which the liberal philosophy of "free entry' was over stretched. This period marked the beginning of formal micro-finance banking (community banks) in Nigeria (Sanusi-2010). The fourth stage was the era of banking consolidation (2004 to 2009). With emphasis on recapitalization the fifth stage is the post-consolidation era of reforms hinged on proactive risk management and corporate governance best practices. The objective of this paper is to determine if the existing internal control systems influence the management of frauds in Nigeria banks.

Objective of the Study
The aimed of this study was to boosting economic growth through job creation which would lead to improved standard of living.

Definition of Concepts
Sustainability
The Longman active study dictionary (2006) defines sustainability as making something existing continuously without becoming weak. To achieve sustainability, banks must ensure that the services they offer meet the demands of clients. They must also ensure that operations are as efficient as possible, costs are minimized and that clients are motivated to repay loans (Leclgerwood, 2000). Stephen, Costa and Shamiso, (2013) observed that banks can be sustainable provided they have enough funds to continue operating in the long-term. Good corporate governance practices can lead to increase in operational revenue for the microfinance institutions (Moauro & Spegyiari, 2011). However, past crisis and closures in the microfinance sub-sector were found to have occurred as a result of weaknesses in internal control systems.

Fraud and Irregularities
Waterfield and Duval (2005) defines fraud as an act done with intent to give some advantage inconsistent with official duty and rights of others. Hashirnu (2008) describes fraud as an illegal act or series of illegal acts committed by non-physical means and by concealment to obtain money or property. The management of banks should adopt control measures that will deter fraudulent practices.

Insider Dealings: According to (Millichamp. 2000) insider dealings cover act of banks directors who unlawfully use their leadership position to gain personal benefits. An essential part of internal controls is guiding efforts towards achieving the goals and objectives of the

organization (Armstrong, 2007) this involves the process of leadership. Leadership can be interpreted in simple terms as getting others to follow or getting people to do things willingly or interpreted more specifically as the use of authority in decision-making (Mullions 2010)

Notwithstanding the existence of code of corporate governance for Banks in Nigeria (CBN, 2006), Sanusi (2009) observed that the governance in Banks has been acknowledged at the highest regulatory and operational levels of leadership to have failed. Banks should embrace best leadership practices in order to ensure sustainability.

Methodology

This study was exploratory descriptive ex post facto research. According to Mugenda and Mugenda (2005), exploratory research provides the opportunity for considering different aspects of a given problem under study because of it's flexible nature. They also point out that descriptive research provide the way things are with subjects by describing attitudes, values and characteristics. Ex post factor research examines the effects of a naturally occurring treatment (Kumar. 2005). Since this research study tried to investigate the effects of internal control systems on sustainable management of frauds in Nigerian banks, this research design is appropriate for the study.

The simple random sampling technique was used in this study. Neuman (2000) observed that this is the most common way to satisfy the representative sample requirement. It ensures that every subset of fixed size in the population has the chance of being included in the sample. Sampling is seen as an indispensable technique in behavioural research (Sigh & Bajpai, 2008). Emphasizing the importance of sampling, Castillo (2009) argued that "in every branch of science we lack the resources to study more than a fragment of the phenomena that might advance our knowledge". According to Castillo (2009), it is impossible to collect data from every respondent relevant to a study. It is therefore necessary to collect data only from some fractional part of the respondents through the process referred to as sampling. Sampling frame for the study was 660 licensed banks branches in Nigeria. A proportionate sample size of 66 banks was selected using simple random sampling technique. This is in line with the proposal of Adedipe (2010) that 10% of the proportion is considered adequate sample in so far as it allows for reliable data analysis by cross tabulation and provides desired level of accuracy.

Table 1 shows the target population and sample size used for the study.

| Towns	Customers	Microfinance Banks (**MFBs**)
Kano	792	36
Kaduna	408	30
Total	**1200**	**66**

A variety of instruments was used to collect data. The use of more than a single instrument facilitated the collection of wide-range of data on the different aspects of the variables. Instruments was developed and validated on 'normal populations. The instruments that were used include personal interviews, questionnaires and observation.

Data Analysis and Discussions

Table 1 shows responses to questions regarding Frauds and Irregularities in Microfinance Banks. The findings indicated that 52% (n = 68) of the respondents agreed that there were occurrences of frauds and errors in their Microfinance Banks, while 48% (n = 64) of the respondents indicated that there were no such cases in their banks. Asked whether Frauds and Irregularities affected provision of services by the MFBs, 85% (n = 58) of the respondents were of the view that these frauds and errors greatly affected the Microfinance Banks ability to provide services to the SMEs clients. Only 15% (n = 10) of the respondents felt that such forms of Irregularities had no effect on services to SMEs client. A vast majority of the respondent (95%) that indicated non-existence of Frauds and Irregularities in MFBs were of the view that this influenced the bank ability in providing sustained services to SMEs. Only 05% felt otherwise.

Table 1: Responses on frauds and Irregularities Microfinance Banks

		Count	Column N%
Are there occurrences of frauds and errors in your bank?	No	64	48%
	Yes	68	53&
If yes, how did these affect the ability of your bank in providing service to its client?	Greatly	58	85%
	Mildly	10	16%
If no, how did these influenced your bank's ability providing sustained services to customers?	Greatly	61	95%
	Mildly	03	05%
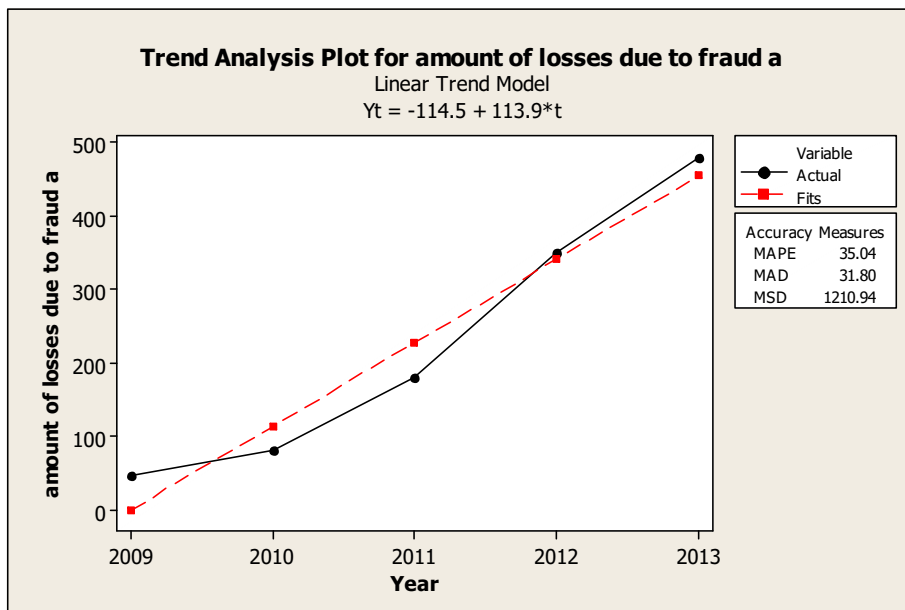
Figure 1: Trend Analysis plot for amount of losses due to Fraud

Frauds cases in Microfinance Institutions (MFIs) is not limited to Nigeria alone, millions of Ghana Cedis is lost to fraud annually in the MFIs sector in Ghana (Akwasi, Gilbert & Hannah, 2014). According to Abor and Qyartey (2010), Small and Medium Enterprises (SMEs) account for 92% of all businesses in Ghana and contribute about 70% of Gross Domestic Product

(GDP) to the Ghanaian Economy. The incidence of fraud in the Ghanaian Microfinance Banking Sector has limited their abilities to provide effective services to the SMEs (Akwasi et al, 2014). This is consistent with the Central Bank of Nigeria (2011) report that 11.244 billion naira were lost to fraud by Nigerian Banks. Ajayi (2014) asserts that such an amount is sufficient to set up at least eleven Microfinance Banks in Nigeria.

This further buttresses the assertions by Waithaka, Gakure and Wanjau (2013) that fraud and other forms of irregularities are among the serious factors affecting the growth of Microfinance Institutions. Central Bank of Nigeria (CBN, 2011) reported that weak corporate governance practices characterized by Frauds and other forms of Irregularities resulted in the liquidation of 84 Microfinance Banks in Nigeria as at December, 2010. Insider Dealings is the most lethal of all risk confronting MFBs in the area of service provision to clients. In essence, Microfinance Banks should ensure the inculcation of the culture transparency and integrity among directors, managers and the entire workforce. This will ensure sustainable growth of the MFBs as well as enhanced service delivery to the SMEs.

To confirm the effect of internal controls on management of frauds, the following statistical tools were employed: Regression Analysis, Test of Variances, Chi-Square, Correlation Analysis and Trends Analysis. Data on Table 2 shows that the correlation between independent variables (Fraud and irregularities, recruitment procedure and Inside dealings) and Services to SMEs in Nigeria is 0.781, implying a strong linear relationship between the independent variables and management of fraud in Nigeria. The coefficient of determination R^2 is 0.516 indicating that 51.6% of the variation in management of fraud is explained by these independent variables.

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	.718[a]	.516	.504	.52393

Predictors: (Constant), insider dealings, Fraud and irregularities, Recruitment procedure

In the table 3 the researcher has done analysis of variation for the variables to know the actual manner in which the three explain sustainability.

Table 4.9: ANOVA[a]

Model		Sum of Squares	df	Mean Square	F	Sig.
	Regression	37.424	3	12.475	45.445	.000[b]
	Residual	35.136	128	.275		
	Total	72.561	131			

a. Dependent Variable: Management of Frauds
b. Predictors: (Constant), insider dealings, Fraud and irregularities, Recruitment procedure

For table 4 the model, ***management of fraud = -1.036 +1.435*Fraud and irregularities+ 1.524*Recruitment procedure -0.241*Insider dealings***, is significant since the p-value (0.00) from the table is less than the chosen significant level of 0.05.

Furthermore the coefficients Table 4 indicate that the independent variables have significant effect on the dependent variable (Management of Fraud).

Model		Unstandardized Coefficients		Standardized Coefficients	T	Sig.
		B	Std. Error	Beta		
1	(Constant)	-1.036	.240		-4.319	.000
	Fraud and irregularities	1.435	.250	.539	5.739	.000
	Recruitment procedure	1.524	.444	.398	3.434	.001
	insider dealings	-.242	.423	-.085	-.572	.568

Spearman Rank Correlation on Frauds and Irregularities in MFBs
The study sought to investigate the effect of fraud and irregularities in MFBs on services to SMEs.

From table 5, the value of Spearman Rank Correlation r = 0.987 signifies a strong positive relationship between the number of frauds detected in microfinance banks by the two sets of respondents-the microfinance banks and the Regulatory Authority (Central Bank of Nigeria). The P-value due to the correlation of 0.000 is showing that the relationship is significant being that in this study, the significant level was 0.05.

This implies that increase in the number of frauds in MFBs affects their ability to render efficient services to the SMEs clients, frauds in microfinance institution has been a source of concern in other parts of the world. As noted by Convoy (2003) fraud and irregularities are main challenges hindering microfinance services in Singapore. In Ghana, Akwasi, Gilbert and Hannah found that inabilities of MFIs to extend services to SMEs are consequences of frauds and corruption, which result in some MFIs closure.
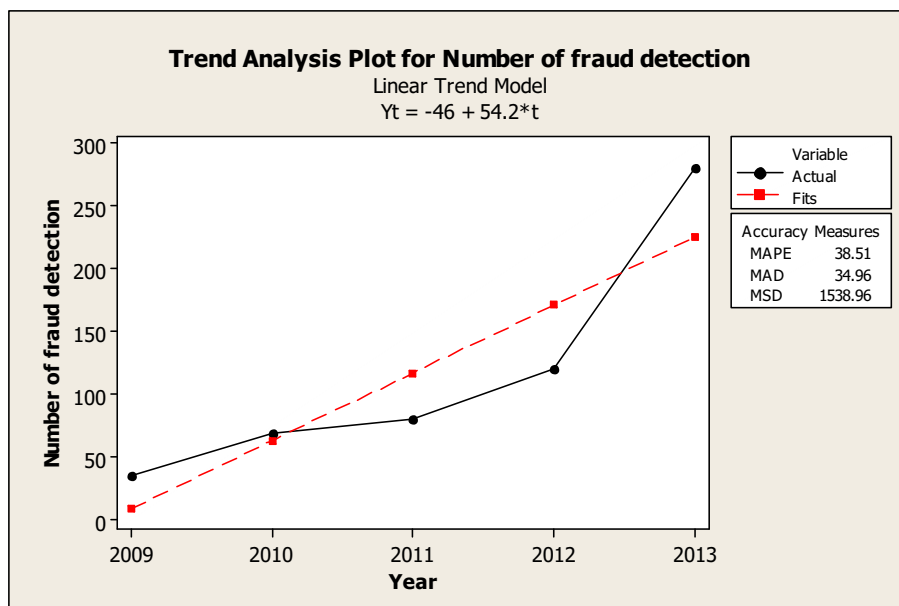
Rising incidence of frauds and irregularities in the microfinance banking sector or has led to calls for stringent control measures including emphasis on external auditing (Akinyomi, 2012). Among the consequences of fraud in Nigeria microfinance banks, loss of loanable funds and loss of customer's confidence top the list (Akinyomi, 2012).

Table 5: Correlation on Frauds and Irregularities

			Number of fraud cases discovered in MFBS	No of fraud detected
Spearman's rho	Number of fraud cases discovered in MFBS	Correlation Coefficient	.987	.987[**]
		Sig. (2-tailed)		.000
		N	5	5
	No of fraud detected	Correlation Coefficient	.987	.987
		Sig. (2-tailed)	.000	
		N	5	5
**. Correlation is significant at the 0.01 level (2-tailed).				

A figure to illustrate the trends of frauds cases detected was then plotted. Figure 4.2 shows that the number of frauds detected in microfinance banks has maintained a rising trend as the years passed by from 35 recorded incidences in 2009, the number roused to: 68 in 2010; 80 in 2011; 120 in 2012 and 280 in 2013. This is a clear indication that increase in the number of fraud occurrence could also lead to increase in the amount of Naira value involved in fraud. This concurs with the findings of Eseoghene (2010) who points to the fact that rising amounts in fraud is related to increased number of occurrences. It can be inferred that the effect of rising cases of frauds in MFBs also affects their ability to extend sustained services to clients.

Trend Analysis Plot for Number of fraud detection
Linear Trend Model
$Yt = -46 + 54.2*t$

Accuracy Measures
MAPE 38.51
MAD 34.96
MSD 1538.96

Figure 2: Trend Analysis Plot for Number of Fraud Detection

Conclusion
Based on the findings of this study, it can be concluded that weak internal control systems encourage frauds in MFBs and affect the ability of microfinance banks to provide services to clients. The enforcement of good control systems have a high potential of fraud detection and prevention. The adoption of Modern Technology in service delivery by MFBs in Nigeria has improved the internal control systems in microfinance banks.

The use of collateral substitutes by microfinance banks has also enhanced service delivery to their SMEs clients. However, the acceptance of collateral substitute can also be abused if not properly managed. Therefore, good leadership practices, such as proper record keeping and good recruitment procedures are essential for strong internal controls. The Central Bank of Nigeria should strive to monitor compliance with established financial management standards by the MFBs.

Recommendations

Microfinance banks should strictly adhere to the code of corporate governance (2006) issued by the Central Bank of Nigeria (CBN). This will reduce insider abuses, fraud and irregularities as well as ensure proper recruitment and selection procedures. Strict compliance with this code will strengthen corporate governance practices in MFBs and sustain stability within the Microfinance banking sector. There is also the need for proactive supervisory approach by the Central Bank of Nigeria (CBN). Accordingly, the CBN should strengthen its on-site and off-site supervisory functions by carrying out a more regular Risk Based Supervision (RBS) as well as Compliance Based Supervision (CBS) of the MFBs. This will ensure long term sustainable service delivery by the MFBs.

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