

CHAPTER ONE

BACKGROUND TO THE STUDY

1.1 INTRODUCTION

Saying that fraud is an important (however not loved) part of business, is nothing new. Fraud is a million dollar business, as several research studies reveal. Among them are important surveys of Price Waterhouse & Coopers (PwC, 2007) and of the Association of Certified Fraud Examiners (ACFE, 2006). The study conducted in the United States by the ACFE in 2004-2005 and the worldwide study, held by PwC in 2006-2007 yields the following insights. No industry seems to be safe and bigger companies seem to be more vulnerable to fraud than smaller ones. Small businesses however suffer disproportionate fraud losses. 43% of companies worldwide have fallen victim to economic crime in the years 2006 and 2007. The average financial damage to companies subjected to the PwC survey was US\$ 2.42 million per company over two years. Participants of the ACFE study estimate a loss of 5% of a company's annual revenues to fraud. Applied to the 2006 United States Gross Domestic Product of US\$ 13,246.6 billion, this would translate to approximately US\$ 662 billion in fraud losses for the United States only. These numbers all address corporate fraud, more precisely internal fraud.

About the way fraud is detected, both studies of PwC and the ACFE stress the importance of tips and chance. However, as a number two detection means in studies, internal audit and internal control systems can have a measurable impact on detecting fraud. The more control measures a company puts in place, the more incidents of fraud will be uncovered. Organizations allocate lots of resources to internal audit and control to prevent internal fraud. These costs, together with the costs of fraud, represent a large economic cost for the business environment.

Academic literature is currently investigating the use of data mining for the purpose of fraud detection. Brockett et al. (2002), Cortes et al. (2002), Est'avez et al. (2006), Fanning and Cogger (1998), Kim and Kwon (2006) and Kirkos et al. (2007) are just a few examples of a more elaborated list of articles concerning the hot topic of fighting fraud. Although a lot of this research may be framed in different settings -going from different techniques to different fraud domains-, there are two characteristics that stand for all executed research up till now: the focus is on external fraud and a predictive data mining approach is applied for fraud detection. We however are interested in internal fraud, since this represents mainly these large costs in the PwC and ACFE surveys. Further, we are convinced that not fraud detection alone, but detection in combination with prevention, is of priceless value for organizations. We use the term fraud risk reduction for encompassing both fraud detection and prevention.

1.2 STATEMENT OF THE PROBLEM

Unfortunately, the problem is getting worse. During the past year, both the number of fraud incidents and the dollar value of fraud increased dramatically, with 55.4 percent of

respondents reporting increased fraud in the past twelve months.

The economy has driven much of the growth. "Increased pressure" is cited as by far the biggest factor contributing to fraud. At 49.1 percent, it is comfortably ahead of increased opportunity (27.9 percent) and more than twice the rate of "rationalized" acts by the perpetrators (23.7 percent).

As in prior downturns, the problem is expected to worsen. More than 80 percent of respondents indicated that they expect the incidence of fraud to increase. Thirty-six percent expect it to increase significantly.

The greatest emerging source of fraud is employee embezzlement which accounted for a disturbing 48.3 percent of last year's increase. Internally generated fraud — e.g. corruption, financial statement fraud, and embezzlement — are also expected to continue to grow substantially.

Unfortunately, the poor economy like Nigeria is increasing the pressure to commit fraud in two ways. In addition to placing more personal economic pressures on employees, layoffs are depleting internal control systems. Nearly 60 percent of CFEs who work as in-house fraud examiners reported their companies had layoffs in the past year. Among those who had layoffs, almost 35 percent of companies had eliminated some internal controls.

1.3 OBJECTIVES OF RESEARCH STUDY

As previously mentioned, audit quality is the output of audit practice, and one of the major elements of audit quality is fraud detection. The objective of this study was to

- Determine the factors which may have a positive or negative affect on audit quality or audit fraud detection.
- Examine the free flow of information needed by the management for proper auditing functions
- Determine whether objective evaluation and measurement of the effectiveness of other controls by internal audit could put a stop to fraud.
- Determine whether well organized internal audit could change orientation of workers towards frauds?

1.4 RESEARCH QUESTIONS

- Can objective evaluation and measurement of the effectiveness of other controls by internal audit put a stop to fraud?
- Can well organized internal audit change orientation of workers towards frauds?
- What factors of human errors undermine the effective operation of the internal audit?
- Why do client's transactions go unchecked for arithmetical accuracy?

1.5 HYPOTHESES

The operation of an effective internal audit system in the public sector will surely reduce the

incidence of fraud.

HYPOTHESES1

-H₀:There is no significant relationship between an effective internal audit system and occurrence of fraud in a public sector.

-H₁:There is significant relationship between an effective internal audit system and occurrence of fraud in a public sector.

HYPOTHESES2

-H₀:An effective internal check will not make fraudulent practices and other irregularity difficult to perpetrate in the public sector.

-H₁:An effective internal check will make fraudulent practices and other irregularity difficult to perpetrate in the public sector.

1.3 SIGNIFICANCE OF THE STUDY

Of course, there are a number of specific ways in which fraud can be thwarted. Many of them provide additional ways to break up closed-off silos or encourage specific reporting.

This study can give an insight on how to protect cash and cash receipts, have checks mailed by someone other than the preparer after signing, have bank statements delivered to the owner unopened and have the bank accounts reconciled by someone independent of the cash receipts and disbursement functions.

It will also examine how to protect inventory and minimize your cost of sales, periodically count cost and compare inventory to control accounts and/or perpetual records. Pre-number documents and account for the sequence when you develop forms for purchase orders, receiving, inventory transfers and shipping. You will also want to take some very concrete actions: Store expensive components, products or tools in a locked closet. Designate a single exit door for your employees. And, of course, check the trash.

Segregated functions and specific purchases are your best strategies on the expense side. Separate requisitioning, purchasing and receiving functions from invoice processing, accounts payable, cash receipts and disbursements, and general ledger functions. Develop an approved vendor list to discourage under-the-table arrangements and shell vendors.

1.8 SCOPE OF THE STUDY

This research work covers internal audit system and how it could be structured and operated as a measure against fraud perpetration in the public sector i.e. how it can effectively prevent

and detect fraud. Public sector as practiced in the Power Holding Company of Nigeria (PHCN). The areas to be covered will include the following.

- Quality control in Auditing
- Internal control in Auditing
- Investigation
- Statutory Audit
- All laws guiding the practice of audit in Nigeria

1.9 LIMITATIONS OF THE STUDY

However, the following are the constraints encountered in the process of the research work.

-Time: Being a student with so much to do such as reading for the forthcoming examinations. Etc., time therefore, constitutes a constraint in the writing of this project.

-Fund: As a student with no steady sources of income, rather than the little from home. The present economic situation in the country today, has an adverse effect on the financial aspect of this research work.

Epileptic Power Supply: The inadequate supply of electricity

THE IMPACT OF INTERNAL AUDIT ON FRAUD DETECTION AND PREVENTION (A CASE STUDY OF POWER HOLDING COMPANY OF NIGERIA)

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