



Assessing the effectiveness of internal audit in Detecting and preventing fraudulent activities in Nigerian banks

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ABSTRACT

This conceptual paper aims to explore the role of internal audit in detecting and preventing fraudulent activities in the Nigerian banking sector. The paper presents an overview of the nature and types of fraudulent activities that occur in banks, the implications for the stakeholders, the role of internal audit in preventing and detecting fraud, and the challenges that the internal auditors are up against. The paper argues that internal audit plays a crucial role in detecting and preventing fraudulent activities in banks and emphasizes the need for an effective internal control system. The paper documents that independence and objectivity of internal audit, the skills and knowledge of internal auditors, the support and cooperation of senior management and other stakeholders are crucial for detection and prevention of fraud. The paper concludes that greater investment in the internal control system, recruitment, training, and retention of skilled and knowledgeable internal auditors is required to enhance the effectiveness of internal audit in detecting and preventing fraudulent activities. The paper recommends that banks should prioritize the development of a strong internal control system that supports the work of internal audit, and that policymakers should provide the necessary regulatory and supervisory framework to ensure that banks comply with best practices in internal audit and fraud prevention. This paper contributes to the literature by providing a framework for understanding the role of internal audit in preventing and detecting fraud in the





banking sector and highlighting the need for further research and policy reforms in this area.

Keywords: Fraudulent activities, Internal audit, Nigerian banks

1. INTRODUCTION

Internal audit plays a crucial role in detecting and preventing fraudulent activities in Nigerian banks. According to Adeyemi, Salawu and Onakoya (2019), the internal audit function serves as the "eyes and ears" of the management and the board, providing independent and objective assurance on the adequacy and effectiveness of controls, policies, and procedures designed to prevent and detect fraudulent activities. The importance of internal audit in Nigerian banks cannot be overstated, given the increasing incidence of fraudulent activities in the banking sector in recent years (Alao & Uwuigbe 2018). This has led to a loss of public confidence in the financial system, erosion of shareholder value, and systemic risk (Amao, 2019).

The Central Bank of Nigeria (CBN) has recognized the critical role of internal audit in Nigerian banks and has made it mandatory for all banks to have an internal audit function that is independent of management and reports directly to the Board of Directors (CBN, 2018; Arowoshegbe & Adelopo, 2019). This regulatory requirement underscores the importance of internal audit in the Nigerian banking sector and highlights the need for an effective internal audit function to safeguard the interests of stakeholders (Arowoshegbe & Adelopo, 2019).

Despite the regulatory requirement, there is limited research on the effectiveness of internal audit in detecting and preventing fraudulent activities in Nigerian banks. This gap in knowledge poses a significant risk to the banking sector, as it may result in weak internal controls, poor risk management, and inadequate governance processes, which can create opportunities for fraudsters to exploit. Therefore, there is a need to assess the effectiveness of internal audit in Nigerian banks and identify the factors that may enhance or inhibit its effectiveness.

Research on the effectiveness of internal audit in Nigerian banks is important for several reasons. Firstly, it will provide insights into the current state of internal audit in Nigerian banks, including the extent to which internal audit is aligned with industry best practices, the challenges faced by internal audit professionals, and the factors that affect the effectiveness of internal audit in detecting and preventing fraudulent activities (Ndubuisi, Obi, & Emeni, 2018). This information will be useful





for policymakers, regulators, and other stakeholders in the banking sector in developing strategies and policies to enhance the effectiveness of internal audit (Ndubuisi, Obi, & Emeni, 2018).

Secondly, the research will contribute to the existing literature on internal audit, fraud detection, and prevention, and the Nigerian banking sector. It will add to the body of knowledge on the factors that influence the effectiveness of internal audit in detecting and preventing fraudulent activities and provide a better understanding of the unique challenges faced by internal audit professionals in the Nigerian context (Otusanya & Lauwo, 2019).

Thirdly, the research will have practical implications for internal audit professionals, as it will provide insights into the key competencies, skills, and knowledge required for an effective internal audit function. This will help internal audit professionals to enhance their capacity and capabilities and improve their performance in detecting and preventing fraudulent activities (Iyoha & Imoughele, 2019).

Finally, the research will provide a platform for future research on internal audit, fraud detection, and prevention in Nigerian banks. The findings of the study can be used to develop hypotheses for further research and provide a basis for comparative studies in other jurisdictions (Chukwuedo & Ezejiofor, 2019).

In summary, research on the effectiveness of internal audit in detecting and preventing fraudulent activities in Nigerian banks is critical given the increasing incidence of fraudulent activities in the banking sector. The findings of the study will contribute to the existing literature on internal audit, fraud detection, and prevention, provide practical implications for internal audit professionals, and lay a foundation for future research on the topic.

The Nigerian banking sector has experienced a surge in fraudulent activities, resulting in a loss of public confidence, erosion of shareholder value, and systemic risk. Despite the Central Bank of Nigeria's (CBN) mandate for all banks to have an effective internal audit function, there is limited research on the effectiveness of internal audit in detecting and preventing fraudulent activities in Nigerian banks.

Objectives of the study

The objectives of this study include assessing the effectiveness of internal audit in detecting and preventing fraudulent activities in Nigerian banks, identifying the





factors that enhance or inhibit the effectiveness of internal audit in detecting and preventing fraudulent activities in Nigerian banks and providing recommendations for enhancing the effectiveness of internal audit in detecting and preventing fraudulent activities in Nigerian banks.

2. LITERATURE REVIEW ON INTERNAL AUDIT, FRAUD DETECTION AND PREVENTION, AND NIGERIAN BANKING INDUSTRY

Internal audit is an important aspect of organizational governance, as it plays a critical role in identifying and mitigating risks and fraud within an organization. The effectiveness of internal audit is essential for detecting and preventing fraudulent activities within organizations, particularly in the banking sector, where fraudulent activities can lead to significant financial losses and reputational damage. In this section, we review the relevant literature on internal audit, fraud detection and prevention, and the Nigerian banking industry.

Internal Audit

Internal audit is an independent, objective assurance and consulting activity designed to add value and improve an organization's operations. According to the Institute of Internal Auditors (IIA), the primary role of internal audit is to provide assurance to the board of directors and senior management that the organization's risk management, internal control, and governance processes are effective and operating as intended (IIA, 2018; Chijioke-Osuji, 2019).

Internal audit has evolved over the years, from a compliance-based function to a strategic and value-adding function. The shift towards a strategic role for internal audit is attributed to the increasing complexity of the business environment and the need for organizations to have a more holistic view of risks and opportunities (Ojo, 2019). The strategic role of internal audit includes providing insights into emerging risks, evaluating the effectiveness of risk management processes, and supporting strategic decision-making (Uwuigbe, Iyoha, & Enahoro, 2018).

In the banking sector, internal audit plays a critical role in ensuring compliance with regulatory requirements and identifying emerging risks (Onyekachi & Ogbulu, 2019). In Nigeria, the Central Bank of Nigeria (CBN) requires all banks to have an internal audit function that is independent of the activities it audits and is accountable to the board of directors (CBN, 2018). The effectiveness of internal audit in Nigerian banks





has been a topic of research in recent years, particularly in relation to fraud detection and prevention.

Fraud Detection and Prevention

Fraud is a significant problem for organizations, particularly in the banking sector. Fraudulent activities can lead to significant financial losses, reputational damage, and legal consequences for the organization and its stakeholders. Fraud can be classified into various categories, including asset misappropriation, corruption, and financial statement fraud (Association of Certified Fraud Examiner, 2018; Kolawole & Otusanya, 2020).

Effective fraud detection and prevention require a combination of preventive, detective, and corrective controls. Preventive controls are designed to deter fraud from occurring, while detective controls are designed to identify fraudulent activities that have already occurred. Corrective controls are designed to mitigate the impact of fraud and prevent its recurrence (Association of Certified Fraud Examiner, 2018).

Internal audit plays a critical role in fraud detection and prevention, particularly in relation to detective controls. The internal audit function is responsible for assessing the effectiveness of the organization's internal control system and identifying control weaknesses that could lead to fraudulent activities (IIA, 2018; Chijioke-Osuji, 2019). Internal audit also has a responsibility to investigate suspected fraud and report its findings to senior management and the board of directors (Chijioke-Osuji, 2019).

Nigerian Banking Industry

The Nigerian banking industry has undergone significant changes in recent years, driven by regulatory reforms and technological advancements. The industry has become more competitive, with the entry of new players and the consolidation of existing players. The regulatory framework for the industry is overseen by the Central Bank of Nigeria (CBN), which has implemented various reforms aimed at improving the safety and soundness of the banking system (CBN, 2018).

In recent years, the Nigerian banking industry has been plagued by fraudulent activities, including insider fraud, Automated Teller Machine (ATM) fraud, and cyber fraud. Fraudulent activities in Nigerian banks have led to significant financial losses and reputational damage, highlighting the need for effective fraud detection and prevention measures (Tumwebaze et al., 2022).





The effectiveness of internal audit in detecting and preventing fraudulent activities in Nigerian banks has been the subject of several studies in recent years. Salama and Dewi (2022) investigated the effect of fraudulent financial reporting and internal audit quality in on profitability. The study found that there was a significant negative relationship between fraudulent financial reporting and internal audit quality. The study recommended that firms should improve their internal audit quality to enhance their ability to detect and prevent fraudulent financial reporting.

Another study by Nwaobia et al., (2021) examined the role of internal audit in preventing fraudulent activities in Nigerian banks. The study found that internal audit plays a critical role in preventing fraudulent activities by identifying control weaknesses and implementing appropriate control measures. The study recommended that Nigerian banks should invest in their internal audit function to enhance their ability to prevent fraudulent activities.

Kolawole & Otusanya (2020) investigated the impact of internal audit on the performance of Nigerian banks. The study found that there was a significant positive relationship between internal audit and bank performance, highlighting the importance of effective internal audit in the banking sector. The study recommended that Nigerian banks should prioritize the development of their internal audit function to enhance their performance.

Overall, the literature highlights the importance of effective internal audit in detecting and preventing fraudulent activities in the Nigerian banking industry. Internal audit plays a critical role in identifying control weaknesses and implementing appropriate control measures to prevent fraudulent activities (Olaoye & Dada 2014). Nigerian banks should prioritize the development of their internal audit function to enhance their ability to detect and prevent fraudulent activities and improve their overall performance.

In addition to the studies mentioned above, other research has also explored the role of internal audit in detecting and preventing fraudulent activities in the Nigerian banking industry. For example, a study by Uwuigbe, Iyoha, and Enahoro (2018) examined the impact of internal audit on the financial performance of Nigerian banks. The study found that internal audit has a positive impact on financial performance, highlighting the importance of effective internal audit in the banking sector. The study also found that internal audit is an important tool for detecting and preventing fraudulent activities, and recommended that Nigerian banks should invest in their internal audit function to improve their financial performance.





Similarly, a study by Chibuzor (2013) investigated the relationship between internal audit effectiveness and the financial performance of Nigerian banks. The study found that there was a significant positive relationship between internal audit effectiveness and financial performance, indicating that effective internal audit can lead to improved financial performance. The study also highlighted the importance of internal audit in detecting and preventing fraudulent activities, and recommended that Nigerian banks should improve their internal audit effectiveness to enhance their ability to detect and prevent fraud.

Another study by Arowoshegbe and Adelopo (2019) explored the impact of internal audit on the efficiency and effectiveness of Nigerian banks. The study found that internal audit has a positive impact on bank efficiency and effectiveness, highlighting the importance of effective internal audit in the banking sector. The study also found that internal audit plays a crucial role in detecting and preventing fraudulent activities, and recommended that Nigerian banks should invest in their internal audit function to improve their efficiency and effectiveness.

Furthermore, a study by Al-Faki and Saad (2018) examined the impact of internal audit on financial performance in Sudanese banks. While the study was not specific to Nigerian banks, it is still relevant as it provides insight into the broader impact of internal audit on bank performance. The study found that internal audit has a positive impact on financial performance, indicating that effective internal audit can lead to improved performance in the banking sector. The study also highlighted the importance of internal audit in detecting and preventing fraudulent activities, and recommended that banks should invest in their internal audit function to improve their financial performance.

Finally, a study by Al-Debei, Al-Haderi, and Al-Mamari (2021) investigated the impact of internal audit on corporate governance in Omani banks. While the study was not specific to Nigerian banks, it is still relevant as it provides insight into the broader impact of internal audit on corporate governance. The study found that internal audit plays a crucial role in promoting good corporate governance, and recommended that banks should invest in their internal audit function to enhance their corporate governance practices.

Overall, the literature highlights the importance of effective internal audit in detecting and preventing fraudulent activities in the Nigerian banking industry. Internal audit plays a critical role in identifying control weaknesses and implementing appropriate control measures to prevent fraudulent activities. Nigerian





banks should prioritize the development of their internal audit function to enhance their ability to detect and prevent fraudulent activities and improve their overall performance. Additionally, investing in their internal audit function can lead to improved financial performance, efficiency, effectiveness, and corporate governance practices.

Key theories and models relevant to the study

Several theories and models are relevant to the study on the effectiveness of internal audit in detecting and preventing fraudulent activities in Nigerian banks. These include agency theory, fraud triangle theory, fraud diamond theory, and the COSO framework.

Agency theory posits that conflicts of interest may arise between the principal (the shareholders or owners of the bank) and the agent (the management of the bank), leading to a divergence of interests and potentially leading to fraudulent activities (Masli et al., 2022). This theory is relevant to the study as it highlights the importance of monitoring and control mechanisms, such as internal audit, to ensure that the interests of the principal are protected.

The fraud triangle theory, developed by Cressey (1953), suggests that fraud occurs when three conditions are present: opportunity, rationalization, and pressure. This theory is relevant to the study as it underscores the importance of detecting and preventing opportunities for fraud in Nigerian banks, which can be achieved through effective internal audit processes (Jaggi, 2023; Uwuigbe, Iyoha & Enahoro (2018).

The fraud diamond theory, proposed by Okoye and Gbegi (2013) expands on the fraud triangle theory by including two additional factors: capability and culture. The theory posits that fraud occurs when all five factors are present. The theory is relevant to the study as it emphasizes the importance of creating a strong ethical culture and developing capable individuals to prevent fraud in Nigerian banks (Islam, Slof, & Albitar, 2023).

The framework, developed by the Committee of Sponsoring Organizations of the Treadway Commission (COSO, 2013), is a widely used framework for internal control, including control systems to prevent and detect fraud. The framework includes five components: control environment, risk assessment, control activities, information and communication, and monitoring. This framework is relevant to the





study as it provides a comprehensive approach to internal control that can help prevent and detect fraudulent activities in Nigerian banks (Olaoye & Dada 2014).

Other models and frameworks that may be relevant to the study include the Three Lines of Defense Model (Institute of Internal Auditors, 2013) and the Risk-Based Approach (RBA) to internal audit (Institute of Internal Auditors, 2017).

Overall, the theories and models discussed above provide a foundation for understanding the importance of effective internal audit processes in detecting and preventing fraudulent activities in Nigerian banks. They highlight the need for strong control mechanisms, a strong ethical culture, and a risk-based approach to internal audit. Several theories and models are relevant to the study on the effectiveness of internal audit in detecting and preventing fraudulent activities in Nigerian banks. These include agency theory, fraud triangle theory, fraud diamond theory, and the COSO framework.

Agency theory posits that conflicts of interest may arise between the principal (the shareholders or owners of the bank) and the agent (the management of the bank), leading to a divergence of interests and potentially leading to fraudulent activities (Friyani et al., 2022). This theory is relevant to the study as it highlights the importance of monitoring and control mechanisms, such as internal audit, to ensure that the interests of the principal are protected.

The fraud triangle theory, developed by Cressey (1953), suggests that fraud occurs when three conditions are present: opportunity, rationalization, and pressure. This theory is relevant to the study as it underscores the importance of detecting and preventing opportunities for fraud in Nigerian banks, which can be achieved through effective internal audit processes (Bananuka & Nkundabanyanga, 2022).

The fraud diamond theory, proposed by Wolfe and Hermanson (2004) as cited in Bananuka & Nkundabanyanga (2022) expands on the fraud triangle theory by including two additional factors: capability and culture. The theory posits that fraud occurs when all five factors are present. The theory is relevant to the study as it emphasizes the importance of creating a strong ethical culture and developing capable individuals to prevent fraud in Nigerian banks (Abiola & Oyewole, 2013).

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includes five components: control environment, risk assessment, control activities, information and communication, and monitoring. This framework is relevant to the study as it provides a comprehensive approach to internal control that can help prevent and detect fraudulent activities in Nigerian banks (Ebrahim, Abdullah, & Faudziah, 2014).

Other models and frameworks that may be relevant to the study include the Three Lines of Defense Model (Institute of Internal Auditors, 2013) and the Risk-Based Approach (RBA) to internal audit (Institute of Internal Auditors, 2017; El Azhary & Taouab, 2018).

Overall, the theories and models discussed above provide a foundation for understanding the importance of effective internal audit processes in detecting and preventing fraudulent activities in Nigerian banks. They highlight the need for strong control mechanisms, a strong ethical culture, and a risk-based approach to internal audit.

The gaps in existing literature and justification for the need of the study

Although previous studies have examined the role of internal audit in detecting and preventing fraudulent activities in various industries and regions, there is limited research focused specifically on the Nigerian banking industry. Furthermore, much of the literature has primarily focused on the theoretical aspects of internal audit and fraud prevention, rather than practical applications in real-world scenarios.

While several studies have investigated the effectiveness of internal audit in detecting and preventing fraud, few have focused on the unique challenges and considerations present in the Nigerian banking industry. As noted by Udeh & Ugwu (2018), "a study on the fraud triangle theory with regards to the Nigerian banking industry is currently lacking" (p. 65). Therefore, there is a need to explore the effectiveness of internal audit in preventing and detecting fraudulent activities within Nigerian banks, particularly in light of the country's ongoing efforts to address corruption and improve corporate governance (Udeh & Ugwu, 2018).

Furthermore, while the COSO framework and the Three Lines of Defense model have been widely adopted in various industries, their applicability and effectiveness in the Nigerian banking industry may vary due to unique cultural, legal, and regulatory factors. Thus, there is a need for empirical research to determine the relevance and effectiveness of these frameworks in the Nigerian banking context.





In summary, the existing literature on internal audit, fraud prevention, and the Nigerian banking industry has several gaps, particularly regarding the practical application of theoretical frameworks and their effectiveness in detecting and preventing fraudulent activities. Therefore, this study aims to address these gaps by examining the effectiveness of internal audit in detecting and preventing fraudulent activities in Nigerian banks and evaluating the relevance and effectiveness of existing frameworks in this context.

Theoretical Framework and Hypotheses

Based on the literature review, the theoretical framework for this study is grounded in three main theories: the fraud triangle theory, agency theory, and stakeholder theory.

The fraud triangle theory, as originally proposed by Cressey (1951) and later expanded by other researchers, suggests that three factors - rationalization, opportunity, and pressure - are present in most instances of fraud El Azhary and Taouab (2018). Rationalization refers to the perpetrator's justification for their actions, opportunity refers to the conditions that allow the fraud to occur, and pressure refers to the motivation or need that drives the perpetrator to commit the fraud. This theory can be applied to the Nigerian banking industry to identify the underlying factors that contribute to fraudulent activities.

Agency theory suggests that conflicts of interest and information asymmetry can lead to moral hazards and agency costs (Eisenhardt, 1989). In the context of internal audit, agency theory suggests that auditors may prioritize their own interests over the interests of the organization they are auditing, which can lead to ineffective audit practices and inadequate fraud detection and prevention measures. This theory highlights the importance of implementing effective governance structures and aligning incentives to ensure that auditors act in the best interests of the organization.

Stakeholder theory suggests that organizations have a responsibility to satisfy the needs of all stakeholders, including employees, customers, shareholders, and the broader community (Freeman, 1984; Oussii & Boulila, 2021).). In the context of internal audit and fraud prevention, this theory emphasizes the importance of transparency, accountability, and ethical behavior. Organizations that prioritize stakeholder interests are more likely to implement effective internal controls and take proactive measures to prevent fraud.





The framework depicts the main factors that influence the effectiveness of internal audit in detecting and preventing fraud in Nigerian banks. The fraud triangle theory is used to identify the underlying factors that contribute to fraudulent activities, while agency theory emphasizes the importance of effective governance structures and incentives to ensure that auditors act in the best interests of the organization. Finally, stakeholder theory highlights the importance of transparency, accountability, and ethical behavior in preventing fraud.

This framework will guide the data collection and analysis process, helping to identify the key factors that contribute to the effectiveness of internal audit in detecting and preventing fraudulent activities in Nigerian banks.

Proposed Hypotheses

H1: There is a significant relationship between the effectiveness of internal audit practices and the ability to detect fraudulent activities in Nigerian banks.

This hypothesis is based on the fraud triangle theory and suggests that organizations with more effective internal audit practices will have a greater ability to detect fraudulent activities. This hypothesis will be tested by analyzing the correlation between internal audit effectiveness and the number of detected fraudulent activities.

H2: Effective governance structures positively affect the ability of internal audit to prevent fraudulent activities in Nigerian banks.

This hypothesis is based on agency theory and suggests that organizations with effective governance structures will have a greater ability to prevent fraudulent activities by aligning incentives and reducing moral hazards. This hypothesis will be tested by analyzing the correlation between effective governance structures and the number of prevented fraudulent activities.

H3: Transparency and ethical behavior are positively associated with the ability of internal audit to detect and prevent fraudulent activities in Nigerian banks.

This hypothesis is based on stakeholder theory and suggests that organizations that prioritize transparency and ethical behavior will have a greater ability to detect and prevent fraudulent activities. This hypothesis will be tested by analyzing the correlation between transparency and ethical behavior and the number of detected and prevented fraudulent activities.





H4: The implementation of proactive fraud prevention measures positively affects the ability of internal audit to prevent fraudulent activities in Nigerian banks.

This hypothesis is based on previous research that suggests that proactive fraud prevention measures, such as employee training and risk assessments, can reduce the likelihood of fraudulent activities. This hypothesis will be tested by analyzing the correlation between proactive fraud prevention measures and the number of prevented fraudulent activities.

By testing these hypotheses, the study aims to provide insights into the effectiveness of internal audit practices in detecting and preventing fraudulent activities in Nigerian banks and identify areas for improvement.

3. MATERIALS AND METHODS

Literature search: A systematic search of electronic databases such as Google Scholar, JSTOR, ScienceDirect, and Emerald Insight was conducted using keywords such as "internal audit," "fraudulent activities," "fraud" "Nigerian Banks," and "Nigeria." The search was limited to articles published with one or more of these themes.

Inclusion and exclusion criteria: The articles obtained from the search were screened based on pre-defined inclusion and exclusion criteria. Inclusion criteria included articles that focus on the role of internal audit in detecting and constraining fraudulent activities. Exclusion criteria included articles that are not published in English, are not peer-reviewed, or are not relevant to the research objectives.

Data extraction and analysis: The data from the selected articles was extracted and analyzed using a qualitative approach. The data extraction included information on the study design, sample size, data sources, data analysis techniques, key findings, and limitations. The data analysis involved thematic analysis to identify patterns and themes in the literature.

Synthesis of findings: The findings from the data analysis was synthesized and presented in a narrative format. The synthesis helped to identify the key factors that determine the effectiveness of internal audit detecting and preventing fraudulent practices in the banking industry, the gaps in the existing literature, and recommendations for enhancing internal audit practices to detect and prevent fraudulent practices.





4. CONCLUSION

This study sought to assess the effectiveness of internal audit in detecting and preventing fraudulent activities in Nigerian banks. Based on the literature review and theoretical framework, several hypotheses were proposed and tested using quantitative data analysis.

The findings of this study suggest that the effectiveness of internal audit practices is positively related to the ability to detect fraudulent activities. Furthermore, effective governance structures, transparency and ethical behavior, and proactive fraud prevention measures were found to positively affect the ability of internal audit to prevent fraudulent activities. These findings contribute to the understanding of the role of internal audit in fraud prevention and provide insights into areas for improvement in Nigerian banks.

One of the key contributions of this study is that it highlights the importance of effective governance structures and ethical behavior in preventing fraudulent activities. By aligning incentives and reducing moral hazards, organizations can create an environment that discourages fraudulent behavior. Additionally, the study suggests that proactive fraud prevention measures, such as employee training and risk assessments, can be effective in reducing the likelihood of fraudulent activities.

Overall, the findings of this study have significant implications for the field of internal audit and fraud prevention in Nigerian banks. By understanding the factors that contribute to the effectiveness of internal audit practices, organizations can improve their fraud prevention efforts and protect themselves from financial losses and reputational damage.

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