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## The Role of Internal Audit in Fraud Prevention and Detection

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### Abstract

This article aims to not just briefly describe the role of the internal audit in the detection of possible frauds, but also to highlight its importance in preventing the commission of frauds in any economic entity. Moreover, the analysis intends to especially point out the advantages that an internal audit can offer to the management of an economic entity and its partners, and to the society as a whole as well.

Starting from the premise that auditors are not the adversaries of an entity, one should remember that: the internal audit is a function of assistance offered to the leadership of that entity in order for them to better manage their activities; it expresses judgments on all decisions taken by the leadership that ensure the normal and efficient functioning of its activities; and its objective is to create added value.

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*Keywords:* internal audit, fraud, auditor.

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### Research Methodology

We have focused the research that we suggest in this paper on the analysis and systematisation of the literature written in this field, as well as on the rules governing the activities of internal audit published at the national and international level.

In order to conduct our study, we have approached different research methods in our endeavour. We have applied a qualitative analysis, and focused on the method of comparison by presenting an analogy between internal audit and fraud. Also, we have used the synthesis in what drawing conclusions and offering solutions were concerned, in order to explain and assess the situations we found, as well as the limits and the characteristic of internal audit.

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Nonetheless, we have used the method of documenting ourselves by analysing the rules regarding the internal audit that were published nationally and internationally, and then completing our study by consulting different works published by specialists in this field in our country.

## 1. Introduction

Fraud is not a recent phenomenon associated to some highly-publicised cases of financial fraud from the last two centuries. It can be found early in the history of our world as men have made use of tricks, manipulation, and deceit in order to acquire money, land, goods, or trust, with the overall objective of making profit. The creation of accounting and audit are connected in economic history with the desire, especially on the part of the state and the church, to contain and prevent stealing and misrepresentation in their finances.

Traces of the precursors of audit can be dated back to Antiquity, to ancient Babylon and Egypt, where archaeological finds have proven the existence of some justifying documents of commercial transactions that allowed for a rudimentary form of verification and accounting (Bogdan, A.M., 2005, pp. 8-9). And once the commercial trades blossomed during a period or another, the need to keep a record of transaction also emerged albeit at a primitive level. But with economic prosperity came also the temptation to deceit and manipulate others for self-profit. Control mechanisms were, therefore, developed by state institutions in order to verify and supervise the use of funds and the circuit of transactions, as was the case for example in ancient Rome, where the questors elected by the people were responsible of this role (Bogdan, A.M., 2005, p. 11).

During the Middle Ages, however, the interest to control financial documents and accounts and to verify the use or misuse of funds increased in Western Europe. The main objective was to discover those who eluded payment, appropriated funds, or misused money and property, and to defer them to justice. The three institutions that introduced as early as the 13th-14th centuries the idea of verifying accounts and hold the wrongdoers accountable were the state (represented by the reigning monarch), the Catholic Church, and the universities (especially those from Northern Italy), and employed functionaries or monks to keep the accounting of their respective structure (Le Goff, J., 1977). It is not a coincidence that the bases of accounting are found within the financial and administrative apparatus of the Catholic Church, which was extremely interested in having detailed and correct records of its accounts, responsible transactions, and detection of possible frauds. A complex hierarchy of the fiscal apparatus was, therefore, created, presided by a Minister of Finances within the Catholic Church, that included a category of specialists called 'scriptores registri' who we can deduce that were the accountants responsible with registering and examining the financial entries (Rapp, F., 1995, Part I). The founder of accounting, Luca Paciolo created in the late 15th century the double entry accounting precisely to avoid thefts and misrepresentations in financial documents, at first within the Church and then the state (Epuran M., Baba V., Imbrescu C., p. 13). Another interesting aspect in the development of accounting is that, unlike the image of merchants, traders, or usurer, the men responsible with this work were not perceived in a negative manner in society or marginalised (Le Goff, 1990, pp. 47-48), because they were associated with the good management of the state and the church, having both an economic and a judicial role (since they prevented or discovered the commission of a financial crime and therefore helped protecting state or church patrimony).

From the Modern Era on, the state was the main institution interesting in implementing and supervising the accounting system in order to prevent, detect, and punish any fraud committed, both in its structures and in the public sector. And as the economic organisations became more complex and powerful in society, they also started to employ the services of specialist functionaries or accountants with the aim of maximising their profit and avoid losses or thefts by means of distorted or erroneous financial entries. The industrial revolution brought a quick economic development, but also an increased interest in the systems of capital, investment, and control of transactions (Lesourd, J.A., Gerard, C., 1986, vol. 1). But with the economic boom grew also people's desire to make money quickly by malicious or deceitful means, and therefore the public opinion became more aware from the 18th century about the existence of financial fraud and other fraudulent schemes meant to acquire trust, property, goods, or political power (Stratmann L., 2012, pp. 7-9, and all the cases discussed by the author). The main reason many scientists give to an individual's desire to acquire financial, spiritual, or symbolic profit is related to his greed, as it gave birth to novel and creative scenarios to impress upon other people (Goldberg, M.H., 1995, p. 18). Although big scandals related to financial fraud existed in Western Europe in the late Middle Ages and early

Modern period (Sarna, D.E.Y., 2010, Ch. 4), it was during the 19th and 20th centuries that more emphasis was put on coherent accounting and financial investigations. The aim was that fraud, deceit, and misrepresentation could be discovered, punished, and eventually corrected in order to avoid future fraudulent situations like the ones that had occurred (Sarna, D.E.Y., 2010, Ch. 17, 20-23).

From the mid-19th century, the professional category of accountants and auditors emerged as a specialised group of people involved in preventing and detecting real or possible frauds and errors in the financial situations within the state or an economic entity. Their role was not only to investigate, but also to assess possible risks and to guarantee the responsibility of internal control mechanisms. At the end of the 20th century and the beginning of the 21st century, auditors have become a necessity for the good-functioning and efficiency of an economic entity's management that can prevent and deter possible scenarios of trickery, funds embezzlement, or theft.

## 2. Defining Fraud

The fraud negatively affects an economy as a whole, by causing huge financial losses, weakening social stability, threatening democratic structures, leading to a loss of trust in the economic system, or corrupting and compromising economic and social institutions (Nicolescu C., 2007, p. 92).

Until not long ago, the companies did not consider fraud prevention as a main objective within their organisation's system of internal control. The action for fraud prevention was considered an implicit component within the general objectives, of compliance, of the internal controls, and therefore not seen as a structured programme, with clear and explicit aims regarding fraud prevention and detection (Petrașcu D., 2013, p. 35). Furthermore, in the past, the shareholders, the board of administration, and the management tended to deal with fraud cases as mere anomalies resulted from the faulty functioning of the internal controls that only occurred rarely.

As a result of the numerous famous fraud cases discovered at the beginning of the 21st century within some of the most prestigious multinational companies, this vision regarding fraud prevention has radically changed. Nowadays, fraud is considered to be one of the most important risks that an organization is exposed to, having a close connection to market, credit, judicial or reputational risks (Munteanu V., Zuca M., Zuca Ș., 2010, p. 33).

A novelty is also the fact that investors have become more sensitive to the problem of fraud risk, since the collateral losses generated by a fraud ended up exceeding considerably the direct financial losses caused by that respective fraud. These collateral losses include negative publicity that can seriously affect the reputation of an organization. In this manner, the investors lose foremost the trust they have in the organisation's leadership and the way it is managed, a fact that obviously entails a drop in its value. It affects as well all business relationships and employee morale. As a reaction to this situation, the investors impose the development of anti-fraud mechanisms focused on measures to prevent fraud and detect it on time. More and more interest is given to internal control and internal audit as core elements of these mechanisms (Munteanu V., Zuca M., Zuca Ș., 2010, p. 33).

The term of 'fraud' appears in the broader concept of 'irregularities'. An irregularity refers to any transgression from legality, regularity, or conformity, as well to any breach of the above mentioned. Deficiencies, transgressions, and malfunctions represent breaches of the normative framework, violations of the procedural code consisting of errors, omissions, or unintentional mistakes.

The concept of fraud has several meanings, such as the ones listed below.

Fraud represents the sum of irregularities and illegal actions committed with the intention of deceiving (Modalități practice de aplicare – MPA 1210 [Practical Means of Application – MPA 1210]. A2-1. Identificarea fraudei [Fraud Identification]).

Fraud can refer also to the lack of communicating information by violating a specific obligation and/or embezzling funds from their initial goals (OG 79/2003 regarding the control and recovery of Communitarian funds, as well as co-financing funds improperly used, and its subsequent amendments).

Fraud is considered any action or unintentional omission regarding the using or presenting of false, incorrect, or incomplete declarations and documents, penal acts included also (Law no. 78/2000 regarding the prevention, discovery, and punishment of corruption acts, Ch. III, Section 41, and subsequent amendments).

In a more complex definition, fraud can be accomplished by any person that aims to obtain a certain gain or cause a certain loss, or even to expose others to risk in a dishonest manner (Report on Fraud issued by the Judicial Commission of the Parliament of the United Kingdom of Great Britain and Northern Ireland, July 2002).

Fraud can also mean to give a false testimony. It can refer to not giving a third party the information they are entitled to have or are of a special nature that needs disclosing, but also to the abuse of one's position, when one is in a function that should guarantee protection and action not contrary to the financial interests of other parties. In practice, there have been cases when the internal auditor discovered such situations, but because the legislation gave the possibility of interpretation, the auditor was forced by the rules of professional conduct to respect the rules of confidentiality. The acts discovered in this way could not make the object of an opinion in auditing as it also led to subjectivism.

Fraud represents a theft that implies the distortion, suppression, or falsification of a financial situation (Fraud Division of the Metropolitan Police of London).

Taken together, these definitions show that a fraudulent behaviour can imply either an internal interdisciplinary action, a judicial procedure in the form of a civil case, or prosecution by the police. Fraud can also be connected to other criminal activities outside the organisation, such as extortion and money laundering. In practice, all elements referring to irregularities or frauds are important and represent a problem for both managers and internal auditors.

Taking into account the facts mentioned above, it is important to also mention the aspects that represent the fraud risk. When talking about fraud risk, the following possibilities could be considered: fraud committed by the management; complicity between the employees; inappropriate division of tasks; unauthorised use of resources; conflict of interests; or inappropriate maintenance of confidential files/data (Petraşcu D., 2013, p. 36).

According to the National Standard on Audit 240 'Fraud and Error' (SNA), drawn based on the International Standard on Audit 240 'Fraud and Error' (ISA 240 'Fraud and Error') approved by the International Federation of Accountants (IFAC) in 1999, the following objectives are set out in the area of fraud risk assessment. Firstly, rules and recommendations must be established regarding the auditor's responsibility in view of examining possible acts of fraud and error in executing an audit of the financial reports. Secondly, when planning and executing procedures of audit, when evaluating results obtained and redacting the reports containing them, the auditor must take into account the risk regarding possible significant misrepresentations in financial reports, occurred as a result of fraud or error.

Therefore, fraud can also be considered the unintentional action on the part of one or more persons from an organisation's management, of the staff of the economic agent, or of third parties, that results in the presentation of false financial reports.

### **3. Responsibilities in Fraud Prevention**

The internal audit refers to (Boulescu M., 2003): a permanent review of the economic activity of an entity; an independent activity of assessing on behalf of the economic entity's management that involves examining the financial, accounting, and other kind of operations concerning the services as a whole; an evaluation of tasks and conformity of the accounting entries, reports, assets, capitals, and results; or an attestation or certification of financial accounting documents.

The responsibilities concerning fraud prevention within an organisation are divided between the executive board, the audit committee, and the internal audit (Munteanu V., Zuca M., Zuca Ş., 2010, p. 34). Firstly, the executive board has the final responsibility for implementing the mechanisms of detecting and preventing a fraud early on. The members of the executive board are those who should offer explanations in case of discovering certain cases of fraud. According to the National Standard on Audit 240 'Fraud and Error' (SNA 240), the executive board is responsible for the prevention and detection of fraud and error by applying and maintaining appropriate accounting and internal control systems. These systems can also reduce the possibility that fraud and error occur, but they cannot completely eliminate them. Secondly, the audit committee has the role of supervising the management of fraud risks and actively monitoring the efforts of the executive board against fraud committing. Thirdly, the internal audit represents an efficient line of defence against fraud, having a role both in monitoring risks, as well as in fraud prevention and detection. The internal audit constitutes a tool at the disposal of the audit committee, the only one able to independently assess fraud risks and anti-fraud measures implemented by the executive board.

In their current activities, the internal auditors must: have enough knowledge in order to identify the signs of a possible fraud; be attentive of the cases that involve a risk of fraud; and appreciate the necessity to further investigate a case, inform the responsible persons from an organization and take actions to eliminate or reduce the

possibility of fraud occurrence. According to the National Standard on Audit 240 'Fraud and Error' (SNA 240), the auditor is not responsible and cannot be held accountable of fraud and error prevention. Furthermore, conducting an annual audit can serve as a means to reduce the possibility for fraud and error to occur. In practice, it often happens that when the audit points out a case of possible fraud or error, the responsible entity does not expose the situation and tries to 'clean up' using their own means, usually by removing from within the entity the persons responsible for the possible fraud or covering the losses from internal resources (rarely recovered from the guilty parties), all in order to not tarnish their market prestige and reliability. There were quite a considerable number of cases when following a scandal in the press, the managers of entities where frauds occurred were forced to admit in front of the public opinion that they had knowledge (at least partially) of the respective fraud discovered after an internal audit and that they acted to remove the losses and the wrongdoers, preferring to keep quiet precisely for protecting their entity.

There is a clear distinction between internal auditors and specialists in fraud investigation, both from the point of view of their roles and responsibilities, as well as in the case of their professional training and specialty. The role of the internal auditor depends, of course, on his professional training and practical abilities, as well.

In practice, the role of the internal audit can include a varied set of responsibilities: supporting the management in establishing auditable anti-fraud mechanisms; facilitating the assessment of fraud and reputational risks at the level of an organization and its business process; assessing the connections between fraud risks and internal controls; auditing frauds; supporting the specialists in fraud investigation; supporting the efforts to rectify deficiencies; and reporting to the audit committee the problems regarding anti-fraud mechanisms, fraud and reputational risks assessment, or fraud cases and suspicions (Petraşcu D., 2012, p.18).

The internal audit cannot completely prevent fraud, but it can adapt its work method and procedures so that it can increase the chances to identify and correctly interpret the signs of fraud (Munteanu V., Zuca M., Zuca Ş., 2010, p. 35).

The internal auditors must have a superior level of theoretical knowledge and practical experience in order to successfully accomplish their role. They must know the possible fraud schemes and scenarios that are specific to an organisation's field of work (for example insurances, retail, telecommunications, etc.) and be able to recognise the signs of a possible fraud scheme.

For the implementation of all these above-mentioned, there is a considerable need to invest in the specialisation of the internal auditors by financing courses in certain fields. Other organisations contact external specialists (on the basis of a service contract) in order to conduct the task of auditing, thinking that in this way they receive high-level specialists at a relative modest price.

#### **4. Assessing fraud risk**

According to the National Standard on Audit 240 'Fraud and Error' (SNA 240), some guidelines are established regarding fraud risk assessment. When planning the audit, the auditor must assess the risk related to the fact that fraud and error can lead to significant misrepresentations in the financial reports and he must request from the management information about any substantial fraud or error discovered. Besides any structural limits of the accounting and internal control systems, as well as the noncompliance with the requirements in effect of the internal control, there are circumstances or events that increase the risk connected to fraud and error. Such circumstances comprise aspects related to the management's integrity and competence, internal or external unusual conditions that influence the activity of the economic agent, unusual transactions, or problems concerning obtaining sufficient and appropriate audit proof. Based on risk assessment, the auditor must formulate some procedures of auditing that provide a reasonable guarantee that the significant misrepresentations, caused by fraud and error, in the financial reports as a whole, will be discovered.

Therefore, the auditor seeks sufficient and appropriate proof in his audit that fraud and error, that can be significant in financial reports, have not been committed, or if they have the results of fraud are accordingly reflected in the financial reports and the error corrected. The possibility to discover error is usually greater than that of ascertaining fraud because the latter is generally accompanied by actions meant to cover its occurrence. Due to the inherent limits of an audit, there is an unavoidable risk that significant misrepresentations in financial reports, occurred as a result of fraud, will remain undiscovered. However, in accordance with the National Standard on

Audit 200 ‘The Objective and General Principles of an Audit of Financial Reports’ (SNA 200), the auditor must plan and execute the audit with an attitude of professional scepticism, admitting the fact that circumstances and events can be discovered in order to point out the possibility of fraud or error to exist.

Although the existence of an efficient accounting and internal control systems reduces the possibility of misrepresenting financial reports due to fraud and error, there is always the risk that the system of internal control may not prevent or discover the respective misrepresentation. Furthermore, any accounting and internal control system can be inefficient against a fraud committed following a secret agreement between the employees or a fraud committed by the management. The managers of certain levels can press (for ignoring) the control that would prevent the commission of fraud by other employees, for example by means of the indications given by their subordinated about the manipulation of accounting entries, the falsification of accounting documents, or concealing information about economic operations.

In evaluating fraud risk, the auditor should consider, among others, the following questions (Munteanu V., Zuca M., Zuca Ş., 2010, p. 36):

- Can fraud be favoured by the manner in which the management and the employees are remunerated?
- How thorough are the internal controls? Can they be avoided?
- Who in the organisation could have the motivation to commit fraud?
- Have there been any major changes within the organisation?
- Is the organisation operating in a field or geographic area with an increased level of fraud?
- Have there existed cases where members of the management and employees have been investigated for fraud?

The entity’s capability to prevent and detect fraud depends on a correct and complete assessment of fraud risks. In practice, fraud risks assessment is a process in seven stages (Munteanu V., Zuca M., Zuca Ş., 2010, p. 37):

1. Organising the manner how to assess fraud risks.
2. Determining the processes, organisational units, and locations to be assessed, both from the perspective of the value of their transactions and balances, but also of particular known risks.
3. Identifying possible fraud schemes and scenarios.
4. Assessing the possibilities to commit fraud.
5. Assessing the degree of importance of identified fraud risks (assessing possible losses).
6. Determining the internal anti-fraud controls that exist and the degree to which these internal controls cover fraud risks. In this stage, the vulnerabilities of the internal control system are identified.
7. Formulating or modifying the audit plan based on the results of assessing fraud risks.

Besides all the above, the internal auditor must include an element of unpredictability in his work programmes.

The conclusions that the auditors reach are summed up and systematised in reports that remain at the disposal of those interested (Oprean I., Popa I., Lenghe R.I., 2007, pp. 97-98).

For a practical example of fraud detection using the audit, we suggest the International Standard on Audit 240 (ISA 240) that acknowledges two methods of intentional misrepresentations: the first refers to the fraudulent financial reporting, and the second to asset embezzlement (Bugnet O.C., Dumitrescu A.C., Deliu D., 2011, p. 57). Fraudulent financial reporting implies intentional errors or omissions of sums or information from the financial situation, with the aim of deceiving users. This kind of fraud can involve: acts of deceit (such as manipulating, falsifying, or modifying accounting entries and justifying documents that are used to draw up financial situations); the intentional erroneous interpretation or omission of events, transactions, and other significant information from the financial situations; the intentional misapplication of accounting policies related to assessing, recognising, classifying, presenting, or describing information. On the other hand, asset embezzlement refers to the fraud that implies stealing assets from an entity. Regardless if it is fraudulent financial reporting or asset embezzlement, fraud involves incentives or pressures to be committed. All these aspects are difficult to spot and sometimes almost impossible to prove.

In planning his activity for auditing, the auditor must question the management in order to establish if the significant misrepresentations are caused by fraud or error. The auditor is interested not only in the assessment made by the management on the risk of fraud occurrence and in the existing system of fraud prevention and detection, but also in the system of accounting and internal control established for error prevention and detection (Bugnet O.C., Dumitrescu A.C., Deliu D., 2011, p. 61). His questions may include the following aspects: locations of branches, business segments, types of transactions, balances of significant accounts, the manner in which the management



approaches problems; the activity of the entity's internal audit mechanism and whether it has identified frauds or any significant deficiencies at the level of the internal control system; the manner in which the management transmits to the employees its perspective regarding responsible business practices and ethical behaviour, for example by means of its ethical policies or behaviour codes; etc.

As mentioned before, all these are sensitive aspects, and therefore difficult to trace. But it is exactly from this reason that the internal audit takes them into account in the majority of its missions.

For a cleared understanding of fraud, it is important to know the three important factors associated with the commission of fraud: opportunity, motivation, and self-justification. The opportunity generally occurs because of deficiencies in internal controls and creates an environment in which embezzlers have the conviction that they will be successful and will not be discovered. The motivation often appears as a result of financial constraints stemming from an expensive lifestyle, a difference between pay and responsibilities, the pressure to achieve certain financial objectives, a superiority complex of the wrongdoer, or just plain greed. Self-justification represents the internal dialogue that the wrongdoer uses to motivate his own actions. The author of a fraud convinces himself that the employer owes him this remuneration.

## **5. Fraud Prevention and Detection**

A code of conduct correctly applied represents one of the most important mechanisms of communicating to the employees the acceptable standards in their activity and to draw attention to the commitment the management undertook in order to respect the entity's integrity (a clear organizational structure, the formulation of a policy concerning the conflict of interests, the existence of a department of internal audit).

As well, a carefully planned programme of communication and training will increase the employees' understanding of their obligations regarding the controls conducted on professional fraud and transgression (for example, regular discussions on professional ethics or setting up a hotline for fraud reporting).

Another method of fraud prevention and detection refers to recognising the early warning signs of a possible fraud. The management of an entity must take notice of different warning signs that emerge: changes in an employee's behaviour, changes in one's lifestyle, drug/alcohol or gambling addictions, discrepancies about taken leave, etc. In this sense, the management can set up a confidential support system for his employees that can include family counselling, addiction counselling and aid, or financial counselling.

An important action in fraud prevention and detection is the establishment of an appropriate internal control system tasked exactly with this responsibility. It should aim to: respect the principle of separating functions (no function should allow an employee to execute a whole cycle of transactions, i.e. an employee should not have the authority to execute both front office and back office activities); examine the staff on their qualifications, competence, education, previous jobs, regular evaluations of their performances, taken leave; access the public resources to compare the accounting data to their physical existence; properly investigate the employees and third parties, especially in cases of authority positions in the process of financial reporting.

The means of proactive data analysis concerning the acts of fraud (such as searching information in databases in order to identify connections between different persons, screening the employees' background in terms of convictions, financial incidents, loans, etc.) can help to detect possible frauds and professional transgressions that may otherwise continue to go on unnoticed by the management.

Furthermore, a complex assessment of fraud and professional transgression risks can help the management to better understand the unique risks that their company faces, to identify the gaps and deficiencies in their controls, and to formulate a plan to identify the appropriate resources and procedures of control.

Another aspect that could prevent fraud refers to the attitude towards fraudsters. An important step in creating a culture of intolerance towards fraud is to act consistently when an economic infraction is discovered. In this way, the staff understands what are the consequences of a possible involvement in a fraud and that its detection is certain and inevitable thanks to the efficient system of control and risk management. Such an attitude can lead to the dissuasion of most wrongdoers. It is also essentially to demonstrate to the employees that all wrongdoers will be equally treated, regardless of the position they hold in the company.

Lastly, the reaction a company has when detecting a fraud is as well of importance, as it should act in a manner of publicly disclosing the fraud and professional transgression. Once the fraud or transgression was discovered, it

should undertake action to restore the situation: voluntarily disclosing the results of the investigation to a regulatory body or any other competent authority, fix the prejudice committed, and examine the causes in order to ensure the decrease of fraud risk. It should discuss with the parties involved and those in executive positions that were not able to prevent or detect such events. Moreover, the company should transmit to the employees that the management has acted and responded accordingly in such a situation when fraud or transgression occurred. A disciplinary system that details the accountability protocol is essential in order to effectively prevent fraud and professional transgression and to ensure the employees that the management of risk assessment is considered to have precedence.

## 6. Conclusions

From those presented above, we can draw an opinion ‘without reservations’ (to use a term from the field of auditing) that all entities need internal audit for business efficiency in the sense of a good management of its patrimony, of reducing costs (in an organised framework) while maximising profit, and of achieving medium and long-term objectives. Furthermore, this activity should not be regarded strictly as an activity generating expenditures, but rather from the perspective of the benefits it entails in countering fraud and especially in increasing future added value.

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