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The Role of Internal Audit in Fraud Risk Management

Lamkaraf Ikram, Zaam Houria

Abstract— This work focuses on the study of the role of internal audit in the management of the risk of fraud that emanates from the economic and professional reality, and targeting all companies whatever their size and activity.

Indeed, the risk of fraud is one of the most important risks in companies and can have serious consequences in terms of cost and image. The originality of this study is the provision of an integrated conceptual framework for internal audit and fraud risk. The results of this literature review show that internal audit plays a key role in detecting and preventing the risk of fraud.

Index Terms— Internal Audit, Risk of fraud, Board of Directors, general direction.

1 Introduction

IN addition to financial and commercial risks, companies face the risk of fraud or misinformation. The risk of fraud is part of the operational risks. It's a real, non-virtual risk. This is the only risk everyone can act on. Therefore, assessing the probability of fraud occurrence and its impact must be part of the organization's risk assessment process initiated by management and the board of directors.

Recent decades have been marked by financial scandals related to fraud (Enron, Worldcom ...), which have revealed a significant gap between the information disclosed by the leaders and the economic reality of companies. This situation has led to the promulgation of several laws and regulations including the Sarbanes-Oxley Act in the United States, the Financial Security Act in France, the law against money laundering, etc. These texts aim to improve governance and restore investor confidence.

At the same time, the quality of the published accounting and financial information and its audit by the auditors (internal and / or external) has become a priority aiming at greater transparency and consequently reducing the operational risk, namely the risk of fraud. The goal is therefore to know if internal audit could reduce the risk of fraud, and the problem would be:

« What is the role of internal audit in fraud risk management ? »

In what follows, we first define fraud, its typologies. We will then introduce the function of internal audit. Finally, we will examine the role of internal audit in preventing and detecting fraud in order to improve the process of corporate governance.

2 Fraud : Definition and Typologies

Fraud, in the international sense, is defined as « an intentional act committed by one or more officers, by persons constituting corporate governance, by employees or by third parties, involving fraudulent tactics in order to obtain an undue or illegal advantage » (Normes ISA 240-IFAC). For Vernier (2018), for there to be fraud, it is necessary that three elements exist cumulatively:

- The commission of an act: it takes an act, not a simple desire or thought;
- The intentional fraudulent maneuver; the act must be voluntary, knowing that it is prohibited by law;
- The benefit gained must be undue or illegal, whether material (cash, in nature) or moral (recognition, status).

According to the definition proposed by the Certified Fraud Examiners Association the fraud is : « using one's own job to enrich oneself personally while deliberately misusing or diverting resources or assets from the business » (Quang J. et al., 2013).

For the Institute of Internal Auditors, fraud is defined as « Any illegal act characterized by deception, concealment or breach of trust without violence or threat of violence. Fraud is perpetrated by individuals and organizations to obtain money, goods or services or to secure personal or business advantage ».

The natures of frauds are multiple and typological approaches numerous. Schematically, let us remember that there are three main categories of fraud: misappropriation of assets, corruption and accounting fraud.

- **Misappropriation of assets**

Asset embezzlement is an act of theft or appropriation of assets belonging to the enterprise. Misappropriations generally relate to monetary items (misappropriation of the company's cash) but may also relate to other assets such as inventories, fixed assets or trade receivables. (Ouamiche M., 2015)

- **Corruption**

It can be defined as the misuse of power in order to gain a personal benefit or someone else in return for a gift, money or other benefits. It is a behavior by which a person solicits, agrees or accepts benefits for the purpose of performing, delaying or omitting to perform an act in a direct manner in the performance of his duties. (Vaurs L., 2011)

- **Accounting fraud**

Accounting fraud is the intentional presentation of accounts or financial information that does not reflect the economic reality of the business. According to Ouamiche (2015) accounting fraud can relate to :
- The statutory accounts or consolidated accounts;
- Management data internal to the company (reporting, dashboards);
- The financial data communicated to the third party (financial communication).

This type of fraud results in the manipulation of encrypted information in order to mislead the reader about the patrimonial situation and / or the economic performance of the company. Accounting fraud is less frequent than hijacking insofar as it is necessarily the fault of people at the top of the company hierarchy (managers, corporate governance).

3 Definition of Internal Audit

The concept of audit is an old concept whose purpose was to verify and protect financial statements. This is why the audit mission has long been linked to the Court of Auditors. As Mikol (2000) said, this is an accounting audit mission. However, the internal audit developed after a long evolution, during which he was able to acquire a great maturity. It is now understood as synonymous with objectivity, efficiency and a decision-making tool thanks to the recommendations of which it is the source. According to Candau « *the audit is the control of the controls* », which means that it should measure and evaluate the effectiveness of the internal control system within the company. According to the Institute of Internal Auditors (1999), internal audit is defined as « an independent and objective activity which gives an organization an assurance on the degree of control of its operations, gives it advice to improve them and contributes to creating added value. It helps this organization achieve its objectives by evaluating, through a systematic and methodical approach, its risk management, internal control and corporate governance processes and by making proposals to enhance its effectiveness ».

4 Internal Audit Function and Risk of Fraud

The internal auditors have a privileged position since they are in permanent contact with the company, they can thus be led to detect a fraud during their missions. Their responsibilities and roles in fraud risk management are mentioned in the Professional Standards for Internal Auditing.

The Standard (1210.A2) states that « internal auditors must have sufficient knowledge to assess the risk of fraud and how this risk is managed by the organization. However, they are not supposed to possess the expertise of a person whose primary responsibility is the detection and investigation of fraud ». Indeed, the main responsibility of the internal audit, in terms of assessing the risk of fraud, is to ensure that management has examined its risk exposure and identified, where justified, the possibility of fraud as a business risk. However, the internal auditors only hold true what they have verified and proved.

According to the Standard (1220.A1), « internal auditors must take all necessary care in their professional practice by taking into consideration […] the probability of significant errors, fraud or non-compliance […] ».

The Standard (2060) obliges the head of internal audit to « report periodically to senior management and the board of […] risk of fraud […] ». For Standard (2120.A2), it states that « internal audit must assess the possibility of fraud and how this risk is managed by the organization ».

Petrascu and Tieanu (2014) consider that internal audit represents an effective line of defense against fraud, having a role both in risk monitoring and in the prevention and detection of fraud risk. However, internal audit is a tool available to the Audit Committee and is the only one able to independently assess the risk of fraud and the anti-fraud measures implemented by the Board of Directors.

For Petrascu (2012), the role of internal audit in fraud risk management is to:

- support management in developing anti-fraud mechanisms;
- facilitate fraud risk assessment at the organizational level;
- assess the links between fraud risk and internal control;
- support specialists in their investigation to detect fraud;
- Report to audit committee on issues and weaknesses regarding enforcement mechanisms.

According to Munteanu and Al (2010), the internal auditor can not completely prevent fraud, but it can adapt its working method and procedures so that it can increase the probability of correctly identifying and interpreting the signs of fraud.

It must provide an independent assessment of the relevance, application and effectiveness of the internal control systems put in place by management to prevent the risk of fraud. There will be questions about organizational weaknesses and controls that can be bypassed without attracting attention.

In addition, internal auditors must have sufficient knowledge and practical experience to successfully complete their assignments. They should be aware of possible patterns of fraud and business-specific scenarios (for example, insurance, telecommunications, etc.) and be able to recognize signs of a potential fraud system.

For Berrada (2017), when it comes to auditing fraud, the internal auditor must achieve the following objectives:

- identify and assess the risks of fraud inherent to the organization's business in the processes, financial statements, etc;
- collect the evidence ;
- provide appropriate responses to identified or suspected fraud.

According to Reding and Al (2015), internal audit can fight fraud in a variety of ways within a company. It can, for example, organize awareness sessions on the problem of fraud, design programs and anti-fraud controls, test the actual functioning of these controls, thoroughly examine wrongdoing / misconduct and investigate reports, or conduct inquiries at the request of the audit committee.

5 Conclusion

Fraud risk management is a fundamental element of corporate governance. It is management that must establish a fraud risk management framework and make it work at the request of the board of directors.

The active involvement of the internal audit function helps the board of directors, or any equivalent body, to gather sufficient objective information to fulfill its stewardship function, to be aware of the risk of fraud and to make effectively account for internal controls.

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