



## **The internal auditor's responsibility for fraud**

**Md. Abdul Baten**

Brentwood Open Learning College, Leicester, United Kingdom

### **Abstract**

In the course of an audit engagement, internal auditors must make numerous judgments and express an opinion on the basis of information collected and test results that are never perfectly diagnostic with respect to the underlying economic state of the firms. Thus, the ability of auditors to process information in audit-related tasks has recently become the subject of research. And research can significantly assist the profession in evaluating the effectiveness of internal auditors' duties, and pursuing continuous future improvements of them. Importantly, one significant reason that senior management is frequently involved in fraud cases is that often a portion of their compensation is based on reported results. This paper, therefore, is expected to provide a number of benefits to the firms that suffered long term damage to its tangible assets due to unscrupulous employees, by considering aspects of deterrence, detection, investigation, and reporting. This study confirms that strong commitment to ethical behaviour from top management which is supported by actions as well as words is sufficient to prevent ethical wrongdoing. Rather than using their talents exclusively to investigate allegations of fraud once they have been reported, antifraud specialists also should be involved during the audit itself to help identify key risk areas, which then can be furnished to the auditors for further consideration. Moreover, the mere presence of antifraud specialists during audits could have a significant impact on increasing the perception that illegal activity will be detected.

**Keywords:** unscrupulous employees, deterrence, detection, investigation

### **Introduction**

Combating fraud before it occurs is vital to the survival of any business. Organizations should take the opportunity to consider, enact and improve measures to detect, deter and prevent fraud before it occurs. A combined effort must be made by the board of directors, the audit committee, internal and external auditors, risk management personnel, investigators, operations personnel and others to manage the risk of fraud. Furthermore, organization's leaders should be able to encourage their employees' awareness to identify unusual things as many as possible that are potentially vulnerabilities to be attacked by perpetrators, and should evaluate them on continuous basis, and determine what types of appropriate actions/ controls are in place that can reduce those threats whether they come from organizational insider or outsider. A simultaneous independent review from high authority might highlight the areas in which internal controls are not designed adequately or are not being followed. Basically, the major objective of such an assessment in this section is to enhance the effectiveness of internal control environment within organization and mitigate the opportunity for fraudulent activities.

Recent study carried out by Maulidi (2017) <sup>[6]</sup> showed that in order to assist the organization to reduce unlawful conducts, internal audit may become powerful control and strong internal controls are the foundation of fraud deterrence in detecting and preventing all material fraud. And within organization's review of internal control, internal auditors' should have unrestricted access to evaluate and examine all of organization's systems, activities, functions, and operations.

Due to the complexity of the field of fraud with the most sophisticated patterns and methods of perpetrating fraud, the concerns for finding proper approach is still everlasting challenge for the internal audit (Flostoiu, 2012). In relation to that concern, therefore, internal auditors to perform their duties as one of fraud deterrence should have well understanding of the business of the organization, the financial and control risks it faces, and the corporate governance process in place to ensure that corporate transactions are appropriately authorized and accurately reported. By giving privilege access, internal audit may play an important role in ensuring the effectiveness of internal controls and it will be a key player in performing assessments of fraud risk to reduce fraudulent activities.

This is very important to note here that Maulidi's work in 2016a <sup>[7]</sup> mentioned that fraudsters are very creative and will come up with various ways to achieve their objectives, and staffs including managers require thinking the unthinkable ways and to be as creative as the fraudsters. because fraud occur at some level and in some ways, managers should use the risk assessment process to identify vulnerable areas after that they should make decision about what are appropriate measures to deal with that type of fraud. Therefore, it is very essential for staffs and managers to get an understanding of what fraud is and the types of fraud, the consequences of fraud, who perpetrates fraud and why, how to report fraud, how to identify fraud, and fraud red flags or symptoms and fraud risks. In other words, the cost of fraud within organization, by introducing and applying an effective awareness program, can be significantly reduced. The success

of these concerns should be strengthened by high authority's instruction that all of employees within company should be mandated to get involved in anti-fraud education and a training of fraud awareness program, and trained in the specific certain alarmed symptoms and prevention and detection methods that are pertinent with their department's functions.

### **Detection**

Internal auditors should establish impressive predictive ability for red flags. The purpose of a red flags approach, here, is to increase auditors' sensitivity to the possibility that fraud may exist at a client. A red flags approach is functional to the extent that it appropriately raises the auditor's sensitivity to the possibility of fraud in fraudulent situations. One advantage of a red flags approach is to anticipate specific features of the typical audit environment, tending to be comprehensive and enhance consensus in detecting a particular fraud. In some cases, although rare in occurrence, fraud comes from various ways, for example due to lack of the qualified employees, absence of the main components of internal control systems, inability to use the necessary technical tools in internal control and lack of specialised professional employees. Therefore, auditors should make effective inquiries. Before making inquiries, they must:

- Ensure that he is as familiar as possible with the matter to be discussed. For example, he should review any previously prepared documentation;
- Ensure that he is meeting with the appropriate individual, i.e., the person best able to answer his questions;
- Formulate an outline of the questions he wishes to ask. This will allow the interview to proceed more quickly and should reduce the need for follow-up interviews to obtain relevant information that was overlooked in the initial interview;
- Obtain as much information as possible, e.g., from other company personnel, as to the personal characteristics of individuals to be interviewed. Such information, e.g., the person is quite busy and does not like to engage in "small talk," should increase the likelihood of establishing rapport with the individual.

Additionally, those matters are based on the assumption that companies having a higher potential for fraud exhibit characteristics (red flags) identifying themselves as being different from their peers. Even if red flags exist for an entity, the ability of the auditor to recognize and evaluate red flags has not been clearly determined. To examine if the use of red flag checklists is an effective method for identifying the potential for fraud, Pincus (1989) [10] conducted an experiment using audit seniors. She found that being provided with a list of red flags increased comprehensiveness and uniformity in data acquisition. However, the use of red flags had no significant impact on fraud risk assessment where no fraud was present and was dysfunctional where fraud existed; that is, those without lists of red flags outperformed those with such lists. Somewhat different results were found by Wright and Bedard (2000) [15]. Using a verbal protocol methodology, their findings suggest that recognition of risk factors may provide a stimulus to auditors with less experience to improve

performance in the planning process. In an examination of whether auditors' identification of risk factors and planning of audit tests is affected by decision aid orientation, i.e., a 'negative' focus wherein client risk and its consequences are emphasized, or a 'positive' focus where such factors are not emphasized, Bedard and Graham (2002) [1] show that auditors using a negative decision aid orientation identify more risk factors than do those using a positive orientation.

In examining both the identification of fraud risk factors and their impact on audit programs, Zimbelman (1997) [16] conducted an experiment to examine how auditors might react to SAS No. 82. His results indicated that performing fraud risk assessments separately as required by SAS No. 82 does influence auditors' attention to fraud cues and audit planning decisions. Specifically, he concluded that SAS No. 82 can be expected to direct the auditors' attention to fraud cues, but leads to overall increases in budgeted hours. However, experimental results suggest that the nature of audit plans may not be affected. Thus, red flags provides mixed evidence as to the reliability and usefulness of using such techniques to predict or identify fraud.

In summary, to be successful in improving our record in fraud prevention and detection, the profession should keep in mind three key factors. The first is that success comes from working together with other interested parties, engaging in "partnering" efforts with constituent organizations. The second is that research is crucial to improve our current understanding of fraud prevention and detection. Third, we must develop an ongoing process in support of continuous improvement efforts in this area. SAS No. 82 is an important step. In addition, ongoing advancement of our understanding of fraud and how to deter and detect it must continue if further progress is to be made.

### **Investigation**

Management is normally responsible for deciding whether or not to pursue a fraud investigation. However, if the internal auditor believes management itself may be involved in the fraud, the board of directors should be notified, and they are then responsible for approving further action. If either management or the board of directors makes the decision to investigate possible schemes, extended procedures are performed to follow up on fraud indicators first noted by the internal auditors. Specialists such as security personnel, investigators, or lawyers may be asked to assist in the investigation.

Caulfield (2014) [4] and Maulidi (2016b) [8] documented that the search for collusion can be elusive as on the surface it generally just leaves indicators to be discovered and it is surprisingly conducted by untrained observers. It is very essential for investigators to take into account the source of information (suspicions) carefully in order to identify and allocate the most critical issues and see where the problems are rising. This step has strong influence of determining appropriate further measures (an investigation plan), at least by assessing are suspicions reliable?, Does the informant have a malicious or personal motive?, Are audits or other findings correct?, Is there any another explanation for the suspicions?. By doing this, investigators' plans, thus, rely on a really solid basis for directing resources with systematic and unbiased

guidance.

After recognition and detection have determined the possibility of wrongdoing and then the probability of wrongdoing have been perpetrated, investigation will take place as soon as possible to deal with those unlawful acts. Investigators, after analysing data and producing investigation procedure, should create hypotheses of what might have happened based on the known facts. Birzer and Roberson (2011) <sup>[2]</sup>, emphasized in their book that ‘in order to explain how the alleged fraud has been perpetrated and who the suspect might be involved, fraud examiners must establish hypotheses’. Therefore, the critical point is that examiners, when developing hypotheses, require thinking the unthinkable way, and being as creative as the fraud perpetrators. After that, examiners when testing hypotheses should look for and consider vertical connection as well horizontal one, including superiority of external information and records, to highlight the patterns of the flow of information, and then examiners should continually reassess those hypotheses when new information available. The major aim of doing these measures is to recognize any management fraud involving employees at or near the top of organization or wrongdoing in which there is a related wrongdoing for the organization.

Furthermore, It is very possible to argue that every individual including senior management and business’ client commonly needs investigation’s result sooner rather than later because wrongdoing is uncomfortable for their organization. In this circumstance, investigators during process of investigation should not be pressured into taking less time to thoroughly complete investigation because it might be those people involved in those scandals. Joseph (2003) <sup>[9]</sup> examining “*thoughts on occupational fraud*” noted that the concept of political theory may play role of the more mundane concerns of occupational fraud in high drama. Therefore, if those fraud examiners cannot manage this process well, obviously it will trigger to the quality of investigation. It is clearly demonstrated by contemporary empirical study conducted by Browrin and King II (2010) <sup>[3]</sup> indicating that public accounting firms for performing test need more time to improve the detection rate for all type of derivations. Similarly, studies performed by Silverstone and Sheetz, (2007) <sup>[12]</sup>, Gundry and Liyanarachchi (2007) <sup>[5]</sup>, Topi *et al.*, (2005) <sup>[14]</sup>, Pierce and Sweeney (2004) <sup>[11]</sup>, Tan *et al.*, (2002) <sup>[13]</sup>, found a negative causal relationship between time pressure and audit quality.

When planning a fraud investigation, the internal auditor’s should evaluate the extent of the scheme and the level of personnel involved. Careful consideration during this step helps to ensure that managers and employees who may be involved are not inadvertently tipped off. Planning also encompasses matching the knowledge, skills, and disciplines required to conduct an investigation with the technical expertise of available internal auditors and other specialists.

If specialists outside the organization are included in the investigation, their credentials should be evaluated. Internal auditors can assist by checking appropriate licenses and certifications and making inquiries regarding the professional reputations of the specialists. Also, internal auditors should ascertain that no relationship between the unit being investigated and the specialist exists.

After the fraud investigation is staffed, procedures should be designed to identify the perpetrators and determine the extent of the fraud, its cause, and the techniques used to perpetrate it. Regardless of whether the internal auditors are involved in the detail work of the investigation, they should coordinate the activities of the specialists with management and legal counsel. All parties involved must keep in mind the rights of alleged perpetrators and should seek to protect the reputation of the organization.

At the conclusion of the fraud investigation, the internal auditors should utilize the information obtained to help the entity in the future. From details of the scheme, the internal auditors may be able to develop recommendations for controls that should be implemented to prevent similar frauds from occurring. Also, from knowledge of actual fraud cases, audit tests can be designed to unearth similar schemes in other units. Finally, information on recent frauds adds to the internal auditor’s warehouse of knowledge and helps in identifying future indicators of fraud.

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