

# Internal Auditor as Accounting Fraud Buster

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*Fraud is a major cause of poverty in various parts of the world. Economic resources are being swindled by powerful politicians, bureaucrats and industrialists in one form or the other, leaving the economies of countries poorer. The corporate sector is not far behind. World over, accounting fraud in corporate balance sheets is continuously increasing in numbers and magnitude. This has also brought great burden on public resources and on the economy of the world and ultimately on public at large. The government and regulatory authorities are continuously revisiting this area to modify and introduce new legislation to check this menace. This paper discusses the effectiveness of internal auditor to contain, detect and prevent the accounting frauds and thus fight this plague in the corporate sector. The paper introduces the concept of appointment of internal auditor by outside stakeholders to strengthen his independence and consequently his effectiveness to detect and prevent fraud.*

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## Introduction

Financial fraud is the “deliberate fraud committed by management that injures investors and creditors through materially misleading financial statements” (Elliot and Willingham, 1980). According to Sawyer (1988), fraud is a false representation or concealment of material fact to persuade someone to part with something valuable. The National Commission on Fraudulent Financial Reporting (1987) defines fraudulent financial reporting as an “intentional or reckless conduct, whether by act or omission, that results in materially misleading financial statements.” The Institute of Internal Auditors (1985), in its SIAS No. 3, has described fraud as “an array of irregularities and illegal acts characterized by intentional deceptions. It can be perpetrated for the benefit or the detriment of the organization.” The Institute of Chartered Accountants of India, in its SIA 11 has described fraud as “an intentional act by one or more individuals among management, those charged with governance, or third parties, involving the use of deception to obtain unjust or illegal advantage. A fraud could take form of misstatement of an information (financial or otherwise) or misappropriation of the assets of the entity” (ICAI, 2006d). The American Institute of Certified Public Accountants (AICPA, 1988), in its SAS No. 3, has described the irregularities as intentional misstatement of financial statements

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(management fraud) and theft of assets (employee fraud). Internal audit can play an important role in detecting and preventing fraud.

The overall objective of internal audit is to suggest improvements in the functioning of an organization and to strengthen the overall governance mechanism of the organization, including its internal control system and strategic risk management. It also helps in safeguarding the assets of an entity (ICAI, SIA 1, 2006a).

Several accounting frauds were reported during last two decades, but Enron accounting fraud jolted the world not only because it was one of the biggest accounting frauds of modern world but also because it brought to light dubious accounting policies which may never be accepted by any professional with common sense. Thereafter, there have been reports of a series of accounting frauds—WorldCom, Satyam Computers and Reebok India. Check on these frauds can be ensured through proper internal control system, internal audit and strict implementation of regulations. This paper discusses the effectiveness of internal auditor in containing, detecting and preventing accounting frauds in the corporate sector.

### **Need of the Hour: Not a New Regulation, but the Strict Implementation of the Existing One**

Though the regulators became cautious and made amendments in regulations to check these frauds, it appears that there is not much effect of all these changes on the corporate world. Are we so helpless? Is there no will to curtail these financial crimes? These frauds leave a marked impact on the lives of people/investors at large and in many cases make their lives financially crippled forever. There is a great thrust by the governments to sternly deal with other crimes such as drug trafficking, smuggling, tax defaults and theft, murder, rapes, FEMA violations, etc.—crimes that cause social disorder and economic volatility, leading to sub-standard life of the countrymen. But the accounting fraud that swindles the public resources and causes great loss to the financial institutions, banks, exchequer and public at large, and makes the investors financially crippled for life, compelling them to live a long degraded orphaned life without adequate finance in hand, is more disastrous for civilized society. Don't regulators and political masters realize this? Have we killed our souls? Had these not been the reasons, the series of accounting frauds would have been dealt with expeditiously and efforts would have been made to stem the recurrences. The investors would not have suffered for decades without redress of their grievances as has happened in the case of CRB Capital Markets and Kuber Finance in India where the fraud was unearthed in the late 1990s and justice has not been done till date.

These accounting frauds have occurred in the 1990s, but regulators are still waiting for some new fraud to happen and then to promulgate one more law. *The Times of India*, Delhi Edition dated July 17, 2013, reported that, "Indian Cabinet will consider measures to check ponzi schemes, such as Saradha Chit Fund scam that devastated thousands of gullible investors in West Bengal, by arming SEBI with enhanced powers to investigate and punish fraudsters." It further reported that "changes suggested to deal with scams of chit funds or para-banking

operation are intended to improve effective supervision and take deterrent action swiftly once a breach of law is detected" (*The Times of India*, 2013, p. 23).

Almost two decades have passed since CRB Capital Markets accounting fraud, 15 years have passed since Enron fraud was reported and four years have passed since Satyam Computers fraud surfaced. After the frauds were reported, regulations and compliances were strengthened. The Fraud Office of Ministry of Corporate Affairs gears up for action swiftly once the fraud is reported. "But those who must regulate and enforce fraud laws do not necessarily apply the right course of action and the development of courses of action often aims at wrong target" (Michel, 2008, p. 384).

The question is, when so many financial frauds have been reported in the last few decades why a new regulation is imposed just to pacify the public at large rather than implementing the existing one more stringently, there being no dearth of existing penal laws to punish fraudsters sternly.

Gravity of accounting frauds can be highlighted with the reported news that some investors who lost money committed suicide. What a shame on the governance that we are chanting for decades for reforms! If China can prosecute its ex-Railway Minister with suspended death penalty for committing fraud on public resources, why cannot this lesson be learned by other civilized societies' governance pundits/rulers (*The Times of India*, July 9, 2013, p. 1)? The last decade has witnessed the unfolding of enormous fraud (both in numbers and amount involved) committed by people involved in governance and management of corporate. Internal auditor can be a great help in detecting and preventing fraud, provided he is skilled enough for the work and understood the organization well before finalizing his audit program.

### **Internal Auditor**

An internal auditor may not be useful for all kinds of organizations. This is a very professional work area and hence the skills of one internal auditor may not be suitable for all kinds of organizations. Suitable selection for better results is a must. Further, the main causes due to which accounting fraud takes place are yet to be established completely by the regulators and accounting professionals and accounting professional bodies/torch bearers. Hence, it becomes difficult to know as to how to fight against this menace in a systematic and structured mode. It is as good as fighting without knowing your opponent. Tzu (1994, p. 179) aptly remarked:

Thus, it is said that one who knows the enemy and knows himself will not be endangered in a hundred engagements. One who does not know the enemy but who knows himself will sometimes be victorious, sometimes meet with defeat. One who knows neither the enemy nor himself will invariably be defeated in every engagement.

Now how to know oneself (identification of persons bestowed with the power to govern/regulate and certify) and the enemy (the menace of accounting fraud and the reasons for its occurrence) are the real questions to be ascertained to curtail such crimes.

### **Accounting Fraud, a Great Drain on Public Resources**

Accounting fraud is done to swindle company assets or to reduce the tax burden. Either way company resources land into private hands at the cost of other stakeholders. And if the entity

resources are financed by government/public financial institutions/banks, these frauds cause loss to these institutions due to non-performing loans which ultimately result in loss to public at large. Hence, cascading effects of accounting fraud are deep-rooted and it should be ensured to eliminate/minimize such frauds.

In the light of the above discussion, this paper attempts to highlight the issues relating to the internal auditor's effectiveness to combat this evil of accounting fraud. Identification of right internal auditor and his/her assessment of real business environment and checks and balances in the organization which he/she is auditing will be the hallmarks of successfully detecting and preventing corporate accounting frauds. The simple principle is that to implement the right course of action, one must know the opponent, its weaknesses, gaps and trenches of loose internal controls. This requires knowing the organization well and the key characteristics of various types of accounting frauds. The internal auditor will also be required to keep himself abreast of all changes happening in the organization and internal systems across the board.

The goal behind the fight against financial crimes and accounting fraud is to protect the backbone of the economy, to restore and enhance the investors' confidence, to communicate the integrity of the financial markets and to provide safety to savings, besides ensuring that the industrial and corporate platform remains free from the stains of financial crimes.

## Literature Review

Many researchers have worked on the role of internal auditor to detect and prevent accounting fraud. It has also been observed that investors expect a lot from the auditors so far as detection and prevention of accounting fraud are concerned, but there is lot of gap between the expectations of the investors and actual performance by the auditors. Internal auditor could have proved to be a better fraud buster, but due to his independence issue, he could not prove himself (Epstein and Geiger, 1994).

The major focus of the researchers has been on various fraud models relating to employee fraud which are generally committed by the employees due to employees' pressures, opportunity to commit fraud and integrity (Wells, 1997). But the magnitude of management fraud is much high.

Researchers have also found and suggested various accounting/financial frauds which should be known to the internal auditor, as these will help in making audit programs detect and prevent fraud (Hillison *et al.*, 1999). Studies have also outlined that internal auditor is in a better position to detect and prevent fraud as compared to statutory/external auditor due to the latter's paucity of time, matching compensation, and proximity to the organization.

Analyses of these researchers have suggested fraud signals and risks which must be studied by the internal auditor (Hillison *et al.*, 1999). Constructive steps, which an internal auditor should ascertain and recognize to detect and prevent fraud, have been suggested by the Association of Certified Fraud Examiners.

Various institutes and accounting bodies have suggested guidelines and standards on internal audit which would be useful for the internal auditor to effectively discharge his duties towards detection and prevention of accounting fraud (IIA, SIAS 3, 1985; and ICAI, 2006e).

## Objectives

The objectives of this study are:

- To ascertain the factors which affect the independence of internal auditor;
- To suggest ways through which independence of internal auditor may be ensured, leading to detection and prevention of accounting fraud; and
- To find out as to how the effectiveness of internal auditor in detecting and preventing fraud can be improved.

## Data and Methodology

Secondary data has been collected through manuals, internal audit standards and guidelines developed by various accounting bodies, institutes of internal auditors and association of certified fraud examiners which constitute a major reference material for the internal auditor to consider to detect and prevent fraud. Various research papers were reviewed and their findings were used as secondary data to develop this paper. Some fraud surveys have been conducted by world renowned audit firms like KPMG and Deloitte. The results of these surveys provide useful information and they have been considered at relevant places in this paper. Newspaper reports have also been considered while collecting the data.

Experienced audit professionals were interviewed by the authors of this paper, using their vast experience for over three decades, on various aspects of strengthening internal audit, especially to detect and prevent fraud and also on the issues of independence of internal auditors enjoyed hitherto.

## Discussion

The important outcome of the discussion with experienced audit professionals is presented here.

### Accounting Fraud and Expectation Gap

The auditing profession has long been criticized for its failure to detect fraud, and this is due to the fact that on the one hand, an external auditor has limited exposure to the organization and its systems and procedures, and on the other hand, the internal auditor lacks independence, while a survey indicates that more than 70% investors expected that material misstatements in the financial statements resulting in fraud would be detected by the auditors (Epstein and Geiger, 1994).

According to Porter (1996), the users of financial statements believe that the responsibility to detect and report fraud and financial misinformation of the independent auditors is greater than was being met. These bodies include:

- Public Oversight Board of the AICPA's SEC Practice Section (USA) (AICPA, 1993).
- Reporting and Audit Expectation Task Force (Australia).
- Commission to Study the Public's Expectations of Audits (Canada) (MacDonald Commission, 1988).

- AICPA Expectation Gap Roundtable (USA) (AICPA, 1992).
- Financial Reporting Commission (Ireland) (Ryan Commission, 1992).
- National Commission on Fraudulent Financial Reporting (USA) (Treadway Commission, 1987).
- Committee on the Financial Aspects of Corporate Governance (UK) (Cadbury Committee, 1992).

It has been reported that independent auditors detect only 5% of fraud (Zeune, 1997; and KPMG Peat Marwick, 1998). This abysmal rate of fraud detection success has widened the 'expectation gap' which refers to the difference in auditors' understanding and true reporting of their function and investors', creditors' and other users' expectation of the auditors' role. This expectation gap is not limited to USA and Canada (Bellavance, 1998) but it exists in South Africa (Singleton-Green, 1994), the UK and Japan (*Accountancy*, 1996) and Australia (Monroe and Woodliff, 1994). And this widening gap has been the subject matter of criticism of accounting and auditing profession.

Looking into the seriousness of the accounting fraud problem, the AICPA implemented Statements on Auditing Standards (SAS) No. 82, 'Consideration of Fraud in a Financial Statement Audit', in December 1997 (AICPA, 1998). Auditing Standards Board, a technical body of AICPA, issues SAS. The US Congress also showed seriousness in reducing unreported fraud by passing Private Securities Litigation Reform Act, 1995, under which independent auditors have been entrusted with new legal responsibility to report fraud and other illegal client acts.

It emerged from the findings of various research papers that the investors and other stakeholders have a lot of faith and dependence on auditor's work so far as detection and prevention of fraud are concerned. But this expectation has not matched with the results of internal auditor's work. For matching these expectations, various researchers have developed fraud models for employee fraud.

### **Accounting Fraud Model**

Accounting frauds may be due to employee's involvement at senior, middle and lower levels, and it may also be caused due to involvement of promoters/owners of the company, as was the case in Satyam Computers Fraud, CRB Capital Markets Fraud and Kuber Finance Fraud. It is easier to curb the frauds of employees but when top management gets involved in accounting fraud, the situation becomes grimmer. While the external auditor has limited time to devote for the audit and cannot cover the entire spectrum of accounting process in detail, the internal auditor, in spite of having regular checks on accounts throughout the year, may find it difficult to bring on surface the frauds committed due to his so-called dependent status. Hence, it is important that independence of internal auditor is ensured, and this can be achieved through involvement of various stakeholders in the appointment process and reporting the relationship of internal auditor with the appointing agency.

The findings of the previous research reveal that the three basic parameters that constitute the fraud model, so far as financial statements fraud or assets misappropriation by the employees

of the organization are concerned, are: (1) Employee's Pressure, (2) Opportunity to commit fraud and (3) Integrity of employees (Wells, 1997). This fraud model has its roots in the research of the renowned criminologist, Donald Cressey.

### ***Employee's Pressure***

This relates to duress caused due to employee's financial difficulties and the immediate need for assets (Cressey, 1973). A group of fraud researchers are of the view that 95% of all fraud cases are caused due to financial difficulties. This pressure may not be visible to others. It has also been noted that only a few fraudsters commit fraud to hoard assets (Albrecht *et al.*, 1995). A combination of urgency and need is the common pressure to commit fraud. Since pressures are not normally visible in employee behavior or day-to-day activities, it is important that the internal auditor gains maximum knowledge and understanding of employees and the prevailing pressures (Hillison *et al.*, 1999). A common list to pressures to misappropriate assets of organizations may be listed as:

- Living beyond means
- Habits of drugs, alcohol and gambling
- High personal debts
- To become big overnight
- Employee surrounded by affluence
- Family pressure to enhance wealth
- Illicit sexual relationships and related highly expensive bills
- Employer-related reasons: low pay, worse environment, job insecurity, disrespect, and low employer morals
- Greed
- Peer pressure
- Hierarchy requirement

This list is not exhaustive, but it definitely includes pressures that fraud researchers have identified for employee fraud (Albrecht *et al.*, 1984; ACFE, 1995; and Ratliff *et al.*, 1996). It may not be within the purview of the internal auditor to resolve these pressures associated with employee fraud; he may bring it to the attention of the management to address these issues and the management may take the initiative to introduce employee assistance program to curb such pressures like drug, alcohol and family-related issues.

### ***Opportunity to Commit Fraud***

When internal controls are not commensurate with the size and requirement of the organization or when an employee reaches the level of trust in the organization, the employee perceives this as an opportunity to commit fraud and avoid detection. Adequate internal controls may prove to be important means to control such frauds. Even in a well-controlled environment, trusted

employees can override the control and commit fraud. However, the internal auditor's consistent role in implementing and evaluating the existing controls with suitable modifications can mitigate the opportunity to commit fraud. The control-related issues which may increase the opportunity for employee fraud are:

- Fast employee turnover
- Inefficient segregation of duties
- Poor/inadequate accounting records
- Consistent crisis conditions in operations
- Breakdown of procedures, like inappropriate computer access and ineffective physical inventories (Albrecht *et al.*, 1984; and Bologna and Lindquist, 1987)
- Improper transaction authorization
- Lack of physical control
- Lack of access to information to employees other than the one committing fraud
- Unchecked authority of an employee

Fraud cases exist where an employee does not have access to physical inventory but initiates shipping documents to have assets delivered to himself or someone in collusion with him (Albrecht *et al.*, 1995). Such a case has been reported in India, in 2012, in the accounting fraud at Reebok India. Employees who do not take leave for a long time and work overtime consistently may be behind such frauds. Internal auditor must observe such cases and report the same to the management for timely action.

### ***Integrity of Employees***

Individuals do not commit fraud without it being consistent with their personal code of ethics (Hollinger and Clark, 1983). Personal integrity is the key limiting factor in misappropriation of assets for a majority of employees, and in such cases, they would not commit fraud even when there is an emergency or opportunity for committing fraud. The internal auditor should exercise 'professional scepticism' particularly since fraud is committed by those whom we trust most because these trusted employees are given the control and management of assets. Personal integrity of employees may be breached due to the following reasons:

- Underpaid
- Overworked
- Feeling that everyone is doing fraud
- Temptation of stakeholder in assets
- Assumption that it is only temporary until operations improve (Albrecht *et al.*, 1984; Bologana and Lindquist, 1987; and Wells, 1997)



- Low self-esteem or morale
- Belief that nobody will get hurt
- Belief that rank has its privilege
- Fraud is for good purpose
- To seek revenge

Though such factors are out of the control of management and internal auditors, yet if fraud prevention is routinely discussed with employees as an ongoing program, it may help.

The fraud model for promoters/owners show that there may be a wide variety of reasons for committing fraud as under:

- First generation entrepreneur with limited financial resources
- Political connections
- Business expansion/diversification
- Race for rating slot
- Incompetency of promoter
- Political, business and economic environment
- Safety and security not only for their future, but for several generations

The means of fraud by promoters are very difficult to identify, but independence of internal auditor may unfold such frauds. This issue has been discussed later in this paper.

Due to various circumstances and reasons, the occurrence of fraud has been spotted in various forms. The auditor must be conversant with such fraud spots. This study will not only help the internal auditor to prepare audit programs that are comprehensive and commensurate with the organizational goals and environment, but will also give him inputs to explore various spots further.

### **Fraud Spots**

Fraud may be committed by manipulation in financial accounts/statements, misinformation in these statements, misappropriation of business assets and through off-balance means.

#### ***Manipulation/Misstatements in Financial Accounts/Statements***

- Overvaluing/undervaluing closing stock
- Recording fictitious sales
- Not recording sales return
- Not recording purchase return
- Overstating/understating expenses

- Overstating/understating income
- Overstating the cost of project and getting it financed
- Overstating/understating assets
- Overstating/understating liabilities

### ***Misappropriation of Business Assets/Funds***

- Received checks forged
- Recording goods not returned and stealing cash
- Cash sales shown as credit sales and cash stolen
- Discount on sales not given but shown in books and money siphoned off
- Credit sales collected but not recorded
- Writing off receivables as bad debts and stealing the cash received
- Collusion between buyer and seller to process refunds for goods not returned
- Stealing assets, stores and spares, raw material, and finished goods
- Sales not done but invoiced and goods stolen
- Selling waste and scrap material and pocketing receipts
- Including fictitious employees on pay roll and taking out their proceeds
- Embezzling payroll and other tax withholdings
- Encashing unused payroll checks
- Encashing unused dividend pay checks
- Unauthorized overtime shown and cash withdrawn
- Charging personal purchase to company by misusing purchase orders or organizational credit cards
- Diverting advances to personal use
- Special price or privilege to customers and suppliers against kickbacks
- Paying false invoices obtained through collusion with suppliers
- Altering bank deposits
- Stealing cash funds
- Credit swaps
- Bank account manipulations to give benefit to one at the cost of the other and taking kickbacks.

- Public funds obtained in one company invested in subsidiary and continuous loss shown in subsidiary and funds siphoned off.
- Creating personal wealth through setting up of subsidiary companies at the cost of parent stakeholders; the parent company becomes sick and the subsidiary flourishes and in a few years' time, the subsidiary company funds are also siphoned off by different means.

### ***Off-Balance Sheet Assets at Risk***

- Telephone
- Intellectual property
- Data files
- Trade secrets
- Customers' list
- Vehicle usage
- Computer time and resources
- Employee time (assigning non-work-related activities to subordinates)

These fraud spots may be considered by internal auditor as well as statutory/external auditor alike. But the internal auditor's work is considered more comprehensive than that of the other auditors, and consequently the success in detection and prevention of fraud by internal auditor is considered better.

### **Internal Auditor Better Equipped Than Statutory/External Auditor in Detecting and Preventing Fraud**

The depth and coverage of audit work by external auditor cannot be equated with the scope and coverage of the audit work by internal auditor for the following reasons:

- Time available with internal auditor is throughout the year, as compared to external auditor who has limited time due to his focus and compensation.
- Internal auditor's work scope is much larger than that of the external auditor.
- Internal auditor is far more conversant with the organizational setup, its environment, its system and procedures including internal control systems, as compared to external auditor.
- Internal auditor may remain in constant touch with the changes taking effect in the internal control systems and business model, employees' accessibility to various resources of the organization and possibilities of misappropriation of business assets.
- Since internal auditor remains in constant touch with the various facets of the organization throughout the year and year after, his knowledge about organizational

affairs and financial reporting is far superior and deeper and he may be in a better position to understand and detect fraudulent reporting in financial statements.

Due to the above reasons, auditing practitioners worldwide realize and acknowledge that external auditors are not well positioned to detect fraud. They lack continuous presence most necessary to chalk out a program to detect and prevent fraud. Consequently, the question arises as to who is the best person in an organization to detect and prevent fraud? This paper identifies and focuses on the importance, role and responsibilities of one associate of an organization who can be the best line of defence against fraud—the Internal Auditor, his independent status and his internal audit program (Hillison *et al.*, 1999). The internal auditor's focus on detection and prevention of accounting fraud, especially the misappropriation of assets and financial statement misreporting, will go a long way in supporting the organizational goal of enhancing not only shareholders' wealth but optimizing the wealth and resources of the organization for all concerned stakeholders, be it the employees, tax authorities or lending institutions.

To prevent, detect and deter accounting frauds, the paper identifies the following:

### ***Fraud Signals and Risks That an Internal Auditor Should Ascertain and Recognize***

The internal auditor should be aware of common types of frauds and symptoms of fraud. While the awareness of common types of frauds would enable the internal auditor to remain vigilant and chalk out internal audit program accordingly, signals or symptoms of fraud would enlighten him to be alert on those specific areas and accordingly he may advise the management to strengthen internal controls in those areas. Some signals or symptoms of fraud may be as under:

- Duplicate payments
- Excessive credits
- Outstanding receivable accounts over the long term
- Continuous increase in stock
- Excessive cash and bank balance
- Warnings by external auditors
- Complaints by customers
- Unusual journal entries made at the end of the year
- Journal entries without supporting documents
- Common names, addresses and telephone numbers of creditors and customers
- Alteration of documents
- Stale items on bank reconciliation
- Cash shortage, unreasonable expenses or reimbursements
- Products purchased in excess than required

- Excessive credit notes/debit notes issued
- Failure of certain employees to take vacations
- Failure to follow up on past due receivables
- Significant increase or decrease in account balances
- Shortage in delivered goods
- Unexplained adjustments in accounts receivables, accounts payable, revenues or expenses
- Frequent changes in accounting policies
- Employees on payroll who do not sign up for benefits
- Missing documentation
- Old checks received but not presented for payments
- Unusual financial statement relationships like:
  - Decreased revenue with increased receivables
  - Increased revenue with decreased purchases of inventory
  - Increased inventory with decreased purchases or payables to vendors

### ***Steps That an Internal Auditor Can Take to Detect, Prevent and Deter Fraud***

The internal auditor should mingle with the organizational systems, procedures and environment as DNA in human body. He has to plan his work very meticulously, be vigilant throughout his work performance and must keep pace with the changing environment of the organization so as to achieve his objective of detecting, preventing and deterring fraud chances to the maximum. His sustained focus on preventing fraud may deter employees from engaging in fraudulent activities. A proactive stance on preventing and detecting fraud must increase employees' perception of likelihood of detection of fraud. The Internal Audit Standards Board of the Institute of Chartered Accountants of India has devised 18 standards ranging from 'Planning an internal audit' to 'Consideration of laws and regulations in an internal audit' as under (ICAI, 2006e):

- Planning an internal audit
- Basic principles governing internal audit
- Documentation
- Reporting
- Sampling
- Analytical procedures
- Quality assurance in internal audit
- Terms of internal audit engagement

- Communication with management
- Internal audit evidence
- Consideration of fraud in an internal audit
- Internal control evaluation
- Enterprise risk management
- Internal audit in an information technology environment
- Knowledge of the entity and its environment
- Using the work of an expert
- Consideration of laws and regulations in an internal audit
- Related parties

These standards are important guidelines to an internal auditor which, if considered by him in his work design and performance, would go a long way in helping him discharge his duties efficiently, at an economical cost and to the best advantage of the organization. While some standards are guiding forces that facilitate in planning his work systematically, others highlight important issues for consideration of an internal auditor to detect and prevent fraud. The internal auditor mainly focuses on understanding the environment of an organization, constant review of internal control systems, enterprise risk management review and effective communication with management while discharging his work. For fraud detection, prevention and deterrence, it is necessary that internal control systems should be studied, reviewed at constant intervals, and tightened wherever necessary.

The Association of Certified Fraud Examiners (ACFE) (1995) has suggested certain steps to combat fraud by internal auditors as under:

**Increased Use of Analytical Review:** Manipulations and fraud tend to affect financial analysis and ratios. If financial analysis is done over a period of a few years, anomalies in accounts presentation will come to surface and concealed fraud in accounts may be unearthed. Various techniques of analysis may be used in this regard like trend analysis, budgetary comparisons, ratio analysis, review of ledger accounts and general entries, especially at the end of the year, and comparison with industry averages. In the process, unusual items should be pursued further to determine if fraud has been committed. When analytical procedures of internal auditor identify significant fluctuations or relationships that are inconsistent with other relevant information, the internal auditor should investigate and obtain adequate explanations and evidence (ICAI, 2006c) .

**Performing Threat Analysis:** Assessment of environment of assets exposed to possible theft and misappropriation by employees should be done by the internal auditor. It is essential to outsmart the crooks. Many off-balance sheet assets like financial information, customer data, and technology are very much prone to theft or misuse. The internal auditor can plan the audit program in such a way as to address these issues as well.

**Imposing Mandatory Vacations and Job Rotation:** Internal auditor must implement, monitor and enforce a strong internal control system as it helps in deterring and preventing the fraud. KPMG Peat Marwick (1988), in its fraud survey, reported that poor controls led to almost 60% of the frauds that occurred. Internal auditor can take two steps to strengthen internal control system, one to enforce mandatory vacations and periodic job rotation for employees. Vacation must include the period in which the employee is supposed to do high-risk tasks like month-end reconciliation. Job rotation program should be so designed as not to allow the rotated employee access to documents and files which he or she had access to in the previous job before rotation. Frauds are bound to surface through these checks.

**Creating and Maintaining a Fraud Policy:** ACFE (1995) has urged every organization to have a fraud policy in place, which must be read and signed by every employee. This policy will inform the employees in advance the consequences of even losing their job in case of fraud detection. This way employees would think several times before committing fraud. Suitable training programs should be organized for employees, and new hires should be shown this policy at the time of induction. ACFE has suggested a sample fraud policy which is given in Appendix.

**Reviewing Company Contracts:** This area is highly amenable to fraud. Contract prices are inflated and kickbacks are obtained. It involves a conspiracy between the contractor and employees. These types of frauds can be detected by reviewing contract files for the same contractor routinely bidding last, bidding lowest and obtaining the contract.

**Checking Employee References Twice:** Employees who are to be given charge of assets and other important assignments should be doubly checked through references. Such employees, if not checked through references, may be found later as dishonest and it may so happen that they misappropriate the assets and switch over to other organizations before they are caught. One additional technique which may be used is for employers to do a second check a few months after the employee starts work. The reason is that such an employee's records in previous employment, if he was dismissed from previous employment, might not have been updated immediately on his leaving for his misdeeds and it might take some time for the full picture to be recorded in his file.

**Surprise Fraud Audits:** Surprise pre-emptive fraud audits are a good weapon in the arsenal of internal audit staff. Surprise audit gives less time to fraudster to alter, destroy or hide records and evidence. For such audits, the employees must be taken into confidence, as honest employees may not like it. The employees should be asked to suggest as to how this audit should be conducted. This will give confidence to honest employees and they will cooperate in the process.

**Employee Fraud Hotline:** This is the single most effective means to detect occupational fraud and abuse (ACFE, 1996). This is a special number on which perpetration of fraud may be communicated by an anonymous caller. A whistle-blowing hotline was established by General Accounting Office (GAO) to combat fraud and abuse (Flesher, 1996). The GAO received 53,000 calls in the first five years of setting up the hotline (Flesher and Buttross, 1992).

Honest employees, though observe the occurrence of fraud, have no tool to report the same anonymously without reprisal. Hotline provided this opportunity. Such hotline may be established in-house or external agency services may be obtained. This hotline is a deterrence tool too. Potential fraud perpetrators would think several times before committing a fraud due to the risk of being caught and/or fraud duly reported on hotline.

**Consulting a Certified Fraud Examiner:** A Certified Fraud Examiner (CFE) generally has vast knowledge on various kinds of accounting fraud and its perpetration in different kinds of organizations. He may be a good resource for internal auditor to use occasionally and get his expert advice. This may be very useful not only in designing effective internal audit program but also as a guiding force to strengthen the internal controls within the organization. The CFE is a credential awarded by the Association of Certified Fraud Examiners (ACFE), the world's largest anti-fraud organization with over 65,000 members and premier provider of anti-fraud training, to a person of high moral character. CFEs have a unique set of skills with a knowledge of complex financial transactions with an understanding of methods, law and how to resolve allegations of fraud.

**Protecting Information Systems:** Information system may be fraudulently manipulated by the fraudsters by entering false/ fraudulent data into it, by altering the computer program or code and by stealing from the system data like customers' list, expansion plans, profitability expected, plans, etc. Information system control is a must to prevent fraud in this area. The following tools may be helpful to the internal auditor in this regard:

- Proper use of suitably structured passwords to be made mandatory. Passwords should be secured.
- Encryption may be another tool to avoid invasion by unauthorized employees over files and communication lines.
- Protection of data files and systems from theft and destruction by disgruntled employees.
- Periodic review of system or network security controls.
- Proper virus protection should be ensured by the internal auditor. Double precaution should be taken to eliminate basic threat from viruses.
  - Use anti-virus software with regular updates.
  - Keep backup of all work and system files regularly.
  - Scan CD-ROMS for viruses.
  - Download scans for viruses.

### ***Independence of Internal Auditor***

The internal auditor is appointed by the organization either on employment terms or from outside professional agencies to audit accounts at regular intervals. Since the appointment of internal auditor is in the hands of the management, it is obvious that his continuation as an



internal auditor depends on management's satisfaction. In case there is fraud by employees, the management would certainly be satisfied, but when the fraud is committed by the management or the owners, it becomes difficult for the internal auditor to comment on that due to his proximity to the management/owner and his desire to continue as the auditor of the organization. Even if he reports such fraud to the management/owners, it may not be taken cognizance of. Hence, to ensure the independence of internal auditor in protecting the organization from accounting fraud, his appointment process and fraud reporting relationship need to be relooked at and has to be redefined.

## Recommendations

The effectiveness of internal audit depends on the following factors:

1. The appointed internal auditor must have the skills to work for the organization that has engaged him.
2. Internal auditor must study the environment of the organization, i.e., its systems, procedures, internal control system, the management, and the employees.
3. A well thought-out audit program should be made, which should be amenable to change with the changing circumstances.
4. Two-way communication with the management should be made at regular intervals.
5. Fraud-related consequences must be discussed with employees and management across the board.

While the first five points have been touched upon by various researchers, accounting bodies, fraud examiners associations and internal auditors associations, the independence of internal auditor, though for importance sake, has been included in their work by some researchers, but the modality to ensure independence has been left open.

6. Independence of internal auditor must be ensured through his appointment process, leading to defining his status in the organization and rewriting his success in detection and prevention of accounting fraud.

The independence of internal auditor plays a crucial role in effective discharge of his duties and detecting and preventing fraud. He occupies a unique position, as he is appointed by the management but has to also review the conduct of the same management. This gives significant tension to the internal auditor as he does not find himself independent of the management. While independence is necessary to objectively assess management actions, his dependence on the management for employment is also very clear. Independence means freedom from conditions that threaten objectivity. Objectivity is an impartial, unbiased mental attitude and avoidance of conflict of interest which allows internal auditor to perform honestly and without significant quality compromises. SIA 2 of ICAI describes that "internal auditor should maintain an impartial attitude. He should not only be independent, but also appear to be independent" (ICAI, 2006b).

The internal auditor is appointed by the management which invariably involves the owners as well due to their representation on the board of directors. If the fraud is committed by the management or promoters, it will be difficult for the internal auditor to bring it to the surface due to his proximity and faithfulness to the management. The auditor's work may be outstanding, but if he is dependent on the management for his appointment, this dependence might not permit him to do justice to his work of detecting and preventing fraud for obvious reasons. Hence, it is necessary that independence of internal auditor is ensured, and it can be only when his appointment is done by some third party who is also a stakeholder in the entity. If an internal auditor is appointed following the process suggested below, it would pave the way for his independence and lead to better fraud detection and prevention.

In an organization, the fraud perpetrators may be broadly divided into two parts:

- Those who are a part of appointment process of internal auditor; these persons include the top management including owners/promoters; and
- Other employees.

When the fraud is committed by 'other employees', the steps suggested in the above discussion would prove to be useful in detecting and preventing fraud, and the independence of internal auditor would be maintained as his appointment authority is the management, including the owners. But this independence is shattered when fraudsters belong to the first category, i.e., 'management, including the owners/promoters'. For this category of fraud perpetrators, the independence of internal auditor, his appointment and reporting process need a relook and a redefinition. An appointee by top management promoters/owners will always be faithful to the master. How can he remain independent if a fraud case involving the promoters/owner comes to his notice? He would not like to divulge the fraud except to the perpetrators (owners) due to the fear of losing his assignment and also to demonstrate his faithfulness to the appointing authority.

Another important issue is that chances of fraud by the first category prevail majorly in those organizations where public funds are involved through public issue of securities and loans from public financial institutions and banks. Own money is not siphoned off. No one raids one's own resources. In such organizations, it is recommended that outside stakeholders and regulators may be allowed to play a vital role to ensure independence of internal auditor, thereby ensuring fraud detection and prevention a success.

### **Appointment of Internal Auditor by Regulators**

Public limited companies, which have issued securities to the public at large and are listed on the stock market, are subject to control of the legislative body (in India, SEBI, in USA, SEC) and concerned stock exchanges. These regulators have made it mandatory for these companies to adhere to corporate governance norms which require constituting an audit committee and conducting meetings, etc., as per guidelines. This report is silent on internal auditor's role, his appointment and reporting. Once the role of internal auditor is made important to detect and prevent fraud, his independence can be ensured by his appointment through the regulators. In case the company is allowed to access public deposit, the central bank (RBI in India), being

the regulator for such funds, should be empowered to appoint the internal auditor. If the public funds are involved, it should be mandatory to have the internal auditor appointed by such regulator(s).

### **Appointment of Internal Auditor by Public Financial Institutions/Banks**

In case the loans are provided to an entity by Public Financial Institutions (PFIs)/banks, they should have the power to appoint the internal auditor above certain threshold limit. It has been seen that organizations which have access to loans from institutions and banks have misused the funds for the benefit of promoters/major shareholder/top management, leaving these institutions bleeding. Distant control has no meaning in this environment where many promoters are desirous of becoming billionaires overnight. Any company has two pillars as its foundation on which its business grows—one is the Board of Directors which is the executor and the other is the auditor who has a check on the executor. For the audit function, internal audit has greater importance due to reasons explained earlier, and the internal auditor's role will be effective when he is independent of the management.

### **Appointment of Internal Auditor by Government**

Many a time, an entity is funded by the government under various promotional schemes. Also the government permits to mobilize funds through external commercial borrowings. Here again public funds are involved and the important function of internal audit should be strengthened, with the government appointing the internal auditor.

### **Constituting a Central Body to Regulate Appointment and Work-Related Issues of Internal Auditor**

When some or all sources of public funding, as discussed above, have been availed by an entity, it may be desirable that a central body of internal auditors is constituted by the regulators, the PFIs and government. This body may be empowered to maintain a panel of internal auditors with impeccable integrity and the internal auditor is appointed by this body on the request of the above constituents, and his fraud-related reports are reviewed and action is initiated by this central body. The appointment should be for a period of three to five years on rotational basis. The internal auditor should abide by the code of conduct and ethics for internal auditors, and strictest punishment should be given to those internal auditors who breach the trust.

### **Conclusion**

High volatility and bad governance have brought the global economy to the brink. Economics wizards and consultants have failed miserably to suggest a solution. Everyone is suffering from high cost and funds shortage. Why is it so? The answer lies only in one fact: that we are marching on all roads except the road of honesty. How fast one can fill one's pocket at the cost of others is the agenda at large these days, and the corporate is no exception to this. They have raided public wealth, they are swindling public resources and they will continue to bleed the public, PFIs and the economy if effective mechanism to check frauds is not introduced and loopholes are not plugged. This is supported by the ACFE warning that as we move into the

next millennium, the occupational fraud is likely to rise (ACFE, 1996). According to KPMG Peat Marwick Fraud Survey (1998), 59% participants were of the view that fraud will be a menace in the future. A solution to protect the public resources enjoyed by the corporate is to strengthen the internal audit function of the public funded organizations by ensuring the independence of internal auditor, which is possible only when his appointment is done by some third party who is also a stakeholder in the entity.

The reason for the appointment of internal auditor by an outside stakeholder is that fraud by management and owners/promoters has a much greater magnitude and grave consequences and it happens when the entity has access to public funds, because nobody steals one's own resources. Always it is the other's fund which is raided and is subject to misuse. It has actually happened time and again, and public companies have cheated the PFIs, the government, public at large and left them bleeding. Then why not have control through internal audit on such entities? Take the case of Enron, WorldCom, Satyam Computers, CRB Capital Markets or Kuber Finance. All of these have misused the public funds and harmed the investors and institutions. The independent appointment of internal auditor will, thus, go a long way in checking the menace of corporate frauds.■

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## Appendix

### Outline of a Sample Fraud Policy

#### **Scope of the Policy**

This section states that the policy applies to employees, consultants, contractors, vendors, shareholders or any other party doing business with the organization.

#### **Policy**

The management acknowledges its responsibility to detect and prevent fraud through this section. What constitutes a fraud and how reported fraud cases are dealt with are outlined in this section.

#### **Actions Constituting Fraud**

This section outlines the behaviors and activities considered by management as fraud. The list may include items such as profiteering through insider information, forgery of financial instruments, misappropriation of funds, securities, supplies or other assets, bribery or other illegal activities.

#### **Investigation Responsibilities**

The organizational unit responsible for detecting fraud is named and its duties and responsibilities are listed in this section.

#### **Confidentiality**

The importance of confidentiality in fraud investigations is outlined in this section.

#### **Authorization for Investigating Suspected Fraud**

In this section, the authority to conduct internal fraud investigations and the activities permitted to conduct such investigations are outlined.

#### **Reporting Procedures**

An employee who suspects fraud, should report the same to the investigation unit and his identity should be kept secret. The policy should also state that the reporting employee should not discuss the alleged fraud with any other person, including the suspected individual. The use of a hotline may be useful in this regard

#### **Termination and Other Sanctions**

This section sets forth appropriate procedures to be followed if an investigation results in a recommendation to terminate or prosecute an individual.

#### **Administration and Approval**

Approval of fraud policy by senior management should be clearly indicated in the policy. Also, the policy should state who is responsible for the administration, interpretation and revision of the policy.

*Source: Association of Certified Fraud Examiners (1995)*

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