# Role of internal auditor in fraud detection & mitigation

**CA. Prashant Daftary**

Author is member of the Institute. He may be reached at prashant.daftary@gmail.com and eboard@icai.in

"AUDITOR IS WATCHDOG AND NOT BLOODHOUND" is well known saying. This is something which is ingrained in the mind of all auditors. Recent events and backlash against the auditing community make us wonder whether this thought is still valid or not. There seems to be a gap between the expectations of the stakeholders and the regulators and what is being delivered. This may be a perception but as it is famously said that perception is reality. The role of internal auditors has also been under the radar.

A few days back there was a news item as regards a van loaded with cash that was stolen by the driver of the Van. Upon investigation, it was identified that the driver had recently joined the organization and the police verification process was not carried out. This directly indicates a process failure that if detected/controlled could have avoided the fraud. This is just one example and if we do a deep dive into most of the cases, fraud is an outcome of what we call a fraud triangle theory which consists of three elements i.e. incentive, rationalization, and opportunity.

## Standard on internal audit (SIA-11) – Consideration of fraud in internal audit

The standard though not mandatory especially requires the internal auditor to consider the fraud risk and ensure due care is taken to address the fraud risk during the course of the internal audit. The role of the internal auditor would be to identify potential fraud indicators or red flags and communicate the same to those charged with governance.

## Changing expectations from internal auditors

In addition to providing value addition and assurance to the management, the internal auditors are now expected to contribute to identifying fraud risk and helping the organization in mitigating & detecting fraud. The internal auditors are required to be more alert and more conscious efforts are needed in those directions. The regulators and the public have constantly questioned the role of the auditors and their inability to prevent and detect fraud.

These changing expectations also result in more opportunities. The internal auditors would have to prepare themselves to face these challenges.

## How do internal auditors prepare for these challenges?

- **Understanding technology** - Technology is changing very rapidly and along with the ease of doing business it also brings about newer risks. Take an example of online payments which are very common now, the auditing procedures and methodology which is required are substantially different as compared to the traditional payment system. The auditing steps should include the potential risk from frauds by modifying the bank account numbers, phishing attacks, compromise of passwords, use of authorized devices etc.

  Many organizations have started moving towards robotic processes and accordingly, the internal auditors would need to upgrade their knowledge about these methods and how to perform audits under such situations. Additionally, developments in the field of artificial intelligence and analytical tools need to be closely tracked. The new ways of doing business and gathering data would have an impact on the auditing procedures, their efficiency and outcomes.

- **Investing & use of technology** – Modern auditing requires auditing through the system and not around the system. The audit firms would need to invest substantially in new technologies which provide them with an edge in performing internal audits and meeting the stakeholder's expectations. The time has come when it would not be possible to perform audits in a conventional manner and using data analytic tools and auditing software will be mandatory.

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- **Big data -** The buzzword today is big data and the auditors would need to develop an eye to understand the data and identify trends or patterns which would help them draw audit conclusions. There is a need for formal training programs within the audit firms as regards how to process and analyze voluminous data. These are specialized skills that need to be developed.
- **Understanding cyber risk –** This has become a very important element in today's world and though internal auditors need not be experts on this subject, it is important that they understand the potential risk emanating from this aspect. The internal audit processes and checklist would have to be redefined to include steps to audit this aspect. In many cases, help from experts should be sought which would make internal audit more comprehensive and provides greater assurance to the management and stakeholders. Earlier there was a conception that such risks are only relevant to very large organizations however they are equally relevant to small and medium businesses also.
- **Being more aware and conscious of the risk –** Being more alert and aware of the potential threat would help the auditors a great deal in developing the audit scope and planning the audit. This would set the ball rolling and will go a long way in meeting desired objectives.
- **Be aware of regulatory guidance and international practices -** The ICAI has issued an auditing standard on the auditor's responsibility relating to fraud in financial statements. Though this forms a statutory audit perspective, knowledge about the same would help the internal auditors as their work is also being used by the statutory auditors of the entity. The framework governing internal audit issued by ICAI which is presently recommendatory also talks about risk management and fraud risk is one of the elements of risk management. Internationally there is guidance available on fraud risk management also through standards and practice guides issued by The Institute of Internal Auditors.

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Fraud is generally understood to mean the risk of unexpected financial, material or reputational loss as a result of fraudulent actions of persons internal or external to the organization. This also includes the risk of misstatements in financial statements.

Though the ultimate responsibility of managing the fraud risk is of the management, the internal auditors with their in-depth understanding of the systems, process risk & controls are best suited to support the companies mitigate and detect fraud risk.

"A stitch in time saves nine" is an old and famous saying and this applies to risk management principles also, and hence fraud mitigation plays a very important role. Some of the areas where internal auditors can play a key role and act as an extended arm of the management are elaborated in the below paragraphs:

## A. Create a framework for fraud risk management

The internal auditors can help the entities to create a fraud risk framework. This would include items like:

- Tone at the top and management philosophy
- Guidelines for fraud risk assessment
- Prevention and detection
- Monitoring and reporting
- Substantiality
- Identifying the responsibilities and accountability

This is usually a starting point in the journey of fraud risk management and the charter document which is presented to the audit committee and board for approval.

## B. Fraud risk assessment

Fraud risk assessment simply means proactively addressing the vulnerabilities towards threats from internal and external sources.

Organizations are exposed to various types of fraud risks including:

- Embezzlement of funds
- Misappropriation of assets
- Theft of propriety information

In order to do a fraud risk assessment, one must understand the concept of the fraud triangle. The fraud triangle is commonly used to explain the reason behind the fraud. It has three main pillars

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|---|---|
| Opportunity | • Weakness in internal control<br>• Concentration of control<br>• Lack of segregation of duties<br>• Lack of management oversight<br>• Lack of documentation |
| Incentive | • Personal incentives<br>• Sales/Profit driven incentives (these create pressure to report numbers)<br>• Expectations from the stock market, investors, etc. |
| Rationalization | • Personal problems<br>• Grievances with management or practice followed by senior management<br>• Poor tone at the top |

## Steps involved in fraud risk assessment

1. **Creation of risk universe** - This is usually the first step in the process of fraud risk assessment. Here the internal auditor meets the senior management and process owners and understands the businesses, existing ERP systems, SOP, etc. Based on this understanding a risk universe is created. During this step, all the possible risks are identified and documented. This process needs to be interactive and in consultation with various process owners and business heads.

2. **Quantify the potential risk and rate them between high, medium and low** - The audit team after having identified the potential risk would perform a detailed examination of system design and controls which mitigate the risk.

   This step would include evaluating the following:

   - Maker-checker controls
   - Concentration of power
   - Inherent controls
   - Understanding whether the controls are manual or automated
   - Testing the systems in different situations

   Based on the above, the frequency and impact of each risk are identified, and a risk map is created. The risk which has high frequency and high impact is usually classified as a high risk.

3. Creation of fraud risk register and treatment of risk - The risks are addressed in the following manner

   - Avoid or terminate the risk
   - Transfer the risk
   - Treat the risk with mitigating controls (this helps in bring the risk down to a manageable level)
   - Assume the risk

4. Integrate the fraud risk register with the internal audit plan - The internal

audit plan should focus on auditing the controls which mitigate the fraud risk. The periodicity and extent of verification would depend on the type of risk and operating effectiveness of the control. One example is tabulated below:

| Function / Activity | Risk | Risk rating | Control |
|---|---|---|---|
| Payment | Risk of unauthorized payment | High | • Multiple checks and approval at different levels<br>• The linkage between PO and payment<br>• Payments only permitted to authorized vendors<br>• Online payments are restricted to specific devices and IP |

## C. Drafting code of conduct & policies

The internal auditors can also have a role to play in supporting the organization in creating the code of conduct for its employees. These typically include:

- Policy as regards acceptance of gifts from vendors, customers, etc.
- Anti - Bribery policies and guidelines
- Gifts to customers/ dealers etc.
- Conflict of interest related guidelines

Having such robust guidelines brings clarity as regards the process to be followed and also once documented, compliance with the same can be covered as a part of the internal audit program.

## D. Fraud awareness training programs

Being aware of potential risk also helps mitigate the risk and as a result, the employees tend to be more careful in their day-to-day operations.

Internal auditors can play a significant role in creating a training calendar for the organization and conducting such training programs.

## E. Fraud risk detection

This is an area where internal auditors can play a key role. One of the expectations from the internal auditor is to identify potential red flags and loopholes in the system. Though an internal audit is different from a forensic audit, it is possible for an internal auditor to identify potential fraud risks.

Some key steps / tips are as under:

- **Planning** - The internal audit plan and checklist should include the fraud risk aspect. This would bring out clarity during the course of the audit. The selection of the audit population should be done after considering the fraud risk.
- Use professional scepticism
- Being alert to unusual transactions / large expenses
- Keeping an open mind and observing things around you
- Look at the larger picture and not be focused only on the sample selected

Some of the examples of red flags are as under:

| Particulars | Details / examples |
|---|---|
| Deficiencies in system design which create opportunities to perpetrate fraud | • The person handling the cash has access to the accounting system<br>• No system to document the price discovery mechanism<br>• Procurement person is also responsible for the bill passing and payment processing<br>• No segregation of duties or maker-checker controls<br>• Modifications to vendor master or employee masters not reviewed |

| | |
|---|---|
| Lack of operating effectiveness of controls | • Many instances of unapproved payments<br>• Bank reconciliations not performed on a timely basis<br>• Many cases of deviations from standard operating procedures<br>• Errors in MIS / reporting to senior management<br>• Deficiencies in supporting documents |

### F. Help companies in setting up fraud prevention & detection software & system

Various software/tools are installed that flag unusual transactions and raise alerts which then can be examined/ confirmed with human intervention. A common example of this can be found in credit card companies. These systems/ software flag high-value transactions or transactions during non-business hours and automated confirmation calls are made to the customers. This acts as an effective fraud prevention mechanism.

The internal auditor can play a role in helping the management identify and implement such systems.

As we conclude, there are numerous opportunities for internal auditors in the mitigation and detection of fraud. However, the auditing fraternity would have to continuously upgrade their skills and make investments in terms of time as well as money in modern technologies. In a start-up era, the promoters and investors would look upon the internal auditors with greater responsibilities and expect them to play a more consultative role in setting up the systems which pave way for future business growth. ■■■

## Virtual Certificate Course on Concurrent Audit of Banks

The concurrent audit system of banks has become very crucial and important for banks. The main objective of the system is to ensure compliance with the audit systems in banks as per the guidelines of the Reserve Bank of India and importantly, to ensure timely detection of lapses/ irregularities. In view of the core competence of the chartered accountants in the area of finance and accounting, risk management, understanding of the internal functioning and controls of banks, etc., the banking sector has been relying extensively on them to comply with these requirements of the regulator. The Internal Audit Standards Board of ICAI conducts 11 days Certificate Course on Concurrent Audit of Banks through Digital Learning Hub. The purpose of the ***Certificate Course on Concurrent Audit of Banks*** is to provide an opportunity to the members to understand the intricacies of concurrent audit of banks thereby improving the effectiveness of concurrent audit system in banks, and also the quality and coverage of concurrent audit reports.

The course is open for the members of the Institute of Chartered Accountants of India

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The details of the forthcoming batches of the Virtual Certificate Course on Concurrent Audit of Banks to be organized by the Internal Audit Standards Board through Digital Learning Hub is as follows:

| Location | Scheduled Dates | Course Structure and other details |
|---|---|---|
| **BATCH 80** | **October 10-20, 2022 (3:00 to 6:00 PM)** | **Structured_IASB_Certificate Course Concurrent Audit of Banks BATCH - 80** |
| **BATCH 81** | **November 4- 15, 2022 (3:00 to 6:00 PM)** | **Structured_IASB_Certificate Course Concurrent Audit of Banks BATCH - 81** |
| **BATCH 82** | **November 18- 28, 2022 (3:00 to 6:00 PM)** | **Structured_IASB_Certificate Course Concurrent Audit of Banks BATCH - 82** |

Chairman
Internal Audit Standards Board, ICAI
E-mail: cia@icai.in;