

Chapter 10

Internal Audit and Fraud

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ABSTRACT

The purpose of this chapter is to study the role of the internal audit function in detecting and preventing fraud. First, this chapter will determine the notion and types of fraud on the one hand and the fraud triangle that companies face and that internal auditors try to detect and address on the other hand. Second, a description of the notion of internal audit will be provided, along with the specificities of this function at the heart of companies. The procedure of internal control and the fundamental principles leading to its effectiveness will be identified. In this regard, the authors analysed the profile of internal auditor. Therefore, an internal audit function with competent staff would generate a good system of internal control and is able to maintain the internal audit's ability to detect fraud. Finally, the role of the internal auditor in preventing fraud is analysed with reference to three dimensions: The first dimension is preemptive. The second dimension is social and ethical. The third dimension is the practical dimension.

INTRODUCTION

No business is immune to the risks of fraud. It represents any act of deceit, and it can be found in all aspects of the economic sector. This criminal act seeks to destroy the social system of civil society and even undermine the sustainability of the enterprise. Fraud is best detected in details, as it takes advantage of control gaps. Thus, the severe impact of fraud on ethics, on economic and financial profitability and on the company's reputation requires certain mechanisms to put an end to these practices. According to several KPMG investigations, internal auditors are more likely to uncover fraud than external auditors because of direct dealing with the activities of the company.

Detecting fraud is part of internal audits job (Brikett et al, 1999). An internal audit is essentially required to deal with these incidents and is well placed to identify certain anomalies that may be symptoms of fraud. He is, therefore, required to provide an independent evaluation of the information along with useful recommendations. For this reason, we present a challenge to be demonstrated by the function of the internal audit: how will this function guarantee the successful detection of and the fight against fraud. In other words, what role can the internal audit play in detecting and preventing fraud?

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Enterprises are interested in establishing a self-control function that manages the situation of its internal control system in order to detect fraud in a timely manner. The primary responsibility for establishing and maintaining this control rests with management, and the role of the internal auditor is to assist this in order to prevent fraud.

The role of the internal auditor is to ensure that the policies of the appropriate authorization for transactions are established and maintained. Therefore, the prevention of fraud is the responsibility of management. This means that internal auditors guarantee the effectiveness of management, including its processes, which makes internal auditors responsible for assessing internal control and assessing fraud risks.

Seeking to minimise the risk of fraud, mechanisms for combating fraud are constantly increasing. One can distinguish between internal and external mechanisms. Internal mechanisms include internal control, inspection and internal audit while external mechanisms include external audit. Gramling et al (2004) state that «the internal audit function is one of the four cornerstones of corporate governance».

Our proportion in this chapter is to clarify the concept of fraud in its different aspects. First, we focus on the function of internal audit as the first line of defense against fraud so that most of the previous research focuses on other control mechanisms; second, we have clarified the role of the internal auditor in the prevention and detection of fraud. The focus of this chapter is centered around internal audit as a function developed by companies to take action against fraud. First, we tackle the different theoretical aspects of fraud (definition, types, models). Then, we highlight the role of the internal auditor in detecting fraud. Finally, we also demonstrate the role of the internal auditor in preventing fraud. The purpose of this chapter is to identify the different roles of the internal auditor in detecting and taking action against fraud.

1. NOTION, TYPES AND PATTERNS OF FRAUD THAT THE INTERNAL AUDITOR TRIES TO DETECT AND COMBAT

1.1. The Notion of Fraud

According to the report of the Association of Certified Fraud Examiners, « fraud within an enterprise is a particular form of economic and financial crime that refers to any form of misconduct that consequently leads to a financial loss to the enterprise». According to the ACFE, corporate fraud is « the benefit by a person of his or her professional activity to enrich himself or herself through the voluntary misappropriation of the resources or assets of his or her employer».

In the same regard, fraud is defined by KPMG (2004) as any dishonest activity involving the extraction of a company's value, whether directly or indirectly, regardless of personally benefiting the owner from these actions. Statements on Auditing Standards N°99 (now SAS) defines fraud as «an intentional act that results in notable inaccuracy in the audited financial statements».

According to the International Standard On Auditing N°240 (now ISA), what is termed as « the auditors' responsibilities for considering fraud in a (revised) financial audit» identify fraud as «an intentional act by one or more individuals between management, governance officials, employees or third parties, involving the use of deception in order to gain an unfair or illegal advantage».

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