

# Responding to Fraud Risk



Exploring Where Internal Auditing Stands

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# About CBOK

## SURVEY FACTS

Respondents	14,518*
Countries	166
Languages	23

## EMPLOYEE LEVELS

Chief audit executive (CAE)	26%
Director	13%
Manager	17%
Staff	44%

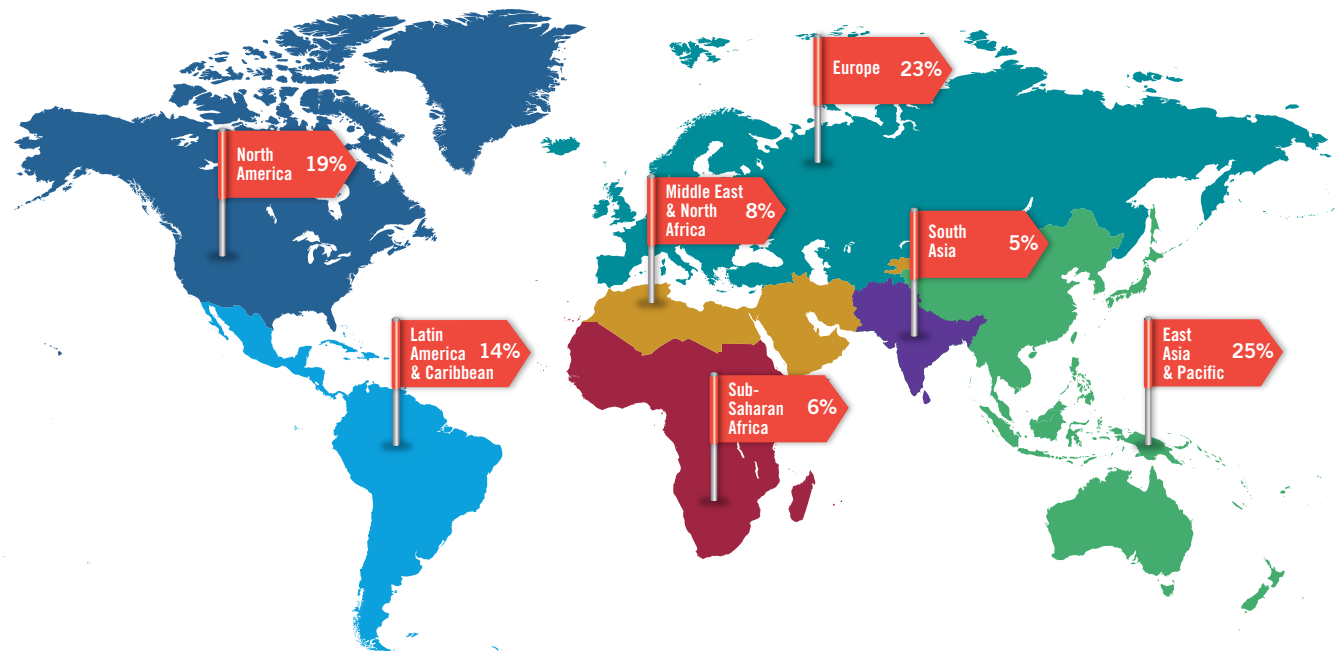
\*Response rates vary per question.

The Global Internal Audit Common Body of Knowledge (CBOK) is the world's largest ongoing study of the internal audit profession, including studies of internal audit practitioners and their stakeholders. One of the key components of CBOK 2015 is the global practitioner survey, which provides a comprehensive look at the activities and characteristics of internal auditors worldwide. This project builds on two previous global surveys of internal audit practitioners conducted by The IIA Research Foundation in 2006 (9,366 responses) and 2010 (13,582 responses).

Reports will be released on a monthly basis through July 2016 and can be downloaded free of charge thanks to the generous contributions and support from individuals, professional organizations, IIA chapters, and IIA institutes. More than 25 reports are planned in three formats: 1) core reports, which discuss broad topics, 2) closer looks, which dive deeper into key issues, and 3) fast facts, which focus on a specific region or idea. These reports will explore different aspects of eight knowledge tracks, including technology, risk, talent, and others.

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## CBOK 2015 Practitioner Survey: Participation from Global Regions



Note: Global regions are based on World Bank categories. For Europe, fewer than 1% of respondents were from Central Asia. Survey responses were collected from February 2, 2015, to April 1, 2015. The online survey link was distributed via institute email lists, IIA websites, newsletters, and social media. Partially completed surveys were included in analysis as long as the demographic questions were fully completed. In CBOK 2015 reports, specific questions are referenced as Q1, Q2, and so on. A complete list of survey questions can be downloaded from the CBOK Resource Exchange.

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# Executive Summary

Fraud risk is a reality that every organization faces today. Recent, high-profile cases of fraud have captured media attention and the scrutiny of regulators worldwide. When a serious fraud occurs in an organization, the company's reputation can be badly damaged, and there is usually a sudden realignment of stakeholder priorities. It is then when we often hear the question, "Where were the internal auditors?"

*Responding to Fraud Risk: Exploring Where Internal Auditing Stands* offers a current global analysis of the importance of fraud risk to internal audit and its stakeholders, the degree of responsibility internal audit has for fraud prevention and detection, and perceptions of internal audit capabilities in responding to fraud risk. Findings are based on the CBOK 2015 Global Internal Audit Practitioner Survey, the largest survey of internal auditors in the world, as well as extensive interviews with internal audit leaders in multiple regions.

Internal auditors can use this report to educate stakeholders, define how internal audit can support the organization's anti-fraud efforts, and build the capabilities of the internal audit team. The report concludes with five key ways chief audit executives (CAEs) can improve their approach to fraud risk in their organizations.

# Introduction

## RESOURCES

Practice Guide, Auditing Anti-bribery and Anti-corruption Programs (Altamonte Springs, FL: The Institute of Internal Auditors, 2014).

Practice Guide, Internal Auditing and Fraud (Altamonte Springs, FL: The Institute of Internal Auditors, 2009).

Global Technology Audit Guide (GTAG) 13: Fraud Prevention and Detection in an Automated World (Altamonte Springs, FL: The Institute of Internal Auditors, 2009).

Before reviewing the survey findings, it is important to look at the key points of reference that internal auditors use to define their role related to fraud risk. First, we will look at The IIA's materials and then we will review the new principle from the updated *Internal Control – Integrated Framework* from COSO (the Committee of Sponsoring Organizations of the Treadway Commission).

## What Does the *Standards* Say About Fraud Risk?

The IIA's *International Standards for the Professional Practice of Internal Auditing (Standards)* defines fraud as:

Any illegal act characterized by deceit, concealment, or violation of trust. These acts are not dependent upon the threat of violence or physical force. Frauds are perpetrated by parties and organizations to obtain money, property, or services; to avoid payment or loss of services; or to secure personal or business advantage.

This is a broad definition that includes a wide variety of fraud types, including bribery and corruption. In addition, this definition does not differentiate between fraud carried out by parties inside an organization (employees, management, etc.) or those from outside an organization (suppliers, customers, etc.). Correspondingly, if we merge fraud into the definition of risk in the *Standards*, fraud risk would be defined as “the possibility of fraud occurring that will have an impact on the achievement of objectives.”

With this definition in mind, let's look at what the *Standards* says about internal audit's responsibility pertaining to fraud risk. The most relevant standards are as follows (not a comprehensive list; emphasis added):

- **1210: Proficiency (1210.A2)** – Internal auditors must have *sufficient knowledge to evaluate the risk of fraud* and the manner in which it is managed by the organization, but are not expected to have the expertise of a person whose primary responsibility is detecting and investigating fraud.
- **2120: Risk Management (2120.A2)** – The internal audit activity must evaluate the potential for the occurrence of fraud and *how the organization manages fraud risk*.
- **2210: Engagement Objectives (2210.A2)** – Internal auditors must consider the probability of significant errors, *fraud*, noncompliance, and other exposures *when developing the engagement objectives*.

In addition, there are other standards that include fraud, and there are standards relating to the role of internal audit in evaluating an organization's ethics and values, which also impact the effectiveness of how fraud risk is managed.

### What Does COSO Say About Fraud Risk?

Another important source of perspective is the new Principle 8 from COSO's updated *Internal Control – Integrated Framework*. The fact that the updated framework includes a principle dedicated to fraud risk is another sign that awareness about fraud risk is growing. **Exhibit 1** shows the new principle and the four recommended points of action that can be applied by internal auditors at all levels in an organization.

### Exhibit 1 *Internal Control – Integrated Framework*, Principle 8: Assesses Fraud Risk

Principle 8 from COSO's *Internal Control – Integrated Framework* (2013) states:

**The organization considers the potential for fraud in assessing risks to the achievement of objectives.**

This principle is further broken down into four recommended points of focus:

- 1 Considers various types of fraud.** The assessment of fraud considers fraudulent reporting, possible loss of assets, and corruption resulting from the various ways that fraud and misconduct can occur.
- 2 Assesses incentives and pressures.** The assessment of fraud risk considers incentives and pressures.
- 3 Assesses opportunities.** The assessment of fraud risk considers opportunities for unauthorized acquisition, use, or disposal of assets, altering of the entity's reporting records, or committing other inappropriate acts.
- 4 Assesses attitudes and rationalizations.** The assessment of fraud risk considers how management and other personnel might engage in or justify inappropriate actions.

Source: *Internal Control – Integrated Framework* (Committee of Sponsoring Organizations of the Treadway Commission (COSO), 2013). Used by permission.

### How Are Internal Auditors Addressing Fraud Risk Today?

Keeping the role of internal audit in mind, now let's look at what the survey tells us about how internal auditors are actually engaged in addressing fraud risk.

**Question 1: How important is fraud risk to executive management and CAEs?**

**Question 2: To what extent are internal auditors responsible for fraud prevention and detection?**

**Question 3: Are internal auditors capable of responding to fraud risk?**

In response to these findings, section 4 of this report provides five key steps internal auditors can take to improve their effectiveness in addressing fraud risk.

# 1 The Global Focus on Fraud Risk

Internal auditors are broadly involved in addressing fraud risk at their organizations, and this section of the report explores their answers to survey questions on the following topics:

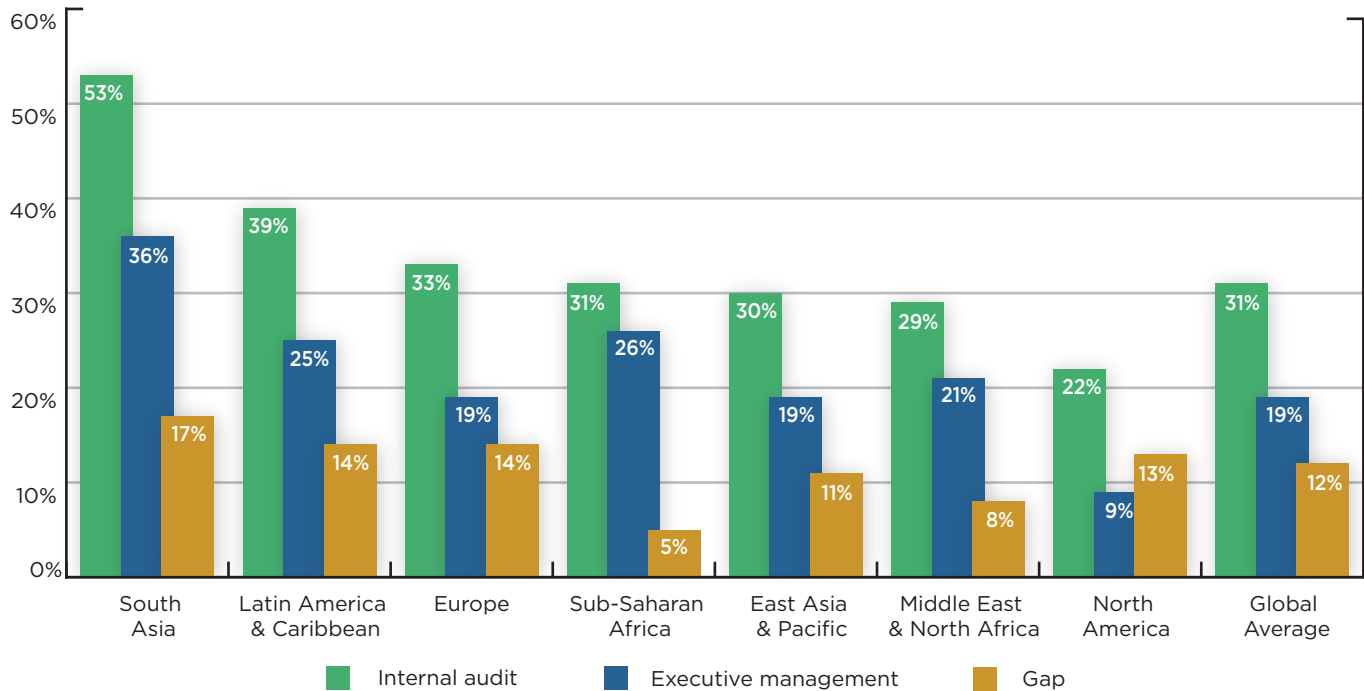
1. Fraud risk as a top five organizational risk
2. Fraud as a value-added activity for internal audit
3. Fraud risk as part of internal audit plans

#### 4. Recruiting for fraud risk skills

#### Internal Audit May Prioritize Fraud Risk More Than Management

CAEs who responded to the survey were asked to rank the top five risks that executive management and internal audit are focusing on. Globally, only 19% believe their executive management focuses on fraud as a top five risk, while 31% say that internal audit focuses on fraud as a top five risk (see **exhibit 2**). In other words,

**Exhibit 2 Fraud Chosen as One of the Top 5 Risk Priorities in 2015 (Region View)**



Note: Q66: Please identify the top five risks on which your internal audit department is focusing the greatest level of attention in 2015. Topic: Fraud, not covered in other audits. CAEs only. *n* = 2,704. Q65: Please identify the top five risks on which your executive management is focusing the greatest level of attention in 2015. Topic: Fraud, not covered in other audits. CAEs only. *n* = 2,705.

“The tone at the top is critical to responding to fraud risk. If a CEO states in meetings that fraud will not be tolerated and that he will be ruthless in dealing with the perpetrators, this tone at the top will send a very strong and positive message across the organization.”

—Dr. Khalid Al Faddagh, former CAE, Saudi Aramco

internal audit places more emphasis on fraud risk than they believe executive management does. As shown by the gold bars in **exhibit 2**, the gap between perceived priorities was highest in South Asia (17%) and lowest in Sub-Saharan Africa (5%). These gaps may indicate situations where internal audit is not aligned with executive management expectations.

**South Asia Has Highest Focus on Fraud Risk**

Globally, the most focus on fraud risk seems to be in South Asia, where the vast majority of survey responses are from India. “India is in transformation stage, as many companies are being listed abroad,” said Umesh Ashar, senior general manager – internal audit at Tata Motors Limited in Mumbai, India. “The new Companies Act has put huge responsibilities on the audit committee, and it requires the statutory auditor of publicly listed companies to report any fraud to the central government. Therefore,

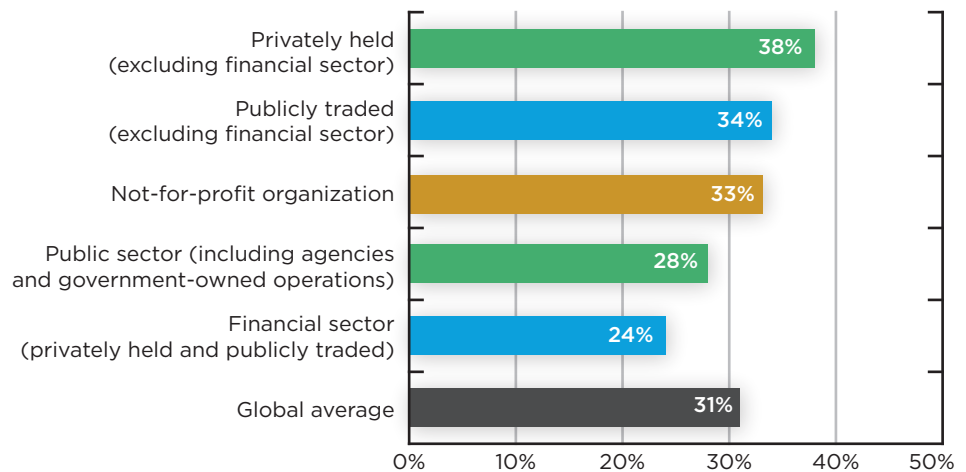
executive management is keen on avoiding reputational risk and ensuring that fraud risk is appropriately addressed and responded to.”

Regarding the Middle East results, Dr. Khalid Al Faddagh, former CAE of Saudi Aramco, said, “I’m surprised and concerned that fraud risk didn’t feature as one of the top five risks in the Middle East region. It could possibly be that the surveyed executives are in denial and believing that fraud only happens in other companies or other countries in the region.”

**Focus on Fraud Risk Is Highest in Privately Held Organizations**

In addition, fraud risk is not cited as one of the top five risks for any region, industry, organization type, etc. However, internal auditors in privately held organizations put more priority on fraud risk than do those from other organization types, with 38% choosing it as a top five risk compared to the global average of 31% (see **exhibit 3**).

**Exhibit 3 Fraud Chosen as One of the Top 5 Risk Priorities for Internal Audit in 2015 (Organization View)**



Note: Q66: Please identify the top five risks on which your internal audit department is focusing the greatest level of attention in 2015. CAEs only. n = 2,742.



### Fraud Adds Value After Other Activities

In the CBOK 2010 Global Internal Audit Survey, 71% of respondents said they carried out “investigations of fraud and irregularities” as part of their activities.\* The global financial crisis was cited as one of the reasons for the high level of activity. The 2015 survey asked CAEs to select the top five value-adding activities for internal audit at their organization from a list that included the option “investigating or deterring fraud.” When asked the question in this way, only about 3 out of 10 chose “investigating or deterring fraud” as a top five value-adding activity (see **exhibit 4**). This is not unexpected because detecting and investigating fraud takes a significant amount of time and redirects internal

\* Marco Allegrini et al., *What’s Next for Internal Auditing?* Report IV of the CBOK 2010 Survey (Altamonte Springs, FL: The Institute of Internal Auditors Research Foundation, 2011), 33.

audit efforts away from important organizational issues.

### Fraud Risk Is a Small Portion of Audit Plans, But Increases Are Expected

Only a small number of survey respondents (4.5%) say they have specialized training in fraud and spend a majority of their time working this field (Q11,  $n = 12,716$ ). This is relatively consistent across ranks/position, and organization type, number of employees in internal audit and industry.

Similarly, looking at internal audit plans, only 3.5% are made up of “fraud risk that is not covered in other audits” (see **exhibit 5**). This is relatively consistent across organization type, number of employees in internal audit and industry. Also, only 25% of CAEs globally believe that internal audit focus on fraud risk will increase in 2015 compared to the previous year (see **exhibit 6**). Regionally, however, this percentage increases to

### Exhibit 4 Top Ways Internal Audit Adds Value

Assuring the adequacy and effectiveness of the internal control system	86%
Recommending business improvement	55%
Assuring the organization’s risk management processes	53%
Assuring regulatory compliance	50%
Informing and advising management	40%
Identifying emerging risks	37%
Assuring the organization’s governance processes	37%
Investigating or deterring fraud	29%
Informing and advising the audit committee	28%
Testing management’s assessment of controls	23%

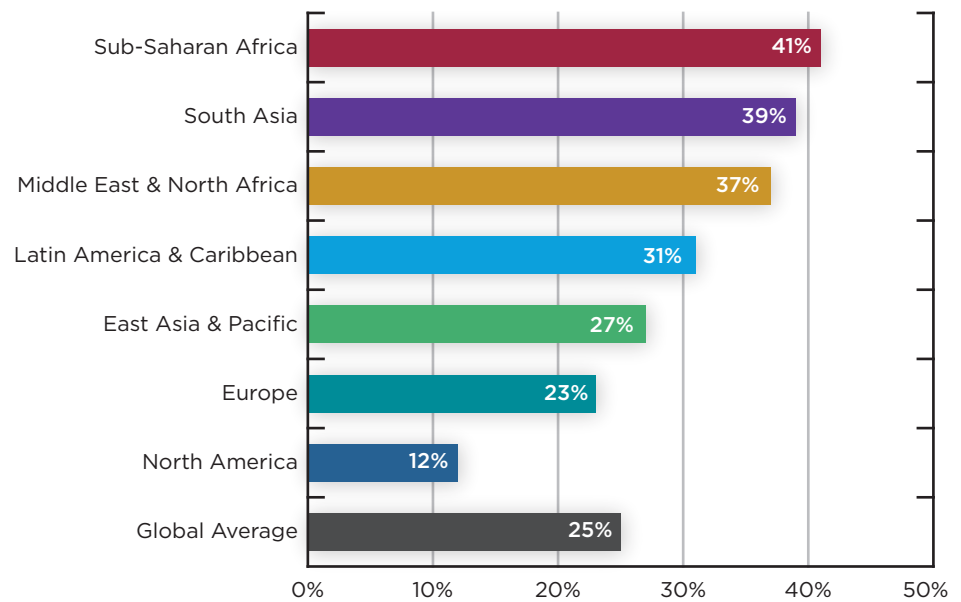
Note: Q89: What are the five internal audit activities that bring the most value to your organization? (Choose up to five.) CAEs only.  $n = 2,636$ .

### Exhibit 5 Fraud Risk in the Audit Plan

Operational	24.5%
Compliance/regulatory	14.9%
Risk management assurance/effectiveness	12.1%
Strategic business risks	10.8%
Information technology (IT), not covered in other audits	8.3%
General financial	6.7%
Corporate governance	6.2%
<b>Fraud not covered in other audits</b>	<b>3.5%</b>
Other (in particular, requests, training, etc.)	3.3%
Cost/expense reduction or containment	3.2%
Sarbanes-Oxley testing or support (United States only)	2.8%
Third-party relationships	2.4%
Crisis management	1.2%
<b>Total</b>	<b>100.0%</b>

Note: Q49: What percentage of your 2015 audit plan is made up of the following general categories of risk? CAEs only. *n* = 2,677.

### Exhibit 6 CAEs Who Expect an Increase in Internal Audit Focus on Fraud Risk



Note: Q50: Compared to 2014, indicate whether audit focus on each of the following areas will increase, not change, or decrease in 2015. Topic: Fraud, not covered in other audits. CAEs only. *n* = 2,476.

about 40% in Sub-Saharan Africa and South Asia.

According to Bruce Turner, retired CAE, immediate past chairman of The IIA's International Public Sector Committee, and chairman of the Audit Committee of IIA–Australia, “Internal audit needs to dedicate an adequate amount of time in their plans to cover all of the basics (including fraud risk) and then make a provision to cover the more interesting, emerging, and strategic risk areas.”

### **Fraud Risk Skills Are Being Recruited Moderately**

The skills being sought for internal audit departments are also an indicator of the overall focus on fraud risk. Although CAEs are looking to hire internal auditors with skills in fraud auditing or in forensics and investigations, these skills are not among the top five for which they are hiring. Only 23% of CAEs chose “fraud auditing” as one of the top five skills they are recruiting or building into their internal audit departments. A similar category, “forensics and investigations,” was selected as a top five skill by only 15% of CAEs. The groups with the most emphasis on fraud auditing are from Latin America (31%) and the construction industry (30%), while for forensics and investigations, the most emphasis is in Sub-Saharan Africa (29%) and South Asia (26%) (Q30,  $n = 3,288$ ).

## **Conclusion**

### **Question 1: How important is fraud risk to executive management and CAEs?**

At face value, fraud does not seem to stand out in terms of the focus of executive management or CAEs. However, it should be noted that certain regulations, such as the U.S. Sarbanes-Oxley Act of 2002, were enacted as a result of fraud. There is a good amount of anti-fraud efforts that go into compliance with this regulation. Due to the 2013 COSO *Internal Control – Integrated Framework*, external auditors have been dedicating more time to Principle 8 and the appropriateness of management's fraud risk assessment.

In developing or emerging markets, CAEs place more emphasis on fraud risk. The same applies to privately held organizations. Even though a major portion of internal audit efforts is not dedicated strictly to fraud risk, internal auditors should keep in mind that fraud risk can have serious consequences for an organization or an internal audit department. “In Spanish, we have a typical phrase: open the umbrella before the rain comes,” says Jorge Badillo, internal audit manager of Sierra Gorda SCM and chairman of the Latin American Federation of Internal Auditors.

# 2 Internal Audit's Responsibility for Fraud Prevention and Detection

“The results aren’t unexpected. There are different maturity levels across both entities and countries, differing societal expectations, as well as many variables that come into play in determining the role of internal audit across a fast-changing business and technological environment.”

—Bruce Turner, retired CAE, immediate past Chairman of The IIA’s International Public Sector Committee, and Chairman of the Audit Committee of IIA-Australia

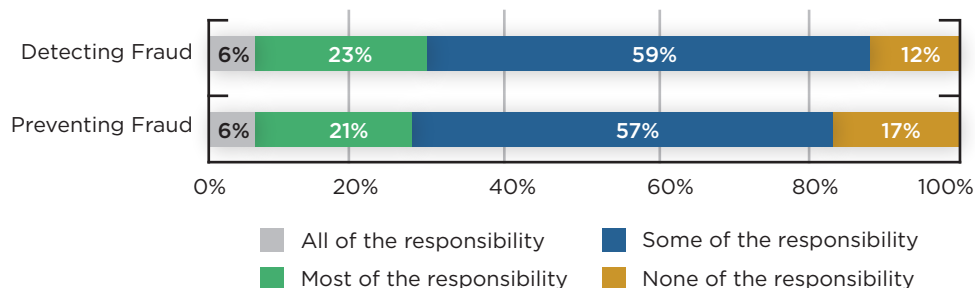
Information found in some textbooks suggests that management is responsible for establishing and maintaining internal controls (including anti-fraud controls), while internal auditors need to evaluate management’s controls and be aware of fraud red flags. Reality often differs from the textbook ideal. Survey results show that there is often a shared responsibility between internal audit and management when it comes to fraud risk. About 3 out of 10 of all survey respondents say internal audit has “all or most of the responsibility” for detecting or preventing fraud at their organizations, with about another 6 out of 10 saying they have “some of the responsibility” (see exhibit 7). The exhibit shows that internal auditors are slightly more likely to be responsible for *detecting* fraud than *preventing* fraud.

## The Problem of All Responsibility or No Responsibility

Exhibit 7 also shows that some respondents say their internal audit departments have no responsibility for fraud detection (12%) or fraud prevention (17%). Many internal audit leaders disagree with the concept of internal audit having no responsibility for fraud detection. Lynn Fountain, author of *Raise the Red Flag: An Internal Auditor’s Guide to Detect and Prevent Fraud*, commented, “Internal auditors need to brainstorm fraud risks as part of every engagement. This is part of the *Standards*, but auditors aren’t really doing it effectively.”

On the other end of the scale, 6% of respondents say their internal audit departments assume *all* of the responsibility for fraud detection and prevention (see exhibit 7). However,

**Exhibit 7 Internal Audit Responsibility for Detecting or Preventing Fraud**



Note: Q55: What degree of responsibility does internal audit have for detecting fraud in your organization? *n* = 11,431. Q56: What degree of responsibility does internal audit have for preventing fraud in your organization? *n* = 11,428. Due to rounding, some totals may not equal 100%.

“Assigning internal audit with all or most of the responsibility for fraud detection is the old-fashioned way, and it is the most comfortable thing for a company to do because it implies that all the other areas in the organization will not be challenged to support the fraud detection efforts.”

—Jorge Badillo,  
Internal Audit Manager,  
Sierra Gorda SCM,  
and Chairman,  
Latin American Federation  
of Internal Auditors

full responsibility for preventing and detecting fraud goes against the concept of internal audit independence and the Three Lines of Defense Model.\* Ashar commented, “I don’t agree with this [internal audit having all responsibility for fraud prevention]. This is the responsibility of management and the first line of defense. However, in many cases, internal audit is expected to review the design of internal controls before they are implemented. This, in a way, is part of fraud prevention.” In the same way, the external auditors are required by their professional standards to assess the risk of material misstatement from both fraud and error when auditing financial statements. Assigning the internal audit department with all of the responsibility for fraud prevention and detection goes against the *Standards* and good practice.

### **Internal Auditors at Private Companies Are More Involved with Fraud Risk**

Fraud responsibility also differs according to the type of organization, with privately held organizations reporting the highest levels of involvement. For detecting fraud, 36% of private sector respondents say they have all or most of the responsibility, compared to the average of 29% (Q55,  $n = 11,431$ ). The gap is wider for preventing fraud, with 35% for the private sector, compared to the average of 26% (Q56,  $n = 11,428$ ). This could be attributed to the tendency of privately held organizations to lack a second line of defense (i.e., risk management and compliance functions).

\* IIA Position Paper, The Three Lines of Defense in Effective Risk Management and Control, January 2013, 3–5.

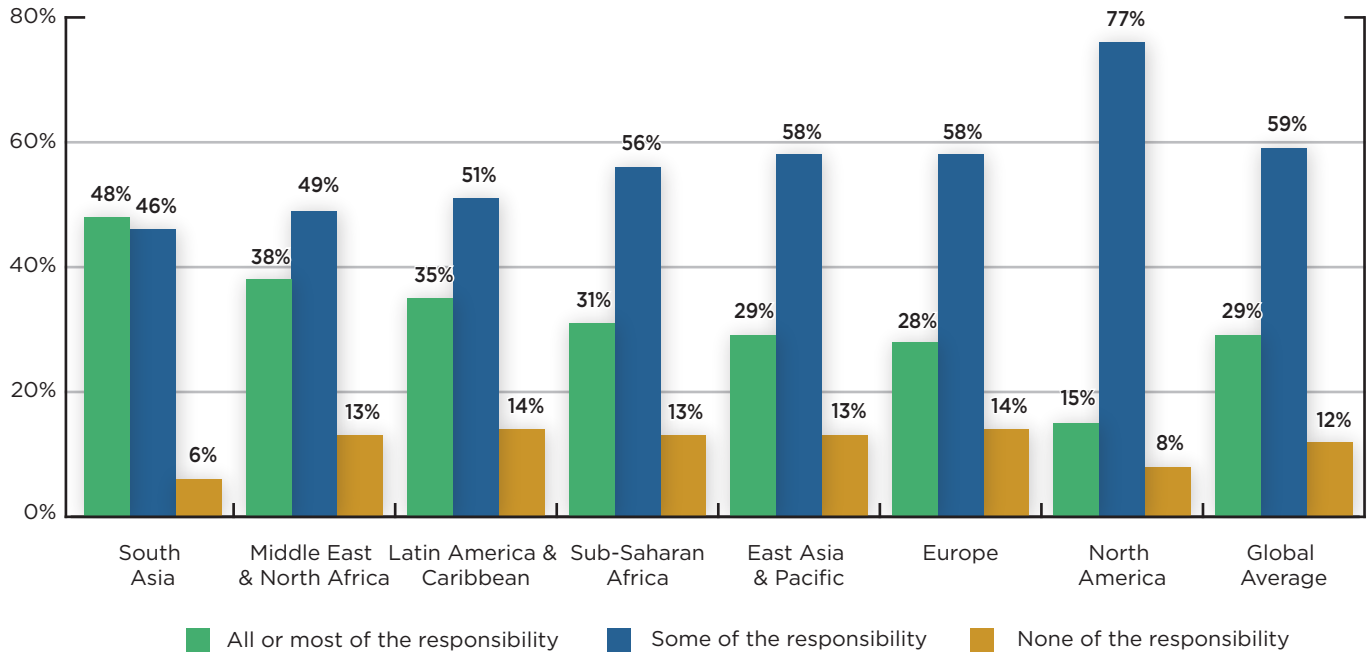
Where internal auditors have responsibility for certain aspects of fraud prevention and detection, these responsibilities include investigating suspected fraud, facilitating fraud risk assessments, monitoring the whistleblower hotline, auditing management’s anti-fraud controls, and providing fraud awareness training.

### **Regions Have Large Differences in Levels of Responsibility**

**Exhibit 8** and **exhibit 9** show the wide differences between regions. The highest degree of responsibility for fraud prevention and detection is reported in South Asia (mostly comprised of respondents from India), where about 5 out of 10 respondents say they have “all or most of the responsibility (green bars).” Other regions with higher levels of responsibility are the Middle East & North Africa, Latin America & Caribbean, and Sub-Saharan Africa (ranging from 31% to 38%). Ashar explains how regulation and control frameworks are shaping internal audit’s role regarding fraud in India: “The Indian Companies Act of 2013 and COSO 2013 have put a lot of emphasis on internal audit and actively addressing fraud. Companies are investing in the establishment of internal audit departments and in building the capabilities of existing ones.”

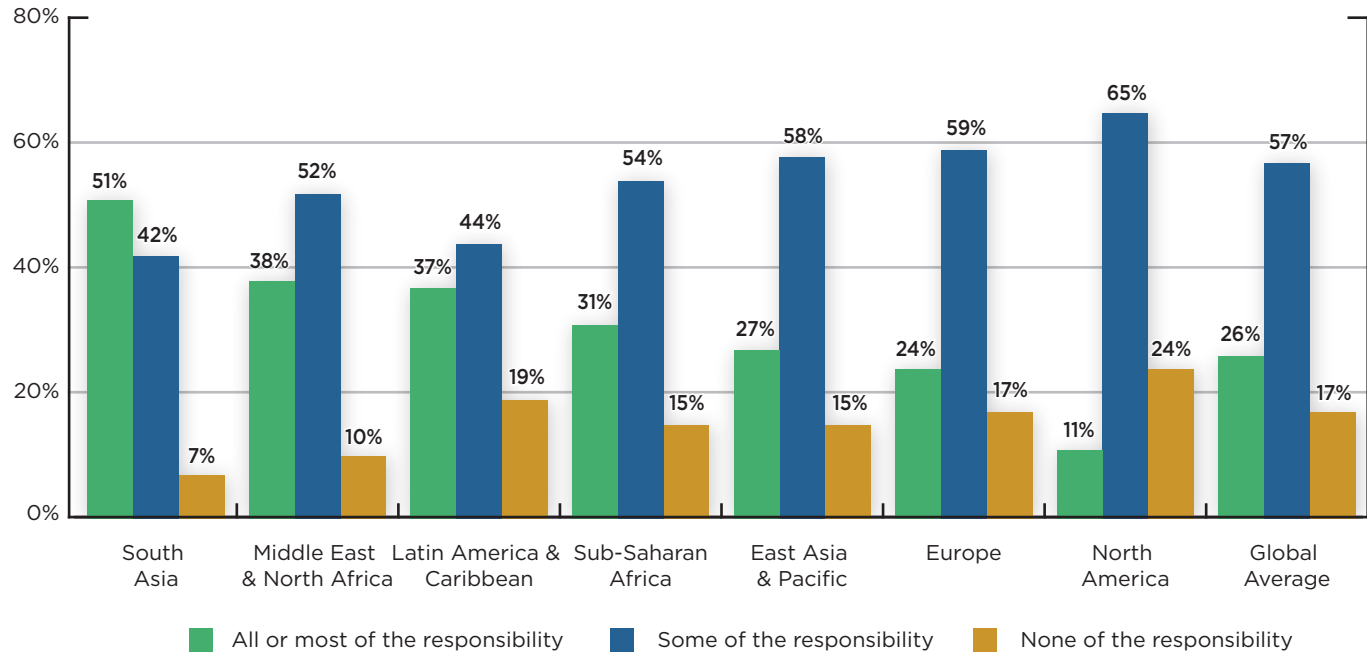
In addition, culture and organizational maturity also have a major effect on the results, explained Owen Purcell, EY lead partner for the EMEIA Risk Centre of Excellence, United Kingdom. “In general, when we look at Europe, we see maturity in terms of how companies manage fraud risk. Internal audit does have a role; however, they are usually not

**Exhibit 8 Detecting Fraud: Internal Audit Responsibility (Region View)**



Note: Q55: What degree of responsibility does internal audit have for detecting fraud in your organization? Due to rounding, some totals may not equal 100%. n = 11,281.

**Exhibit 9 Preventing Fraud: Internal Audit Responsibility (Region View)**



Note: Q56: What degree of responsibility does internal audit have for preventing fraud in your organization? Due to rounding, some totals may not equal 100%. n = 11,279.

leading this. Management and the second line of defense (compliance, risk, etc.) are usually responsible for controlling and managing fraud risk.”

Purcell says cultural attitudes toward fraud and internal audit also affect internal audit’s role. “In South Asia and Middle East, there is the belief that internal audit should always be checking for fraud. There are several layers of approvals and signatures, with internal auditors checking the checkers. The established internal audit functions in the Middle East have high profiles within their companies, and, as a result, management would tend to push more of the responsibility for fraud detection on to them.”

### **Larger Departments Have More Responsibility**

The largest internal audit departments tend to take on more responsibility to prevent and detect fraud than do smaller departments. In organizations with more than 50 internal auditors, 37% of respondents stated they have “all or most of the responsibility” for detecting fraud compared to the global average of 29% (see **exhibit 10**). For prevention of fraud, the results were similar, with 33% of organizations with more than 50 internal auditors taking all or most of the responsibility compared to the global average of 26% (see **exhibit 11**).

The results may be explained by the existence of dedicated fraud specialists or investigators in larger internal audit departments, which usually cannot be justified in smaller departments due to cost constraints. The existence of these dedicated fraud specialists or investigators

increases the perception that internal audit must do more to prevent and detect fraud.

In addition, management’s expectations for internal audit functions also play a role. “From my experience, most Indian companies don’t have separate, stand-alone investigation departments. This includes listed companies. The responsibility is placed on internal audit, and management’s expectation is that internal audit should take a lead role in responding to fraud risk,” says Ashar.

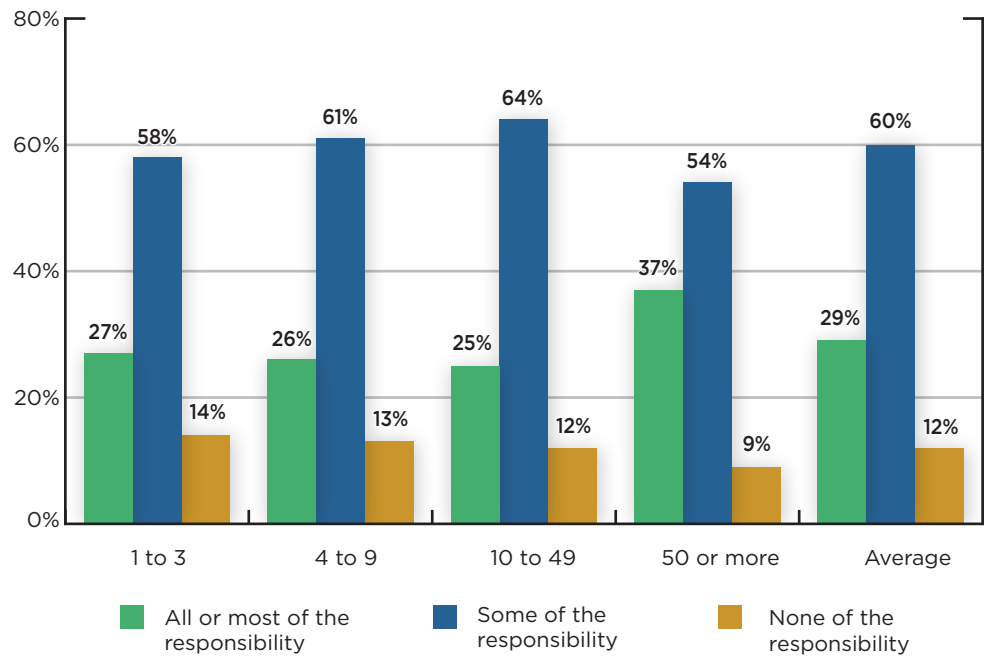
### **A Coordinated Approach to Fraud Risk Is Best**

Internal audit is not the most prevalent means of detecting fraud, according to the Association of Certified Fraud Examiners (ACFE) (see **exhibit 12**). Instead, fraud is detected more often by internal controls (tips from hotlines) and the first line of defense (management review).

An effective response to fraud risk should include multiple lines of defense, with the involvement of the audit committee, senior management, compliance, legal, human resources, and internal audit. Dr. Al Faddagh shares this view: “We need to think about fraud risk management as a process. There are shared responsibilities in this process amongst internal audit, management, and second line functions. When it comes to detection, I believe internal audit bears a higher portion of responsibility than it has for the prevention of fraud.” Without a coordinated approach, there is a higher risk of failing to detect fraud and failing to respond effectively after fraud is detected.

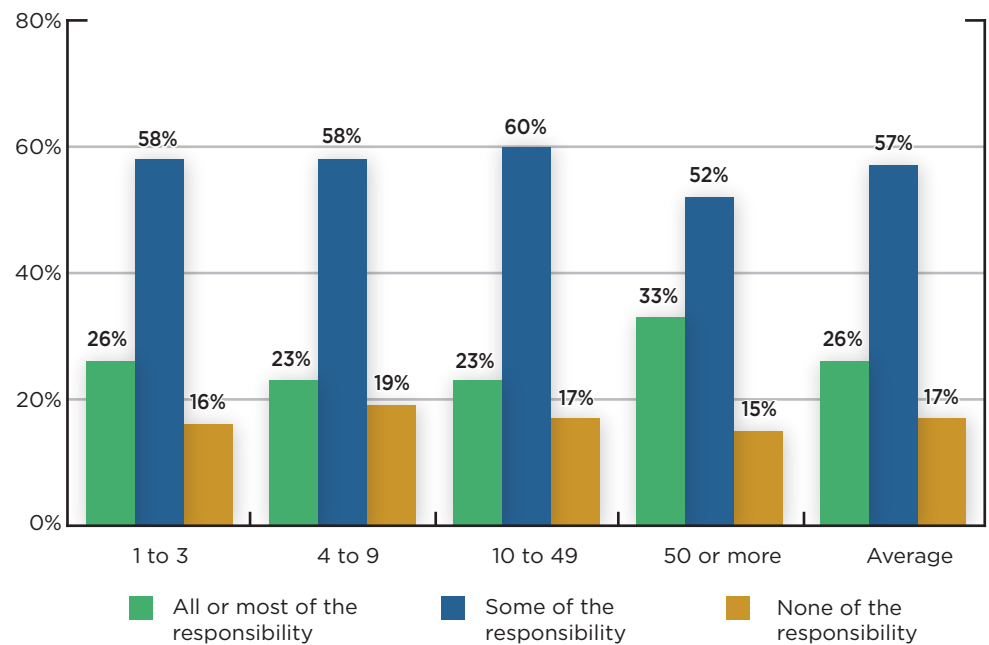


**Exhibit 10 Detecting Fraud: Internal Audit Responsibility (Internal Audit Department Size View)**



Note: Q55: What degree of responsibility does internal audit have for detecting fraud in your organization? Due to rounding, some totals may not equal 100%. *n* = 10,542.

**Exhibit 11 Preventing Fraud: Internal Audit Responsibility (Internal Audit Department Size View)**



Note: Q56: What degree of responsibility does internal audit have for preventing fraud in your organization? Due to rounding, some totals may not equal 100%. *n* = 10,540.



## Exhibit 12 Ways That Fraud Is Initially Detected

Detection Method	Percent of Cases
Tips	42%
Management review	16%
Internal audit	14%
Other methods, such as by accident, external audit, law enforcement, etc.	28%

Source: The ACFE 2014 Report to the Nations on Occupational Fraud and Abuse (Association of Certified Fraud Examiners, 2014), figure 11. Used by permission.

### Conclusion

#### Question 2: To what extent are internal auditors responsible for fraud prevention and detection?

There is no single correct answer. It largely depends on the organization culture, maturity, and the internal audit vision/positioning within the organization. For smaller organizations, it may not be feasible to maintain separate internal audit and investigations teams. However, when internal audit engages extensively in fraud investigations, it may not be able to add the most value to the organization.

According to IIA President and CEO Richard Chambers, involvement in fraud

investigations can affect internal audit's relationships in the organization. "When internal auditors are deeply involved in investigations that may result in disciplinary action against executives or other employees, it can be difficult for the internal auditors to be seen later as 'trusted advisors' who are 'there to help' when they return in their internal audit role," he said.\* Regardless, internal audit should consider the risk of fraud when preparing its risk assessment, be alert to fraud red flags during engagements, and respond in line with the organization's policies and applicable laws.

\* Richard Chambers, "The Dangers to Internal Audit of Donning a 'Black Hat.'" Retrieved from: [iaonline.theiia.org](http://iaonline.theiia.org), July 15, 2014.

# 3 Internal Audit Capabilities in Responding to Fraud Risk

Are internal auditors capable of responding to fraud risk? Do they have the right skills? This section analyzes the capabilities of internal auditors as they relate to the response to fraud risk. It discusses how internal auditors assess their capabilities related to fraud risk, what percentage of internal auditors have fraud-related certifications, and how much internal auditors use data analytics to detect and prevent fraud.

## Internal Auditors Appear Confident in Fraud Risk Skills

Internal auditors appear confident when it comes to incorporating fraud risk into engagements and supporting fraud risk awareness, even though only a very small portion (5%) of respondents have had formal training related to fraud and spend a majority of their time working in that area (Q11,  $n = 12,716$ ). About 6 out of 10 respondents believe they are

**Exhibit 13** Fraud-Related Competency Skill Levels



Note: Estimate your proficiency for each competency using the following scale: 1-Novice; 2-Trained; 3-Competent; 4-Advanced; 5-Expert. Q81: Topic: Support fraud risk awareness ( $n = 11,090$ ) and Q83: Topic: Incorporate ethics and fraud considerations in audit engagements ( $n = 11,204$ ).

“If your fraud policy or internal audit charter says you have fraud investigation responsibilities, you need to have the ability to hire help or have the skills in-house; otherwise, don’t do it.”

—Lynn Fountain, Author of *Raise the Red Flag: An Internal Auditor’s Guide to Detect and Prevent Fraud*

advanced or expert when it comes to incorporating ethics and fraud considerations in audit engagements, and another 5 out of 10 feel this way about supporting fraud risk awareness (see the gold and purple bars in **exhibit 13**).

This level of confidence may indicate that internal auditors are unaware of the specialized knowledge needed to effectively respond to fraud risk. Responding to fraud risk is not solely about analyzing risk and auditing existing controls. There are investigation techniques, interview techniques, digital forensics, and other specialized approaches that need to be accessible to an internal audit department to properly respond to fraud. “Internal auditors can become complacent and think they understand fraud, but in fact they don’t really understand the unique aspects of both anti-fraud programs and emerging fraud schemes,” says Turner.

### Few Internal Auditors Have Fraud-Related Certifications

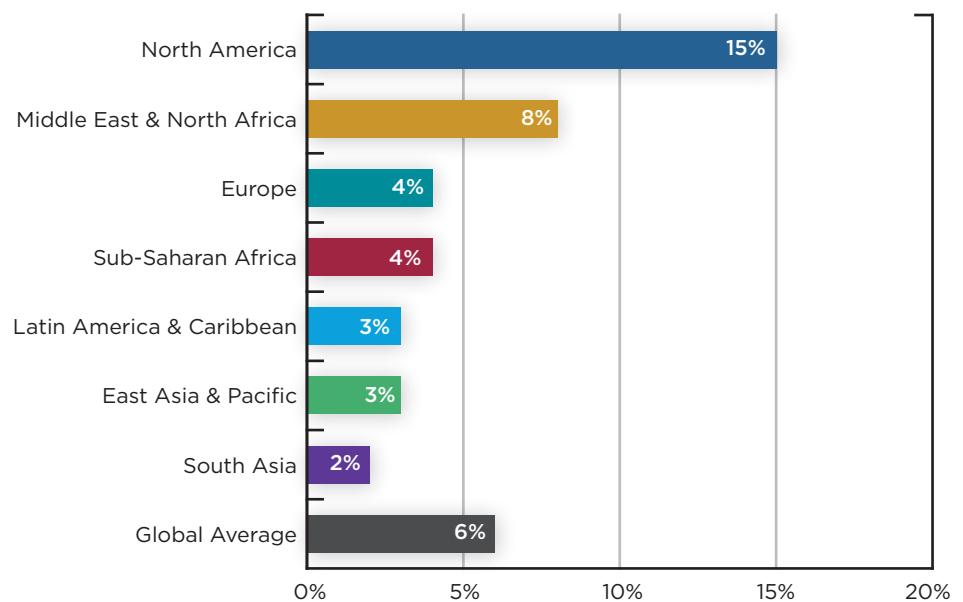
Only 6% of internal auditors globally (5% in 2010) have a fraud examiner certification, such as the ACFE’s certified fraud examiner (CFE) certification (see **exhibit 14**). The highest region of internal auditors with fraud examination certification was North America at 15%, followed by 8% in the Middle East. The remaining global regions had an average of about 3%.

Furthermore, in the CBOK 2010 Global Internal Audit Survey, 11% of respondents indicated that they planned to obtain a fraud examination certification. It seems very few followed through on these plans over the past five years. This is not surprising because internal auditors usually pursue internal audit credentials such as the certified internal auditor (CIA) or the qualification in internal

#### RESOURCE

Lynn Fountain, *Raise the Red Flag: An Internal Auditor’s Guide to Detect and Prevent Fraud* (Altamonte Springs, FL: The Institute of Internal Auditors Research Foundation, 2015).

**Exhibit 14 Respondents with Fraud Certifications**



Note: Q13: Which professional certifications do you have in areas other than internal auditing? (Choose all that apply.) Topic: Fraud examination (such as CFE). n = 12,716.

audit leadership (QIAL) before obtaining specialized certifications such as the CFE.

The role of internal audit in responding to fraud risk and the attitude of the CAE toward certifications may explain these results, says Turner. “In Australia, larger well-established entities often have specialist fraud investigation teams, so internal audit does not investigate fraud in these instances. Another factor is where internal audit shops don’t have professional development plans because they don’t see the value of boosting certifications at the internal audit department level. I think this is a short-sighted view that needs to change for internal audit departments to be fully effective.”

Moreover, survey results show that fraud examination certifications, when available, come later in an internal auditor’s career: 75% of internal auditors with a fraud examination certification are management level or higher. Likewise, 66% of internal auditors with a fraud examination certification are 40 years old or older (Q13,  $n = 11,106$ ). Logically, internal auditors pursue the CIA credential before obtaining other certifications.

Experts disagree on the topic of fraud examination certifications. According to Fountain, “Not having a fraud examination certification does not mean that you will not be able to assess how the organization responds to fraud risk. Knowledge of the organization and its industry is critical to understanding the types of fraud schemes that could take place.”

In contrast, Purcell commented, “Would non-specialist internal auditors be able to create and preserve an evidence trail that would stand up in a court of law?” In the end, internal auditors who

will have an active role in responding to fraud risk will need both fraud examination certifications and specialist training and experience.

### **Data Analytics Frequently Used to Identify Fraud**

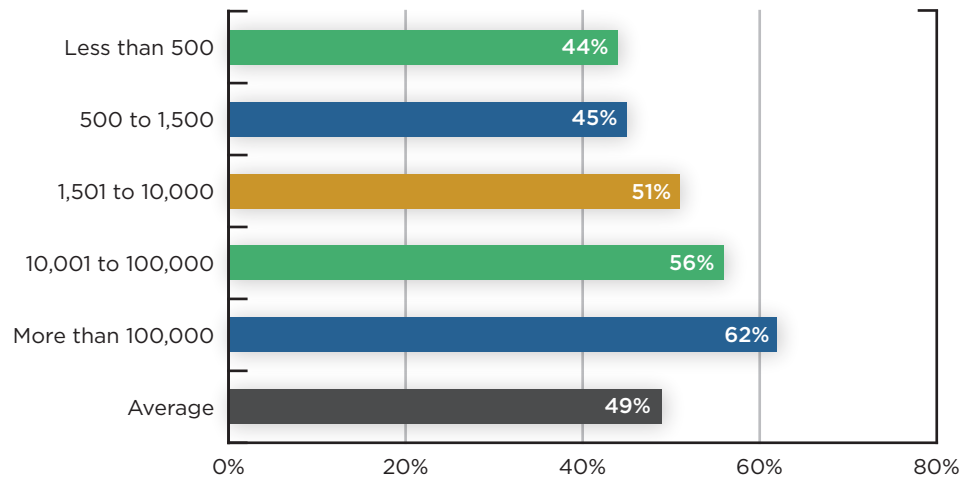
The use of data analytics is an important component of mature anti-fraud programs. About 5 out of 10 internal audit departments that have data analytics activity use it to identify possible frauds, among other things. This rises to 62% in organizations with more than 100,000 employees (see **exhibit 15**). Such results are not surprising given that implementing data analytics requires an investment in both time and resources.

According to a report from the ACFE, proactive data monitoring/analysis is one of the most effective anti-fraud controls in terms of reducing median fraud losses and duration.\* Data monitoring increases the likelihood of detecting fraud schemes (for example, fictitious employees or vendors) and fraud red flags (duplicate payments or invoices, unusual trends/patterns, timing of transactions, manual journal entries, etc.). Dr. Al Faddagh agrees with using data analytics to respond to fraud risk. “Internal audit departments need to create a smart database that includes all fraud incidents which have happened over the years. This database should be searchable, and from there, you can analyze trends and gain useful insights into fraud hotspots and the circumstances which led to committing fraud,” he says.

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\* *Report to the Nations on Occupational Fraud and Abuse* (Association of Certified Fraud Examiners, 2014).

### Exhibit 15 Data Analytics Used to Identify Possible Frauds (Organization Size View)



Note: Q96: Does your internal audit department use data mining or data analytics for the following activities? Exhibit shows respondents who chose “identification of possible frauds.”  $n = 11,101$ .

In addition, data analytics can be even more effective if embedded as part of the first line of defense. Purcell says, “Companies may be using data analytics as part of running the internal audit department, but they also need to use it in the course of managing the business to detect and analyze daily business transactions for fraud. New tools and techniques are emerging and are more ‘in the moment’ than historical in their analysis.” Embedding data analytics into the business is also likely to result in operational efficiencies and not just improved fraud detection.

#### Conclusion

##### Question 3: Are internal auditors capable of responding to fraud risk?

How can internal auditors feel confident in their ability to respond to fraud risk

when most of them do not own the risk, relatively little time is spent on fraud, and the vast majority do not have fraud-related certifications? A logical answer would be that most internal auditors have a skills gap when it comes to fraud risk. This means that they would need to receive regular training on fraud to have sufficient knowledge of fraud red flags and meet the requirements of the *Standards*.

From the technology viewpoint, data analytics (where implemented) is used by internal auditors to identify fraud and fraud red flags. Some experts suspect that the activity is mainly centered around the routine analysis of travel and entertainment expenses, unless there is a mature anti-fraud program in place (which is more likely to be true in specific industries or large organizations). Even though respondents say they are using data analytics to detect fraud, it may only be at a surface level.

# 4 Five Ways to Improve Internal Audit's Approach to Fraud Risk

*“Fraud risk is not adequately addressed. With the increase in use of technology, internal audit needs to incorporate fraud risk assessments into any process audit.”*

—Umesh Ashar,  
Senior General Manager –  
Internal Audit,  
Tata Motors Limited

Dealing with fraud, or even talking about it, can be something management tends to avoid, regardless of materiality. The nature of some fraud instances (whether the ambiguity surrounding them or the sensitive positions of the perpetrators) can divert attention away from core business objectives and risks. Fraud can also take a toll on the organization's morale, resources, and reputation. This is what makes fraud risk more complex than other business risks.

The vast majority of internal auditors globally indicate they have at least some responsibility for detecting and preventing fraud in their organizations (88% and 84%, respectively; see **exhibit 7**). However, fraud risk makes up only 4% of most internal audit plans (see **exhibit 5**), and only 25% of CAEs believe that the focus on fraud risk will increase in 2015 (see **exhibit 6**). And even though the vast majority of internal auditors do not have fraud examination certifications (94%; see **exhibit 14**), about half believe they are competent or better at supporting fraud awareness and incorporating fraud considerations in audit engagements (see **exhibit 13**).

When CAEs were asked to choose their top five risk areas, an average of 3 out of 10 globally chose fraud, but there are large differences between regions (53% in South Asia compared to 22% in

North America; see **exhibit 2**). Results also indicate that internal auditors at privately held organizations are more focused on fraud risk than other organization types (see **exhibit 3**). Finally, fraud risk is more likely to be chosen as a top five risk priority by internal audit than by management, according to internal audit perceptions (see **exhibit 2**).

Even though fraud is not the primary focus of internal audit, when major fraud happens in an organization, management and internal auditors often redirect all of their focus and energy to fraud risk. This poses a dilemma for CAEs. How do you plan for a situation like this? To be prepared, CAEs should make sure the role of internal audit is very clear to all stakeholders. Otherwise, questions may be raised about the effectiveness and value of the internal audit department. This means that CAEs need to be proactive when it comes to addressing fraud risk and apply a risk-based approach to their efforts.

## The Way Forward

The messages from the 2015 survey and this report need to result in tangible actions for CAEs and internal audit departments. The following five recommendations can help improve internal audit's approach to fraud risk in all kinds of organizations.

### **1. Establish internal audit's role regarding fraud.**

What is the role of internal audit in the organization's anti-fraud efforts? What activities will the internal audit department undertake (if any) to prevent and detect fraud? What will be your involvement in investigations? CAEs need to understand the expectations of stakeholders and the requirements of the *Standards* to position their departments and document the role in the internal audit charter and the organization's anti-fraud policy.

Given that investigating or deterring fraud was selected by only 29% of CAEs as a top way for internal audit to add value, CAEs may want to push as much fraud detection and prevention responsibility as they can to the first line of defense (operational management) and the second line of defense (risk management and compliance functions). Purcell says, "Internal auditors should work to push the responsibility of fraud and managing fraud risk onto the business. Internal audit can be educators and make sure that the control framework is operating correctly and that the first or second lines of defense are doing their job; internal audit should not become the first or second line of defense." However, if you work at a privately held organization or in a region with a high focus on fraud, you may need to increase the internal audit department's involvement in fraud risk and see how best to add value to the organization's anti-fraud program.

### **2. Educate management about fraud risk.**

Internal auditors seem very confident in supporting fraud awareness, so it would

make sense to put these skills to use. Promote the Three Lines of Defense Model. Build awareness across your organization about fraud risk, the *Standards*, and the role of internal audit. You may need to address expectation gaps, says Fountain. "It is very challenging to meet the *Standards* and keep up with management expectations. CAEs need to periodically communicate the role of internal audit as it relates to fraud to both the audit committee and management."

### **3. Be proactive in addressing fraud risk.**

Do not just sit and wait for fraud to happen; be proactive! Make use of audit hotlines, audit management controls over fraud, audit investigation protocols, and audit anti-bribery and corruption programs. In addition, you can facilitate fraud risk assessments, increase frequency of audits in high fraud risk processes, champion the need for a digital forensics capability, and so on. Make sure you agree with your audit committee on which assignment would add the most value to the organization. Turner recommends, "Internal auditors need reasonable focus on facilitating fraud risk assessments because this is an area where they can add lots of value by driving strategic solutions to minimize the risk of potentially significant frauds." The *Standards* requires the internal auditor to assess the potential for fraud, and facilitating fraud risk assessments is a good step toward meeting that requirement.

### **4. Build a database of lessons learned.**

When fraud occurs, it should (among other things) lead to the remediation



“When you investigate fraud, you should have to have the skills to do it correctly.”

—Owen Purcell,  
EY Lead Partner,  
EMEIA (Europe,  
Middle East, India, Asia)  
Risk Centre of Excellence,  
United Kingdom

of any control deficiencies. Take ownership of creating a database of what went wrong, the circumstances that led to fraud, the scheme, how it was discovered, the location it took place, and the outcome. This will serve as an excellent tool to educate the internal audit department and executive management. It will also provide historical data on the likelihood and impact of certain schemes by location to prioritize audit efforts or have discussions on the acceptance of any risks.

## **5. Create access to the right skills.**

Make sure your team has the right skills to support fraud prevention or detection efforts. Hire, train, or outsource. Your team needs to be able to assess the risk of fraud and be alert to fraud red flags; this requires experience and maturity. Also, do not forget to train the team on how technology can be used to commit fraud. Consider whether you need to hire internal auditors with specialization in fraud auditing or investigations. Alternatively, negotiate a rate contract with an outsourced provider so you can have easy access to specialists when needed.



# Appendix A: Summary of Findings

## **Section 1: The Global Focus on Fraud Risk**

- At face value, fraud risk does not seem to be high on the agenda of executive management or internal audit departments. However, there is more focus on fraud risk from the internal audit point of view.
- Focus on fraud risk by both executive management and internal audit is higher in privately held organizations compared to other organization types (publicly listed, government, not-for-profit, etc.).
- Although most internal auditors believe they have some responsibility for fraud detection and prevention, CAEs do not consider the investigation or deterrence of fraud to be a major value-added activity.
- Fraud risk makes up a very small portion of internal audit plans, and few CAEs believe that the focus on fraud risk will increase in 2015 compared to 2014.
- CAEs are looking to hire internal auditors with skills in fraud auditing or in forensics and investigations. However, these skills are not among the top five for which they are hiring.

## **Section 2: Internal Audit's Responsibility for Fraud Prevention and Detection**

- Responding to fraud risk involves a coordinated effort across the three lines of defense, and most internal auditors are involved in this effort.
- In South Asia, the Middle East & North Africa, and Latin America & Caribbean, a higher proportion of internal auditors believe they have “all or most of the responsibility” for preventing and detecting fraud.
- In privately held organizations and those with internal audit departments employing more than 50 internal auditors, there is more emphasis on internal audit to prevent and detect fraud.

## **Section 3: Internal Audit Capabilities in Responding to Fraud Risk**

- Internal auditors appear confident when it comes to incorporating fraud risk into engagements and supporting fraud risk awareness, even though only a very small portion of them spend most of their time working on fraud.

- Fraud examination certifications are not common among internal auditors. When available, fraud-related certifications seem to come later in an internal auditor's career.
- The most common use of data analytics by internal audit departments is identifying possible patterns of fraud.

#### **Section 4: Five Ways to Improve Internal Audit's Approach to Fraud Risk**

##### **1. Establish internal audit's role regarding fraud.**

Use expectations of stakeholders and the requirements of the *Standards* to identify internal audit's role regarding fraud in your organization. Document this information in the internal audit charter and the organization's anti-fraud policy.

##### **2. Educate management about fraud risk.**

Build awareness across the organization about fraud risk, the *Standards*, and the role of internal audit.

##### **3. Be proactive in addressing fraud risk.**

Be proactive by auditing anti-corruption measures in use at the organization or by increasing audits in high fraud risk areas. At the same time, make sure you agree with your audit committee on which assignment will add the most value.

##### **4. Build a database of lessons learned.**

Create a database of circumstances surrounding cases of fraud at your organization and use it to prioritize future audit efforts.

##### **5. Create access to the right skills.**

Make sure your team has the right skills, especially in the area of technology. Hire, train, or outsource as needed.

# About the Author

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