

Characteristics of Internal Audits and Fraud Detection – Executive Summary*

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Deterring fraud has always been a fundamental role of internal audit. Internal auditors are in an advantageous position within companies to be able to detect both financial statement fraud and other types of fraud. This study is focused on non-financial statement fraud. Prior to SOX, the structure and aggressiveness of the internal audit departments of organizations largely reflected the organizations' preferences and governance systems. One of the original roles of internal audit was to be the "eyes and ears" of management. SOX, however, has potentially changed the internal audit environment in several ways. If these changes in the internal audit department have reduced the likelihood/ability of internal auditors to detect non-financial statement fraud, it is important to identify the impact they have on fraud detection. This dissertation focuses on four such factors: 1) audit program structure, 2) audit type (SOX vs. non-SOX), 3) audit program approval, and 4) development of expertise.

Internal auditors, similar to external auditors, have been increasingly using a more structured audit approach. SOX tasks performed by internal auditors have been found to be more structured than non-SOX tasks (Martin and Sanders 2009) and because many internal audit departments are spending a large amount of time on SOX tasks, the overall time spent by internal auditors on highly structured tasks has therefore increased. While there are both advantages (e.g. efficiency and consistency) and disadvantages (e.g. inflexibility and mechanistic thinking) that have been identified for structured audits (Asare and Wright 2004), I investigate the impact of internal auditors using a structured versus unstructured audit program on the likelihood of detecting fraud.

Section 404 of SOX mandates that 1) management evaluate its internal controls over financial reporting and file a report with its financial statements about the effectiveness of those controls, and 2) that the external auditor must report on management's assertion about the effectiveness of its internal controls as of the company's year-end. As a result, many internal auditors now have specific "SOX" audits for collecting evidence for the evaluation of the effectiveness of internal controls. Such SOX audits constitute a new type of internal audit task whose impact on fraud detection is not well known. As part of my investigation, I examine whether auditors are more/less likely to detect fraud while performing a SOX versus a non-SOX audit tasks.

Practicing internal auditors feel that SOX audits are subjected to more review and approval by external auditors than other types of internal audits (Martin and Sanders 2009). To meet SOX Section 404 requirements, there is evidence that internal audit departments collaborate extensively with their external auditors to develop a formal, pre-established audit program that is often approved by the external auditor. I test whether this external auditor approval has an impact on the likelihood of fraud detection.

Internal audit professionals have expressed concerns that new internal auditors trained largely on SOX audits may have a "skill gap" in basic audit competencies (e.g. analytical thinking and risk assessment, Pryal 2008). As the process of complying with SOX has come under control, they are

expressing concern that auditors who were trained on SOX will not have the required skills to perform operational or other internal audit tasks. I investigate the effects of experience in preparing SOX audits on the likelihood of detecting non-financial statement fraud.

I examine the potential effects of these factors, which have changed due to the SOX mandate, on the basic internal audit structure and function. I am particularly interested in the willingness of internal auditors to expand the scope of the audit and the likelihood of detecting fraud. These research questions were investigated with an experiment with internal auditor participants. Participants were asked to complete a portion of an internal audit for a hypothetical pharmaceutical sales company for which they are internal auditors. Evidence consistent with an occurrence of fraud was embedded within the materials given to each participant to use while completing the audit. Participants were asked to indicate the likelihood that fraud is involved and also how likely they are to suggest that the audit be expanded among other distraction audit conclusion questions. Participants were also asked manipulation check questions and demographic information questions.

The participants for this study are 135 internal audit professionals. The average number of years of experience was 7.01 years and the average age was 36.5 years old. Thirty-eight (28.4 percent) of the participants are Certified Public Accountants (CPA) and thirty-seven (27.6 percent) are Certified Internal Auditors (CIA). Forty four participants (32.8 percent) have public accounting experience. The current position of the participants are: 40.0 percent internal audit seniors, 34.8 percent internal audit staff, 14.8 percent internal audit managers, 4.4 percent chief audit executives (CAE) and 5.2 percent other. The average size of the participants' internal audit departments is 33.08 internal auditors. The reporting structure for the sample is: 73.3 percent report to the audit committee, 13.7 percent report to management, and 13.0 percent report to others. Ninety (67.2 percent) of the participants have worked as an internal auditor for an organization required to comply with SOX. The mean percentage of time the participants have spent on SOX activities vs. non-SOX activities since 2002 is 26.34 percent on SOX activities and 73.81 percent on non-SOX activities. Thirty three (24.4 percent) of the participants have their SOX audit program approved by the organization's external auditor. Sixty three (47.7 percent) of participants answered that they viewed their external auditor as an authority figure while 69 (52.3 percent) answered that they did not.

Overall, the results of the experiment were inconclusive in regards to the research questions. A statistically-significant relationship between the means was not obtained in the current study. The direction of the differences in the data was consistent with a greater likelihood of detecting fraud and increasing the scope of the audit when the audit work program was unstructured. Opposite what was predicted, the direction of the differences in the data was consistent with a greater likelihood of detecting fraud and increasing the scope of the audit when the audit was a SOX audit compared to a non-SOX audit. The direction of the differences in the data was consistent with a greater likelihood of detecting fraud and increasing the scope of the audit when the SOX audit work program was not approved by the external auditor.

In regards to auditor expertise, non-SOX auditors were found to not differentiate as much as SOX auditors in the likelihood to detect fraud due to the audit type (SOX audit vs. non-SOX audit). SOX auditors were more likely to detect fraud on a SOX audit. No discernable difference was noted in the propensity to increase scope due to auditor expertise; however, both types of auditors were found to be more likely to increase the scope of the audit in a SOX audit.

In considering these results, it is appropriate to consider the variables that may have affected the data obtained. Internal variables include the strength of the manipulation, the length of the task, the sample size, and the wording of the SOX manipulation. External variables include omitted variables including unmeasured individual differences in the internal auditors, the setting for the task, and the auditors' knowledge that they were being measured. Again, while there were no statistically significant results, the product of this research is insightful for future research.

In conclusion, the accounting scandals of the past decade have driven the implementation of SOX and increased the role and importance of internal auditors in governance as well as change the internal audit environment by increasing structure, introducing a new type of assurance engagement (SOX audits), and increasing approvals from external auditors. If these changes in the internal audit environment have an effect on the auditors' ability to detect fraud, it is important that this be brought to light. This study tests the effects of a few internal audit characteristics on the detection of fraud, but there are still many areas to explore.

Bibliography

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