FRAUD RISK MANAGEMENT IN INTERNAL AUDIT

A joint research report by the Internal Audit Foundation and Kroll.

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INTERNAL AUDIT FOUNDATION™

Published by the Internal Audit Foundation
1035 Greenwood Blvd., Suite 149
Lake Mary, Florida 32746, USA

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ISBN-13: 978-1-63454-088-9
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1. Introduction

Several high-profile and large-scale corporate fraud cases have made headlines in recent years. Investigations into a number of these frauds have identified that many of them took place over a significant period of time and often resulted in crippling impact to, and even the demise of, the victim organizations. This trend has catalyzed the debate about who is responsible for fraud risk management from a strategic perspective, as well as who should be involved in the prevention, detection, and investigation of fraud from an operations perspective. One question that has arisen in a number of these cases is, "Why was this not picked up by internal or external audit?"

It is a common belief that the responsibility for detecting fraud lies with the external (statutory) auditor, as demonstrated by recent parliamentary enquiries in the UK and other negligence claims against auditors worldwide. External auditors defend their position as the commentators of the probity and lack of material error of the financial statements, rather than the fraud detectives. Internal audit teams are increasingly coming under pressure and scrutiny, both within organizations and from external stakeholders, to be clearer and more accountable in their role in fraud risk management.

While the role of internal audit teams varies significantly across different industries, jurisdictions, and organizations, the predominant role of internal audit is, according to The Institute of Internal Auditors (IIA), "to provide independent, objective assurance and consulting activity designed to add value and improve an organization's operations." This includes assessing the design and effectiveness of controls in an organization, including controls involving fraud risk management, and providing assurance to management and the board that controls are designed appropriately and function effectively.

Among internal audit communities, there is some discrepancy around the role that internal audit plays in the fight against fraud. In a position paper, The IIA set out the following key points in relation to the role of internal audit in fraud risk management:

- Organizations should have robust internal control procedures to limit the risk of fraud, and internal audit's role is to assess these controls;
- The organization should have a suitable fraud prevention and response plan in place allowing effective limitation and swift response to the identification of fraud and management of the situations. This should include digital data;
- The chief audit executive should consider how the risk of fraud is managed across the organization and assess the fraud risk exposure periodically;
- The risk of fraud should be included in the audit plan and each audit assignment to evaluate the adequacy of anti-fraud controls; and
- Internal auditors should not investigate fraud unless they have specific expertise and experience to do so.

In the UK, the Chartered Institute of Internal Auditors takes the view that "internal audit has a role to play in ensuring that management has effective systems in place to detect and prevent corrupt practices within an organization….But it is not the job of internal audit directly to detect or prevent corrupt practices. This is for executive management. Internal audit's role includes promoting anti-fraud and anti-bribery best practice, testing and monitoring systems and advising on change where it is needed." The IIA (UK) policy paper refers specifically to having the appropriate skills as well as ensuring that independence is retained, and that the internal auditor has the capacity to take on such a role. As an investigations firm, Kroll has worked with a number of organizations around the world in a variety of jurisdictions. In our experience, fraud risk assessment and the implementation of processes and procedures to prevent, detect, and respond to fraud risks have increasingly been on the agenda of senior executives and boards. However, how they apply this focus varies considerably from organization to organization, as does the role of internal audit in these activities.

We have often seen that, as organizations grow, understanding the changing risk profile of fraud risks and the implementation of an effective fraud risk management program has often lagged behind growth in business structures and process optimization. As supply chains have become more integrated and global, this has led to more complexity and challenges for management to have clear visibility over the breadth of the organization. In our experience, those organizations that respond effectively to these challenges have included active participation of a multi-skilled, experienced internal audit team. In these situations, the internal audit teams were involved not only in conducting more standard controls reviews, but they had a seat at the table in driving strategy, identifying how fraud risks impact other business risks, and in coordinating and scrutinizing investigative activity.

The research team considered that it would be timely to conduct a survey to understand internal auditors' views regarding the role of internal audit in assessing fraud risk and preventing, detecting, and investigating fraud in their organization. The research was designed to gather data on the roles, responsibilities, structures, and tools of internal audit teams and to further our understanding of the perceived effectiveness and appropriateness of such structures. While this data is a snapshot in time, it may also be used as a basis for assessing future trends in fraud risk management processes and structures, as well as identifying which trends require further research and analysis.

The landscape under the current climate, with the significant economic challenges that will emerge post-COVID-19, will potentially give more opportunity to fraudsters and result in increased pressure to tighten the purse strings or demonstrate results. In this environment, careful consideration of fraud risk management becomes ever more important.

2. Methodology

Survey questions included nine subject-related questions and five demographic questions. The short questionnaire, which makes up the basis of the results discussed in this report, was distributed to internal auditors globally and received 704 responses. Survey questions may be obtained by contacting the Foundation.

The findings in this report attempt to answer the following key questions:

- To what extent does the involvement of internal audit in fraud risk management impact the perceived effectiveness of the fraud risk management process?
- Where does responsibility for strategic fraud risk management lie within the organization, and who is responsible for operational activity of the prevention, detection, and investigation of fraud?
- What are the challenges and barriers to internal audit's involvement in fraud risk management?
- What are the investment trends in fraud risk management in recent years?

3. Summary of Survey Findings

The survey responses identified a number of themes that challenge the conventional understanding of the role of internal audit in fraud risk management. Responses demonstrate on the whole that a deeper engagement of internal audit teams leads to a stronger, more robust fraud risk management program. However, a number of challenges and barriers remain for internal audit in taking the lead in fraud risk management.

To what extent does the involvement of internal audit in fraud risk management impact the perceived effectiveness of the fraud risk management process?

In general, respondents were confident about the effectiveness of their fraud risk management programs, with 54% stating that they felt their organization's fraud risk management was good, very good, or excellent. A strong trend emerged from the data that those organizations where internal audit was part of the strategic management of fraud resulted in a more effective and robust fraud risk management process. This finding was particularly prevalent where internal audit teams took the lead on enterprisewide fraud risk assessments, with 60% of those who had a leadership role saying they felt their organizations had good or better fraud risk management programs. Aside from this, the identification and management of other risks can also be enhanced by a stronger mandate for internal audit to drive risk analysis and frame how this feeds into senior management decision-making.

Where does responsibility for strategic fraud risk management lie within the organization, and what role does internal audit have in prevention, detection, and investigation of fraud?

Of all the teams taking a lead in fraud risk management within organizations, internal audit took the lead most frequently in organizations surveyed, with 41% of respondents stating that the internal audit team was the main leader in fraud risk management. Additionally, 91% of respondents stated that they had at least some involvement in enterprisewide fraud risk assessment. In contrast to this, almost half of the respondents felt that internal audit was not part of strategic enterprisewide decision-making. This suggests that even though they may have some responsibility in fraud risk management, the function may not feel it has a natural seat at the strategic decision-making table or perhaps the influence to drive change.

In terms of operational activity for fraud prevention, detection, and response, the respondents revealed a strong level of involvement in all three areas, with more respondents saying that internal auditors were involved in reactive investigations than the more proactive areas. This is perhaps unexpected given that, in our experience and supported by the survey data, many internal audit teams are under-resourced and may not have the capacity to be flexible in their audit programs.

What are the challenges and barriers to internal audit involvement in fraud risk?

The majority of survey respondents (80%) felt that there were barriers to internal audit involvement in fraud risk management. The most common barriers noted were lack of appropriate resources, lack of mandate and potential conflict of interest, and to a lesser extent the lack of adequate skills to undertake such work.

The lack of mandate is perhaps the area most prevalent in current debate, with approximately a quarter of survey respondents considering this as the largest barrier. It is common in our experience that business leaders do not perceive that it is the primary mandate of internal audit teams to take a leadership role in fraud risk management and operational activity for prevention, detection, and response. The business objectives, structural priorities, and risk appetite of individual organizations will impact whether or not internal audit is the appropriate place for fraud risk management to sit.

Other concerns highlighted by respondents also support this point. The perceived conflict of interest for internal auditors was highlighted as a challenge for many survey respondents. Internal audit's involvement in strategic fraud risk management and operational activity to manage fraud risk needs to strike a balance between internal auditor responsibility and providing an independent check of the activity of the business.

Overall, the results indicate that in order to be effective in fraud risk management, internal audit teams need to have buy-in from senior management, adequate resources, and the right skill sets while maintaining their independence from business decision-making to allow for objective audits to continue.

What are the trends in investment in fraud risk management?

In general, fraud risk management remains of high importance to organizations in all industries, as a large majority of respondents identified that investment in fraud risk management has either stayed the same or increased in the past five years. In terms of the investment in internal audit teams, and the corresponding ability for internal audit to take more ownership and be more involved in fraud risk management, the data demonstrated a number of interesting areas for consideration.

Larger organizations generally had bigger internal audit teams, as would be expected, but there were some notable exceptions in the data. For example, 15% of organizations with more than 50,000 staff reported internal audit teams of fewer than 15 people. The data also showed, perhaps expectedly, that the largest barrier to internal audit being involved in fraud risk management processes was a lack of resources, particularly for large and medium-sized organizations (those with more than 10,000 staff) with internal audit teams of fewer than 25. The other common barrier for larger organizations was the lack of appropriate skills within the team. While no data was gathered in this survey about the particular skill sets that were lacking, challenges in terms of specific skills to aid fraud risk management include:

Data processing and analytics: In the modern world, more data is produced by organizations and individuals than ever before. Being able to gather, interrogate, and analyze large, disjointed, and often disparate datasets presents a significant challenge. Timely detection of possible red flags of fraud is key to having an effective fraud risk management program, and responsibility for mining such data and providing factual analysis frequently falls to internal auditors.

Analysis of relationships: Another common skill set gap that organizations are facing is the ability to properly understand third-party relationships and break down the corporate veil using modern technology and public records to track relationships and identify risks efficiently. The failure to properly understand the nature of the third-party touchpoints can mean that collusion or collaborative frauds can go undetected.

IT infrastructure knowledge: With the increasing prevalence of cyberattacks and data breaches, knowledge of IT systems and a detailed understanding of the infrastructure, both physical and logical, can be a key tool for internal auditors and others with responsibility for fraud risk management.

Conclusion

The survey results highlight that there appears to be significant variation between organizations' approaches to fraud risk management. These variations are driven by size and sector, local environment and culture, and the appetite for investment in fraud management at a senior level. However, the results highlight the fact that internal auditors are in many cases well placed to play an increasingly important role in managing fraud risk and feeding into more strategic analysis and decision-making. When an outsourced investigation of an internal fraud is initiated, the mandate often comes from the board, chief financial officer, or general counsel. However, the core knowledge of the organization, access to data, and often the instigator of the need for investigation comes from internal audit.

Internal auditors face a challenging present and somewhat unclear future. The world is likely to emerge from the current crisis significantly different from how it went into it. The risk profile will change and fraud risk, in particular, will change significantly. Financial crises can increase the pressure on organizations and individuals, as well as the opportunity to commit fraud. This may be a good opportunity for the internal audit profession to reassess and reconsider where it fits into the broader umbrella of fraud risk management to ensure that internal auditors support their organizations on the road to recovery in the most efficient and effective way.

Recommendations for further research/consideration of guidance

Considering the changing landscape, there is further scope for research and possible guidance in relation to the following topics/questions:

- Consideration by The IIA and the profession about how to balance the perceived threat to objectivity and independence of the internal audit function while taking on fraud risk management activity. The focus should be on avoiding potential perceived self-review, while ensuring that internal auditors can add the most constructive value to their organizations.

- Further analysis on the question of where the management of fraud risk should lie in an organization to allow it to be the most effective and strategically connected. This can drive the question of whether the mandate/lack of mandate is appropriate or not.

- How investment in internal audit growth compares with other areas of organizations that may have responsibilities for fraud risk management, including risk management, compliance, legal, etc.

- How do internal audit teams manage the need to have specific skills in their teams and have a general understanding of the business itself? Is there a perception that it is essential to have data analytics expertise, public record investigation experience, and IT technical knowledge to be effective?

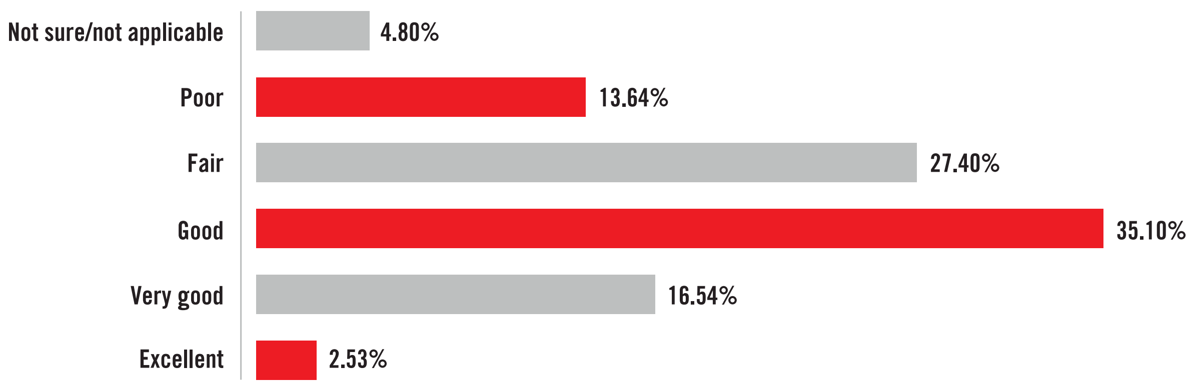
4. Detailed Analysis of Survey Data

4.1 Internal Audit Involvement in Fraud Risk Management and the Perceived Impact on Effectiveness

To assess internal audit's involvement in fraud risk management and the perceived impact on effectiveness, respondents were asked to describe the effectiveness of their organization's fraud risk management program (ranging from poor to excellent) and the extent to which the internal audit team is involved in the enterprisewide fraud risk assessment (ranging from not involved to extremely involved)[1].

Overall, the respondents expressed confidence in the effectiveness of their fraud risk management programs, with 54% considering their fraud risk management programs as excellent, very good, or good. A further 27% considered the programs to be fair, as shown in ***Figure 1***.

FIGURE 1
Overview of Perception of Effectiveness of Fraud Risk Management Programs

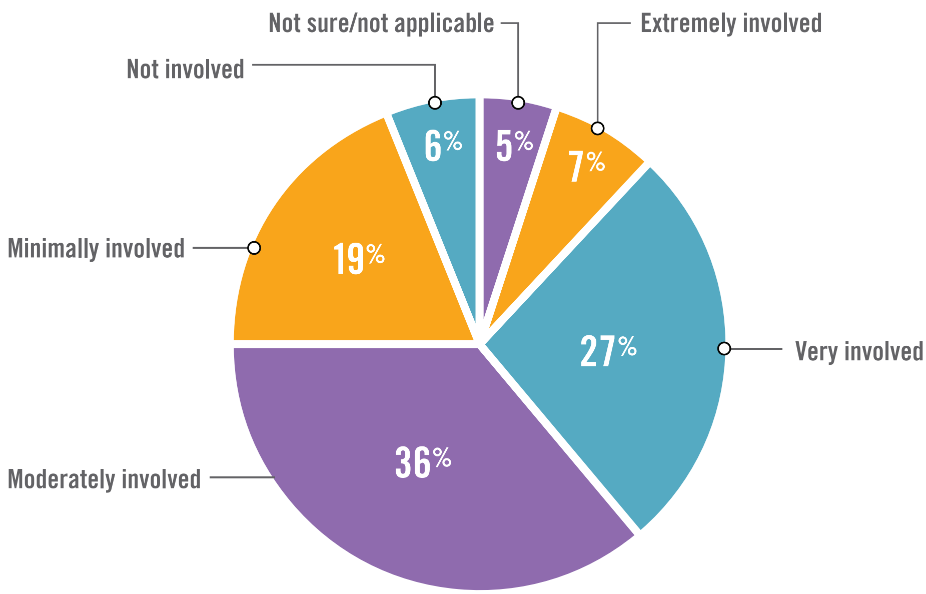


[1] Respondents could also respond not sure/not applicable.

4.1.1 Involvement of Internal Auditors in Enterprisewide Fraud Risk Assessment

An enterprisewide fraud risk assessment can help ensure the risks of fraud are considered holistically and objectively across the organization. Internal audit can be ideally placed to facilitate this process, as consideration of risk should be at the heart of their internal audit planning. The majority of respondents had at least some involvement in enterprisewide fraud risk assessment (89%). Of these, only 34% said they were either extremely or very involved, as shown in ***Figure 2***.

FIGURE 2
Extent of Internal Audit Involvement in Enterprisewide Risk Assessment



4.1.2 Impact of Increased Engagement of Internal Auditors

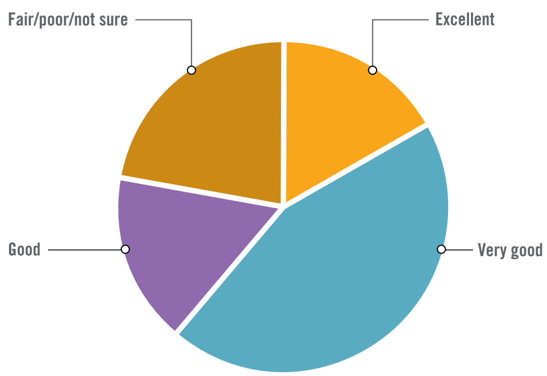
While there are several factors that will impact the effectiveness of a fraud risk management program, according to the data, when internal audit is involved in the strategic management of fraud risk (i.e., the enterprisewide risk assessment), there is a perception that fraud risk management programs are excellent or very good, as shown in ***Figure 3***.

Of the respondents who said that internal audit is extremely involved in enterprisewide risk assessment of fraud risk, 60% felt that the effectiveness of the fraud risk management program was very good or better, with 76% saying it was good or better. For those respondents who were either extremely or very involved, more than 70% felt that the effectiveness was good or better, but the proportion who felt it was very good or better fell to only 31%. For those organizations that had less involvement[2] in enterprisewide risk management, more than half of respondents perceived their fraud risk management as fair or poor.

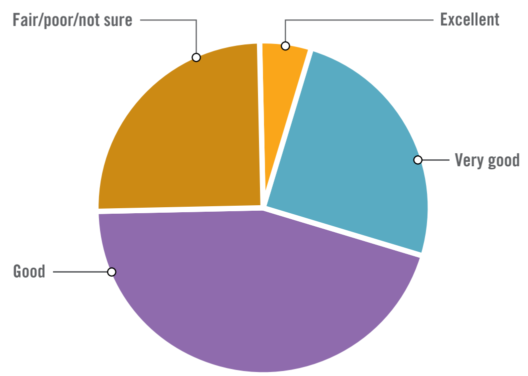
[2] Moderate, minimal, or no involvement

FIGURE 3
Perceived Effectiveness of Fraud Risk Management for Internal Auditors Depending on Their Respective Involvement in Fraud Risk Management

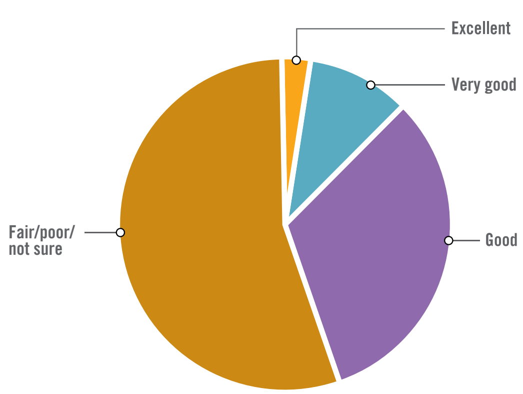
RESPONDENTS WHO WERE EXTREMELY INVOLVED



RESPONDENTS WHO WERE EXTREMELY INVOLVED OR VERY INVOLVED



RESPONDENTS WHO WERE MINIMALLY INVOLVED OR NOT INVOLVED

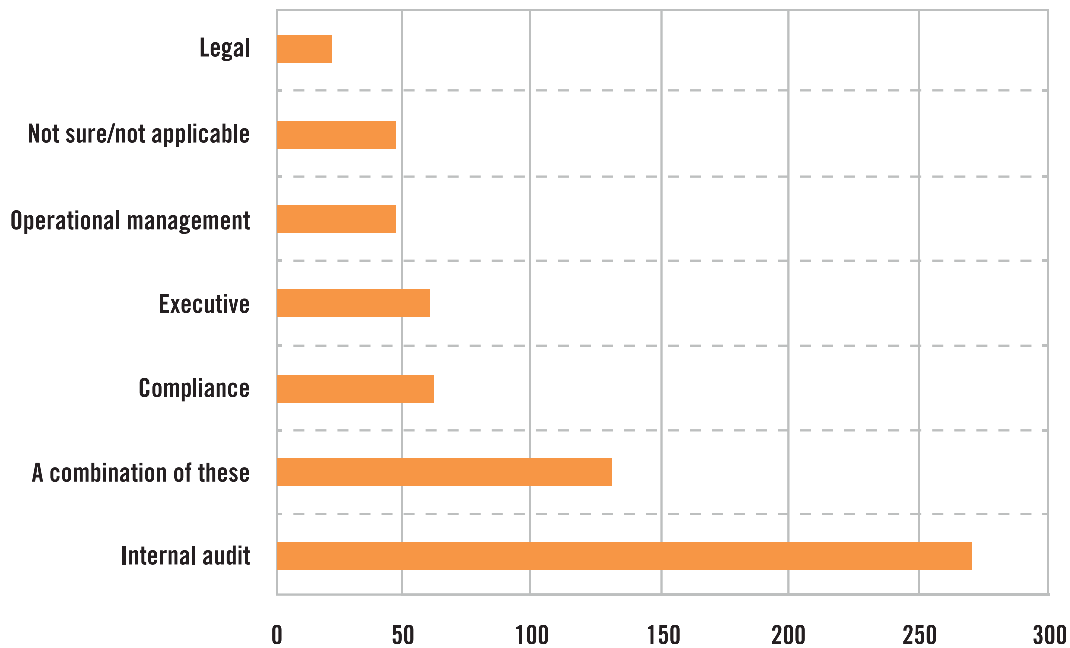


4.2 Responsibility for Fraud Risk Management, Strategic Planning, and Operational Activities

4.2.1 Leadership and Strategic Influence

Internal audit was the most common answer provided in response to the question, “Which team takes the lead in fraud risk management?” A combination of teams was the next most prevalent answer, with risk management and compliance following closely behind, as shown in ***Figure 4***.

FIGURE 4
Survey Responses to “Which Team Takes the Lead in Fraud Risk Management?”



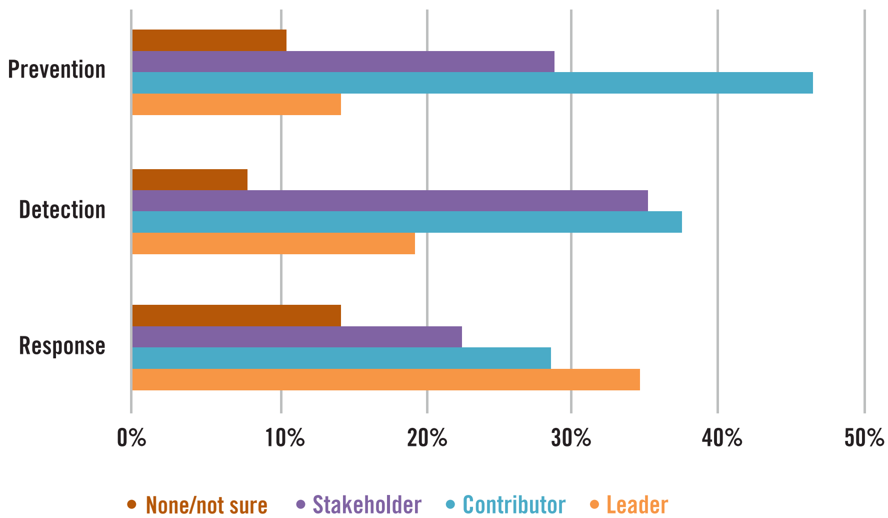
Despite this, approximately 50% of respondents stated that the internal audit team did not contribute or made a limited contribution to a strategic change in the organization, implying a potential mismatch between involving leadership in fraud risk management and driving change in the organization.

4.2.2 Involvement in Operational Activity – Prevention, Detection, and Investigation

Most respondents stated that internal audit was involved in all three thematic areas of fraud risk management. From a leadership perspective, internal audit teams were much more involved in leading investigative activities (34.7%) rather than prevention and detection activities (13.8% and 19.0%, respectively). More than half of the respondents felt that internal audit contributed to or led activities in these three areas. Further details are illustrated in ***Figure 5***. It is important to note that the data does not present a clear pattern of who is leading the various sections.

FIGURE 5

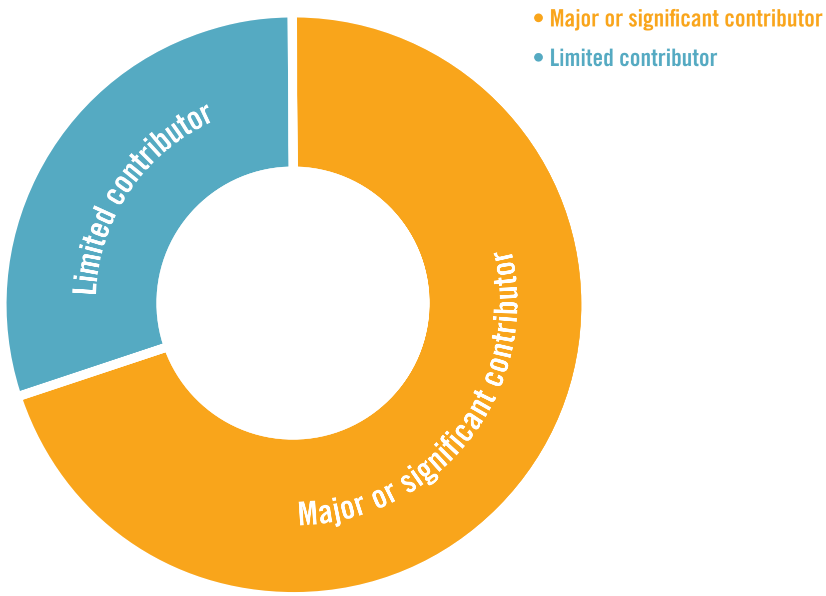
Internal Audit Involvement in Fraud Prevention, Detection, and Investigation



4.2.3 Correlation between Operational Leadership and Contribution to Strategic Direction

Unsurprisingly, those respondents who felt that internal audit took a leadership role in the operational activities of preventing, detecting, or responding to fraud also believed they were significant contributors to the strategic direction within their organizations. Approximately 70% of those who said they had a leadership role in either prevention, detection, or response also said they were significant or major contributors to driving strategic change in their organizations, as shown in ***Figure 6***.

FIGURE 6
Contribution to Strategic Change by Leaders in Fraud Prevention, Detection, and Response



4.2.4 Impact of Leadership in Operational Areas on Fraud Incidences

The data did not present clear conclusions regarding the impact that more focused involvement of internal audit teams had on the incidences of fraud occurring. Respondents who had a more active leadership role in fraud prevention and detection responded that in their organizations, incidences of fraud risk had decreased in the past five years. However, this should be considered in the context of the whole population. Most respondents across the board stated that in their organizations, fraud risks had either stayed the same or increased. This could indicate that fraud is constantly evolving, and fraudsters continuously reinvent new approaches to circumvent internal controls.

4.3 Barriers to Increasing Involvement of Internal Audit

Approximately 20% of respondents did not perceive that there was any barrier to internal audit's involvement in fraud risk management. Of the remaining 80%, a third felt that limited resources was the biggest barrier. Lack of mandate and potential conflict of interest had a similar perception as a barrier, with 23% and 21% respectively citing these areas. Of particular interest, only 11% of respondents felt that they did not have the skills to get more actively involved in fraud risk management.

4.3.1 Barriers for Those with Minimal Involvement

Of the respondents who said that internal audit was not involved in enterprisewide fraud risk management, or those who were minimally involved, the biggest barrier (for approximately one-quarter of relevant respondents) was a lack of mandate, followed by limited resources. This highlights the importance of having clearly defined roles and responsibilities for managing enterprisewide fraud risk, having buy-in from executive management and boards, and ensuring internal audit is well placed to take on a more proactive role in fraud risk management.

4.3.2 Size of Internal Audit Team Relative to Organizational Size

The size of the internal audit team, when compared to the organization's size, can impact the perceived barriers to the internal audit team being more involved in fraud risk management. This is analyzed further in the following section.

4.4 Trends in Investment and Resourcing in Fraud Risk Management

Most respondents (more than 85%) identified that investment in fraud risk management had either stayed the same or increased in recent years, as shown in ***Figure 7***.

FIGURE 7

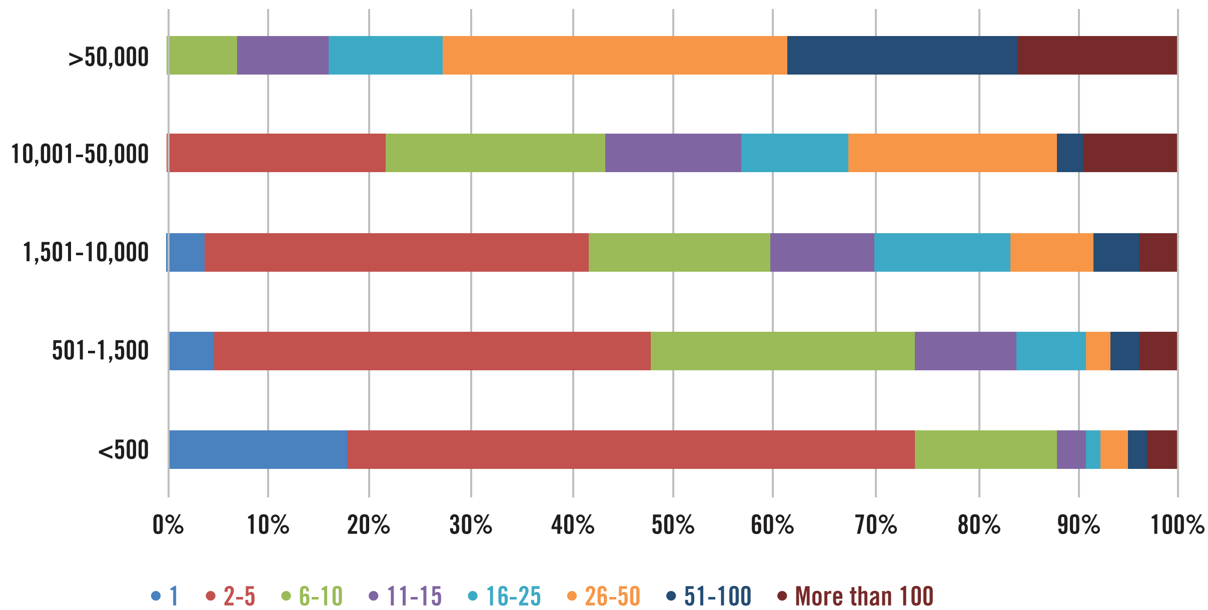
Perception of Investment in Fraud Risk Management in Recent Years

With regard to internal audit teams, respondents highlighted a large disparity in the size of the investment of the team compared to the size of the organization. *Figure 8* summarizes the data on the size of the internal audit team compared to organizational size (by number of employees)[3].

[3] The survey only considers organizational size in terms of number of employees. There may be other measurable indicators that could impact the results, particularly complexity, geographical spread, turnover, profitability, etc.

FIGURE 8

Internal Audit Team Size in Relation to Organizational Size (by Employee Number)



As the chart demonstrates, there is a clear trend toward larger internal audit teams as the size of the organization increases. For the largest organizations in the survey with more than 50,000 staff, 40% of their internal audit teams had more than 50 people, while for organizations with fewer than 500 people, almost 90% had less than 10 in their internal audit team. Notwithstanding variations in complexity and type of organization, having adequate resources to allow internal audit to take a proactive role in fraud risk management, including prevention, detection, and response, along with other significant demands on the time of those individuals, could mean that these important activities are pushed to the bottom of the list. This was also reflected in the data. For those respondents in large organizations who were part of an internal audit team of fewer than 25 people, more than half[4] of the respondents said that having limited resources was the most significant barrier to internal audit having a more active involvement in fraud risk management. Also significant was the skills gap in these smaller teams. Given the increased complexity of the organization, a more diverse and, perhaps, technical set of skills is likely to be required to ensure effective involvement in fraud risk management.

[4] This relates only to the respondents who said there was a barrier to internal audit involvement.

As the size of internal audit teams increases in large organizations, there seems to be a shift in the barriers to greater involvement. It appears that having an internal audit team of between 26 and 50 people is closer to optimal in terms of resources. Although the skill gap was still cited by several respondents of large organizations[5] with internal audit teams of between 26 and 50 people, the majority of respondents in this group did not have any perceived barrier (one-third) or felt that a lack of mandate (26.6%) or skills gap (13%) were the main barriers to internal audit being more involved in fraud risk management. As organizations increase in size, it is important that the mandate for fraud risk management is clearly established.

For medium-sized organizations (with 10,001 to 50,000 employees), the data showed that more than 65% had internal audit teams of fewer than 25 people, with 15% having very large internal audit teams of more than 100 people. For those smaller internal audit teams in medium-sized organizations, lack of resources was cited as the main barrier to internal audit being more involved in fraud risk management, with more than half of respondents with teams of fewer than 10 people citing this as the main reason. For larger teams, lack of mandate and potential compromise of internal audit independence started to feature as a more significant barrier than resource constraints.

For small organizations (fewer than 10,000 people), the majority (86%) had internal audit teams of fewer than 25 people; there were, however, a few respondents (4%) with teams exceeding 100 people. The trend in terms of the main barriers—even for smaller organizations—was a lack of resources for the smaller teams.

[5] Large organization refers to those with more than 50,000 employees.

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2020-0807