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INTERNAL AUDIT – DETERMINANAT FACTOR IN PREVENTING AND DETECTING FRAUD RELATED ACTIVITY TO PUBLIC ENTITIES FINANCIAL ACCOUNTING

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Abstract *The objective of **internal audit** on fraud, identified in the financial and accounting activity in public **entities is to give ensure and guarantee true and fair view of the assets, liabilities and equity, and the financial statements and results**. To provide this guarantee internal audit monitors whether transactions and accounting operations entered correctly reflect the nature of the events that took place and whether they are likely to be distorted. The results of an internal audit mission, must ensure the quality and coherence of the financial accounting system, and to reflect correctly, sincerely and completely the financial accounting transactions from primary accounting documents and financial statements*

Key words:
internal audit, financial and accounting fraud, faithful image, public entity, significant distortions
JEL Codes:
M41, M42

1. Introduction

Internal audit role in improving the financial and accounting activity is to assess whether the activity complies with the regulations and requirements in force and if they operate in accordance with "good practice,, in this field and they ensure effectiveness in achieving objectives. The audit also aims to reduce the risk that internal transactions and operations performed in primary and accounting records of the entity, lead to significant distortions of financial results.

Internal audit performs examinations and assessments on all the components and activities of financial accounting and provides management with information and independent opinions regarding the establishment and efficient and effective use of public resources and public property.

Regarding error and fraud, internal audit is responsible for identifying management's intent or a person within the entity to commit fraud by applying methods and tools specific to audit, investigate the area in which it was conducted and the causes that allowed it to happen. Measures taken include communicating cases of fraud or error found by the entity's management and structures entitled to carry out specific research to these phenomena.

In this context, internal auditors whenever they identify errors or fraud have a responsibility to act in accordance with the requirements of professional standards in this field and to report objectively research results. In the course of their actions, internal auditors must ensure that "*the risk of fraud will not significantly influence opinion and hence the quality of the mission*"[1].

As regards to prevention and detection of fraud linked to financial and accounting in public entities, studies generally describe how to use analytical procedures, which imply a series of mathematical models applied in the internal audit activities[2]. Also, the factors that generate and increase the risk of error or fraud in local public entities are concentrated mainly on the conditions of organizing and functioning of the accounting system and the effectiveness of internal control/ management. Designing and providing with effective internal control/managerial systems within financial accounting activity decrease the probability of financial and accounting records erroneous or fraudulent presentation of financial statements.

In the same context, we underline that any system of internal control attached to financial and accounting activity may prove ineffective if the action of fraud involves management or employees association for having done so.

2. Fraud and error: distinctive factors.

Within the activity of accounting, recording transactions and illegal operations, misstatements in the financial statements or misappropriation of assets may arise from fraud or error**.** The distinguishing factor between fraud and error is the intentional or unintentional actions that result in a distortion of the operations or financial results.

The term "fraud" refers to an intentional action taken by "*one or more individuals among management, employees or third parties, involving the use of deception to obtain an unfair or illegal advantage at the expense of the public entity.*"

In this context, the concept of fraud is characterized by several meanings as follows:

Fraud represents all irregularities and illegal acts committed with intent to deceive[3]*.*

Fraud means any intentional act or omission in connection with the use or presentation of false statements or documents, incorrect or incomplete, including criminal acts[4]*.*

Fraud is an intentional act committed by one or more individuals within the leadership, those charged with governance, employees or third parties, involving the use of deception to obtain an unjust or illegal advantage[5]*.*

Fraud is any illegal acts characterized by forgery, concealment or deception of confidence. These acts do not depend on the threat of violence or physical force. Fraud is committed by individuals and organizations to obtain money, property or services to avoid payment or loss of services, or for personal gain or business[6]*.*

By assigning these meanings to fraud linked to financial and accounting, it is found that the acts committed are vast and found in different areas, like fraud that occurs in any financial transactions or operations if they are not assessed, supervised or approved.

The consequences of fraud may occur through *deliberate presentation of financial operations distorted.* These distortions may occur in the following circumstances[7]:

☞ ***Misstatements arising from fraudulent financial reports,*** *involve changes or intentional omissions of values or information in the financial statements in order to mislead and conceal illegal acts committed.* Fraudulent financial reporting may involve acts of deceit, misinterpretation or intentional omission of events, transactions or operations, and intentional misapplication of accounting principles, etc.

☞ ***Distortions*** *by unlawfully appropriating identifiable assets, assumes false or misleading records or documents in order to hide the lack of stolen assets. In these circumstances fraud can occur due to several ways, including:*

a) manipulating or changing records or documents;
b) distortion of assets, or their stealing;
c) removing or omitting the effects of transactions from records or documents or recording of transactions without substance to beautify financial statements;
d) deliberate misapplication of accounting policies in presenting financial statements that mislead their users.

The term "error" as defined by international auditing standards, refers to an unintentional mistake occurred in financial operations or financial statements**.** Errors are considered *"accidents on recording of transactions and financial operations, and those responsible for their occurrence shouldn't have expected to achieve any personal gain".*

The distinguishing factor between fraud and error ***is given by the action carried out resulting in distortion of transactions and financial operations and their intentional or unintentional nature.*** *In this context, it is unintentional error, whereas fraud is intentional and usually involves deliberate concealment of facts.*

3. Fraud – control and prevention

The standard 1210.A2 states that*"The internal auditor should have sufficient knowledge to identify the indicators of fraud but is not required to have the experience of a person whose primary responsibility is to detect and investigate fraud"*. Considering that the main mechanism for detecting fraud is control, internal auditors' responsibility is to examine and evaluate the efficiency and effectiveness of internal / managerial control. Internal control is a process that aims to track and secure on the objectives set.

4. Decisive factors of fraud related to financial and accounting

To prevent and detect fraud it is necessary to identify the determinants of the risk of fraud that characterized financial and accounting activity, and whose research and analysis will help identify by clues or actions for fraud. In this regard, the determinants of the risk of fraud can be established as a result of controls imposed by management, internal auditors performing tests or analysis of information within or outside entity.

Generally, the conditions leading up to the actions of fraud in accounting activities are:

a) the workplace - employees and management fraud increases under a permissive organizational work environment.
b) pressure on employees - employees may have debts to third parties outside the entity and they

can exert influence on them in order to obtain information or other benefits at the expense of the entity.

c) uncontrolled access to assets - a weak system of internal control / managerial in public entities, there is no set of responsibilities and limits regarding access to information and documents. Meanwhile, in many cases everyone has access to data, information and documents, even if it's not necessary for carrying out the job without subsequently be able to determine who disclosed such information or data illegally.

d) personality traits that work against personal integrity - some employees are impressed by obtaining immediate and undue income or benefits and as such tend to choose the wrong path.

Literature presents determinants of fraud related to financial and accounting activity as a fraud triangle whose characteristics are common to all forms by which fraud can occur.

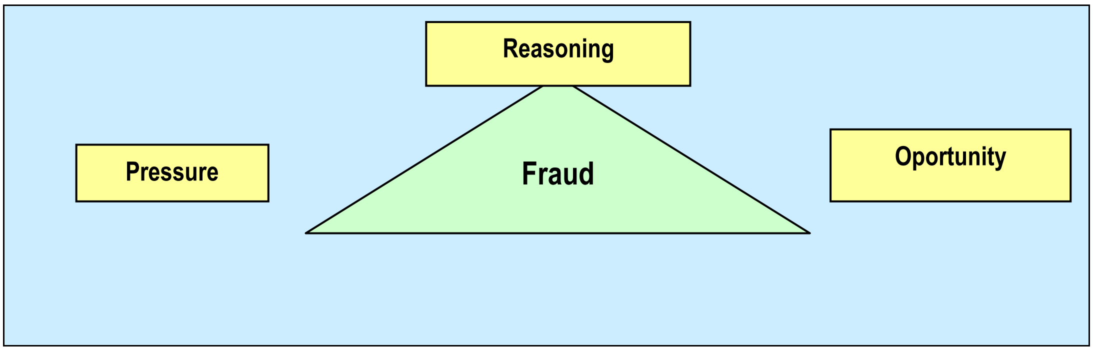


Figure no.1: **Fraud triangle**

(Source: Design suggested by Donald Cressey)

This approach to fraud brings forth only the person performing the fraud, without providing information on factors that have determined financial fraud.

D. Cressey proposed a three-dimensional scaling of the determinants of fraud related to financial and accounting activity, as follows: *opportunities, pressures and reasoning*. This fraud triangle, proposed by Donald Cressey and subsequently adopted in theory and practice by many experts, indicates that the main aspect that leads to fraud in financial and accounting activity is "*breach of trust*" enjoyed by the person performing fraud. To this we add financial difficulties, lack of evaluations on how to achieve the activities and actions, as well as individual creativity when performing fraud, on how to achieve the fraud.

5. Types of fraud associated to financial and accounting activity

From the research, the following types of fraud were emphasized, relating to financial and accounting activity, in public entities:

A. Professional fraud – *involves using personal enrichment in profession through abuse or intentional improper use of resources or entity assets.* Key elements common to this type of fraud are: (1*) professional fraud is covert; (2) contrary to the responsibilities that the perpetrator has towards the entity; (3) is committed to obtain direct or indirect financial benefit for the offender and to the detriment of the entity and (4) employing entity is affected in terms of resources and results.*

Professional fraud associated to financial and accounting activity falls into one of these categories: misappropriation of assets; corruption or fraudulent statement.

In terms of the methods applied in order to prevent and detect this type of fraud, the best methods are focused on receiving information from the entity's staff, customers / suppliers, or third party accidentally discovered.

Most people involved in carrying out the actions of professional fraud are represented by senior civil servants, namely those who generally hold management positions. They are generally at the first deception and have never had problems relating to fraud.

B. Organizational fraud – *include fraudulent financial reporting, fraud controls, theft of goods or assets, abuses or distortions of expense accounts, payroll fraud.* This type of fraud occurs due to the weakening value of the entity, light penalties, low charges, favorable economic conditions and a lack of interest from management in preventing and detecting fraud within the entity. The most common organizational fraud is the misappropriation, which can manifest itself in non-financial embezzlement, fraud registration and realization expenses and financial misappropriation.

6. The relationship between creative accounting and fraud

The importance of compliance control has increased due to the manifestation of a new tendency in the evolution of accounting, namely the emergence of the creative accounting[8]. As shown by the definitions of Naser K. creative accounting reveals that it targets some minuses of the regulatory framework and proceeds to handling accounting figures by choosing those information and measurement practices that enable the transformation of the summaries from what should be to what management wants to be. The author also adds that this accounting is characterized as being the process by which transactions are structured in such a way that may allow implementing a desired accounting result.

Through the research conducted we intend to ***establish the link between fraud and creative accounting to get a response whether it contributes to acts of fraud***.

Regarding ***creative accounting*** specialists in the field give complex opinions. Thus, some experts, namely Bernard Colas believe that "*there is no real result , but the result set using the techniques of creative accounting*"[9], while according to other specialists, namely Kamal Naser, creative accounting, "*is the process that by allowing flaws in the rules, we can manipulate accounting information, taking advantage of the flexibility it chooses those methods of measurement and information that enable the transformation of the summaries from what they should be to what managers want; also is the process by which transactions are structured in such a way as to allow obtaining desired accounting result*. "

In our view, we consider that the legal vacuum in accounting, as well as in other areas represent opportunities for creativity of the specialists. In this sense they "*respect the rules and procedures and record synthetic numbers based on which they develop financial statements*", depending on the entity's situation and aims.

Creative accounting approach is due to the flexibility of the rules, regulations, policies and accounting treatments, which allow for statutory accounting speculation depending on the interests and circumstances in which the entity is.

In these circumstances, *the flexibility of regulations applicable to domain accounts allow skilled in the art to use certain methods and accounting tools to show the real financial situation of the entity*, in which case ***the creativity is used to*** raise the quality of accounting information, or distort the information contained in the financial statements entity and *thus to influence decisions in a certain direction to those who use the information provided by the entity*.

As presented there is a clear distinction between fraud and creative accounting. Thus, the fraud involves a "***willful violation of regulations and accounting principles***" by making illegal or unlawful actions, while creative accounting requires "***adaptation to the specific accounting practices to the development of the entity***."

Also, we mention that ***the goal of creative accounting is to beautify or distort the real financial situation of the entity according to the situation and needs, while the purpose of committing fraud is to get some personal benefits or for others, through misappropriation of assets or of fraudulent financial reports.***

On the other hand, the fraud is the act made in bad faith and in violation of applicable regulations, resulting in illicit material benefits, pressures, opportunities and motivation that cause a person to resort to illegal acts. Creative accounting is still a "*tool for achieving faithful image*", but this picture may be distorted and thus to make the public entity to look more prosperous. In this situation creative accounting may mislead people who have a particular interest in the entity. From this perspective, creative accounting plays a positive role if it complies with the requirement of fidelity or a negative role if it is used for making reports in favor of a limited number of users.

In the opinion of specialists, ***frauds have nothing creative while accounting options have been in practice for a long time and are approved by setters in the field***. Creative accounting occurs because at some point there are no standardized accounting solutions for certain problems.

The person who performs the action of fraud has intellectual capacities, experience, creativity, general culture, but they are used for unlawful purposes or to obtain illicit personal gain for himself or for others. The nature and form of these improper benefits depend on the factors leading to the risk of fraud.

Comparative research between creative accounting and fraud related to financial accounting highlights a number of elements that make them different and that allows that one manifests within law, and one outside the perimeter applicable to law or regulation.

Table no. 1: **The relationship between fraud and analytical accounting**

Item	The criterion for comparison	Fraud	Creative accounting
1	***Legal***	Illegal action	Action within the law
2	***Achievement method***	Falsifies information, documents and data in order to hide the truth	Respects rules and procedures and beautifies figures used for developing financial statements
3	***Role***	Desire to get more by fraud or deceit	Fulfilling the criteria for faithful image
4	***Purpose***	Deceit	Improve the credibility and attract investment funds or other benefits
5	***Cause***	The desire of managers to gain advantage by deception or deceit	Desire to get benefits within the law, to raise funds, assets or other benefits Permissiveness or escaping the law, which leads to grey areas or not regulated by law
6	***Generating factors***	Permissive work environment Pressure on employees Uncontrolled access to assets Personality traits that work against personal integrity	Fiscality; The variety of economic activities; Subsidies and grants; Performance-related pay; low competence of management; times of crisis; insecurity and mistrust; desire for assertion; the interests of users of financial accounting information
7	***Occurrence***	Fraudulent financial reporting and asset theft	Financial reports
8	***Enforcement option***	Ignoring intentional practices, procedures and accounting policies and accounting principles and rules breach in order to mislead	Deliberate choice to apply certain policies or practices by a certain default interest
9	***Consequences***	Economic and financial practices harmful with negative effects on the entity, and the person who commits fraud	the glue between economic reality and faithful image In situations where the application of those policies and practices are made in good faith the possibility exists that professional reasoning to better reflect the reality, while if the situation in which the practice had been constrained by strict regulations will not show a faithful image.
10	***Favorable circumstances***	Employee position within the entity Reliance on employee Inadequate internal control structure Nonexistent internal procedures Complicity Inadequate control of references staff	Accounting flexibility Vacuum or legislative and methodological flaws

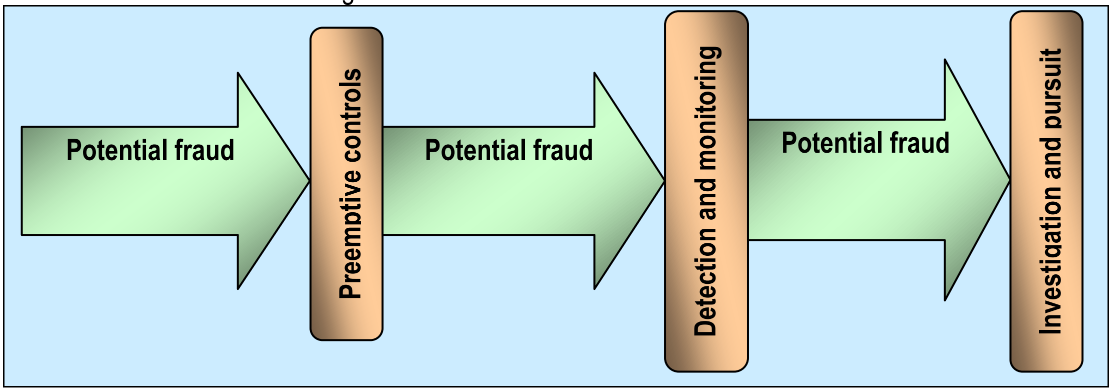
(Source: own projection)

From the analysis of the fulfillment of the criteria of comparison there is a clear distinction between the concept of creative accounting and fraud. Creative accounting cannot be classified as fraud because by the practices used doesn't try to deceit, falsify or mislead, but to maintain and improve the reliability of the entity.

7. Role of Internal Audit in Fraud Prevention

Between frauds, management of the entity and internal audit there is direct link. The management of the entity is responsible for implementing appropriate control measures to prevent and detect errors and fraud, and internal audit by the nature of business is involved in detecting and reporting fraud. At the same time, management is responsible for implementing an adequate control/management system and ongoing monitoring of its functionality, to ensure prevention of errors and fraud.

Figure no. 2: **Fraud Prevention and Detection**



(Source: own projection)

Actions taken by management and internal audit in preventing and detecting fraud are ineffective unless accompanied by an organizational culture based on ethics and transparency to give priority to financial information and internal control effectiveness.

International Auditing Standards state that internal auditors are not required to have experience and specialized expertise to investigate fraud. The role of internal audit is to investigate fraud, but to assess risks and provide a guarantee that the entity has taken sufficient measures regarding internal controls and that risks will not materialize.

In these circumstances, designing and implementing control mechanisms necessary to prevent error and fraud and the development of organizational culture based on ethical behavior is the responsibility of the public entity management. At the same time, internal audit can provide advice, solutions or make proposals to improve control strategies in order to limit the risk of fraud.

Besides the above mentioned, we consider that, in any audit work on the financial and accounting, internal auditors express an assurance about the quality of business operations and asset accounts in the public entity, including the financial statements. Insurance is provided by the existence of documentary evidence, accurate recording of transactions and operations, data accuracy contained and presented by primary documents, and the synthetic ones. To fulfill his duties, an internal auditor must act in accordance with the requirements of the Code of Ethics, approved audit methodology and applicable good practice in the area defined by the International Internal Audit Standards. However it is admitted the idea that in some places financial and accounting activity can be interpreted, in which case the interpretation of the results can lead to distortion and even fraud, unless corrective measures are taken within.

To ensure the limitation of risks and fraud on financial and accounting activity internal auditor shall consider the following:

- ☞ ***Tracking throughout the planning and performance of internal audits of specific elements that can lead to error or fraud.***
- ☞ ***Specific knowledge of organization and functioning of the financial and accounting activity carried out and the factors that influence the error or fraud.***
- ☞ ***Conducting interviews with management, separate from the other objectives set to determine the level of involvement in detecting and removing error or fraud.***
- ☞ ***Plan and perform specific testing procedures to identify errors and fraud.***
- ☞ ***Communication of internal audit results regarding the prevention and detection of fraud and errors.***

Regarding the financial and accounting activity, internal audit role is to reduce the risk that the assets of the entity should be negatively affected and to avoid the financial statements should contain significant misstatements.

To this regard, the internal audit is oriented towards examining if the conceptual framework of accounting is complied with, if the accounting statements and records give a faithful image of patrimony, internal procedures set, as well information provided in the financial statements.

The management of the public entity has the responsibility to ensure that financial and accounting transactions and operations are conducted in accordance with legal provisions and regulations, and mismatches are prevented and detected operatively.

Internal audit objectives relating to knowledge, testing and evaluation of the control system should focus on *assessing the control environment, the accounting and control procedures.*

In our opinion, ***we consider that a robust accounting system and effective internal control can prevent, detect and correct errors or prevent***

fraud. However, no matter how well organized accounting and internal control are, they cannot provide absolute assurance regarding the achievement of objectives, due to limitations in regulations, and risks inherent in sensitive activities characterize the activity of accounting. Lack of internal control or malfunction of its organization *leads in most cases to the appearance of situations in which some employees or management are able to commit fraud.*

In accordance with good practice, internal auditors must exercise within internal audit work a special interest in the phenomenon of fraud and the degree to which the registration of transactions and financial operations is illegal, or the fact that misappropriation of assets or presentation of financial statements misstated may occur in the financial and accounting activity. In many cases, although the internal auditor suspected fraud, the level of detection of this is very low, because (1) of the complex nature of the actions of fraud, (2) the involvement of management of the entity, (3) the falsification of documents, (4) of the false statements made, (5) of the erroneous or deliberate omission to record them (6) association of several people, including management in making fraud (7) aiding or concealing the object defrauded.

The responsibility of the internal auditor in relation to the prevention and detection of fraud linked to financial and accounting activity is to identify, based on research and testing carried out, illegal transactions or operations, misappropriation of assets or misstatements in financial reports, which result in fraud or error.

To this regard,, the actions carried out by the internal auditor in the prevention and detection of fraud and error concern the following [10]: (1) *discussions amongst the audit team of fraud phenomena or the susceptible existence of it; (2) understanding the entity and its environment and on this basis identify and assess risks associated with the phenomenon of fraud: (3) evaluating unusual transactions or financial and non-financial operations, especially those related to the expense; (4) evaluating determinant risk factors; (5) knowing how those responsible for corporate governance and risk assessment accomplish fraud control; (6) discussions with management of the entity on the processes of evaluation and monitoring fraud, ethical norms and behavior and obtaining statements on how to manage the phenomenon of fraud; (7) assessing the accounting policies applied.*

8. Conclusions.

The major role of internal audit in the prevention and detection of fraud is to know and understand schematics and mechanisms by which fraud is manifested that the evaluation and control of the risk of fraud is sufficient and is performed at the right intensity. Internal audit findings should provide assurance on the quality and consistency of financial accounting system, fairness on operations and transactions from primary documents and accounting and sincerity and fidelity of financial statements. The involvement of internal audit in preventing and detecting fraud investigation must take into account all the elements and circumstances related to pressure, encouragement or perception of committing fraud:

The internal auditor considers the existence of risk and detection of errors, significant distortions in primary documents and accounting entries made in the accounts or financial reports produced, throughout the action of internal audit. He, also has to maintain an attitude of professional skepticism, even if aware of the honesty and integrity of management, there is always the possibility that financial and accounting activity conducted presents errors, that the documents are drawn up incorrectly, operations or transactions are recorded incorrectly or assets are misrepresented.

To prevent errors and fraud internal auditors apply risk assessment procedures, in order to analyze: (1) if the risk of fraud is related to recent significant and unusual economic evolutions, requiring special attention; (2) the complexity of transactions and track whether the risk involves significant and unusual transactions or operations; (3) the degree of bias in managing significant risks that may cause errors or fraud; (4) whether the risk involves significant transactions or operations, and its manifestation can lead to discontinuing operations.

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