

## INTERNAL AUDIT IN COUNTERING FRAUD – TRENDS AND PERSPECTIVES

Valeria Dineva<sup>1</sup>  
e-mail: [vdineva@unwe.bg](mailto:vdineva@unwe.bg)

### Abstract

*Many companies have fallen victim to fraud despite having an internal audit function. This paper studies and presents the role of internal audit in countering fraud in theoretical and practical terms. Based on studies of reputable organizations and authors, major trends in the current role of internal audit are highlighted. Opportunities are suggested and perspectives for internal audit are outlined to improve its effectiveness. The use of modern technologies, the application of complex approaches, achieving adequate competence, integrativeness and proactivity in anti-fraud processes are some of the opportunities that would increase the effectiveness and usefulness of internal audit*

**Keywords:** internal audit, fraud, digitalization, frameworks

**JEL:** M42, O33

### Introduction

Fraud is a serious threat to businesses. As a result of fraud, companies suffer financial losses, often accompanied by a loss of reputation. „What we have learned is that occupational fraud is very likely the largest and most costly form of financial crime in the world, with estimated annual costs in trillions of dollars. These crimes are a threat to every type of organization in all industries in every region throughout“ (Association of Certified Fraud Examiners, Inc., 2024, p. 2)

According to the Global Internal Audit Standards, referred to as the Standards for short, the mission of Internal auditing is to strengthen the organization's ability to create, protect, and sustain value by providing the board and management with independent, risk-based, and objective assurance, advice, insight, and foresight.

Internal audit has the potential to play a significant role in countering fraud due to the position it occupies within the organisation and the specific nature of the function it performs. To what extent has internal audit been able to realise this opportunity? What are the likely obstacles it may encounter? What are the chances for internal audit to increase its effectiveness? These answers will be sought in this study.

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<sup>1</sup> Assoc. Prof., PhD, Department of Financial Control, Faculty of Finance and Accounting, University of National and World Economy, Bulgaria

The purpose of this study is to examine and present current trends in the role of internal audit in countering fraud, outlining opportunities and prospects for its improvement.

The author's thesis is that countering fraud is a complex problem that requires complex approaches, complex interactions and complex solutions. Internal audit can be an important component in this complexity, but not as a presence, but as an effectively working function.

In order to achieve the objective, studies of literature sources related to the theory and practice of the subject were carried out. For the purposes of analysis documents and studies of the Institute of Internal Auditors (IIA), Association of Certified Fraud Examiners (ACFE), etc. have been used.

Methods used are: synthesis, comparison and justification, secondary data analysis, comparative-historical method, observation method and the method of system analysis.

The study mainly refers to occupational fraud<sup>2</sup>

### **The role of internal audit in countering fraud**

Internal audit as an independent and objective activity performs certain functions and tasks. The main tasks are related to assessing and improving the effectiveness of risk management, control and governance processes in general. It can be said that these are the three main focuses, which appear as a kind of classic objects of internal audit – risk management, control and overall management of the organization. By assessing each of these, internal audit can provide an assessment of the relevant processes involved in countering fraud. For example, an assessment of the effectiveness of risk management processes would logically include an assessment of fraud risk management. The same applies to the assessment of controls, which should include an assessment of the controls in place against fraud risks. In assessing governance, internal audit must necessarily assess the design, implementation and effectiveness of the organization's ethics-related tasks, programs and activities, as well as the oversight of controls and risk management, including fraud risk, the communication of risk information and control to the relevant parts of the organization, etc.

The new standards of internal audit (Institute of Internal Auditors, 2024), which will enter into force on 9.01.2025, pay attention to fraud, specifying the main requirements for the internal audit function in this context. These requirements can be summarised as follows:

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<sup>2</sup> Occupational fraud: The use of one's occupation for personal enrichment through the deliberate misuse or misapplication of the employing organization's resources or assets (Association of Certified Fraud Examiners, Inc., 2024).

- Internal auditors should develop competencies related to: Pervasive risks, such as fraud (3.1).
- Internal auditors must exercise due professional care by assessing the nature, circumstances, and requirements of the services to be provided, including: Probability of significant errors, fraud, noncompliance, and other risks that might affect objectives, operations, or resources (4.2).
- The internal audit plan must: Consider coverage of information technology governance, fraud risk, the effectiveness of the organization's compliance and ethics programs, and other high-risk areas (9.4).
- Internal auditors must identify the risks to review by: Considering specific risks related to fraud (13.2).

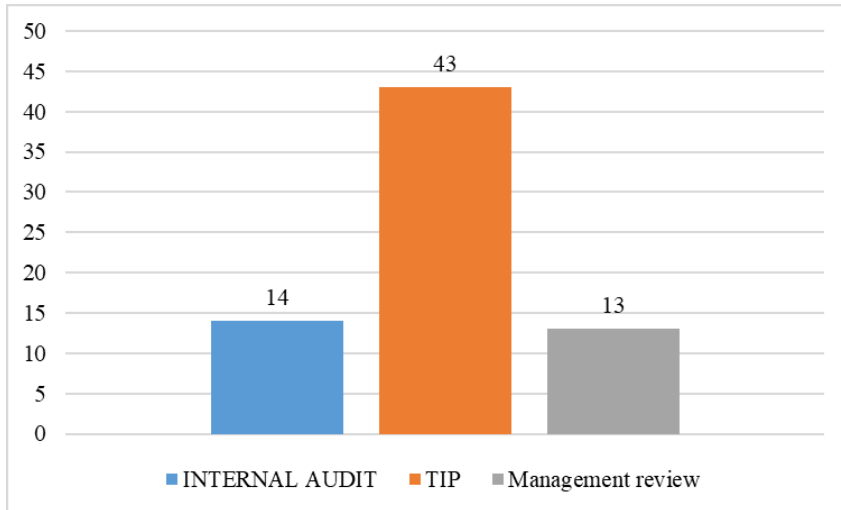
Given the stated requirements, the following conclusions can be drawn:

- In terms of countering fraud, it makes impression that there are not many requirements. The requirements are set in the context of risk in general, while still emphasizing the importance of fraud risk.
- The standards treat fraud risk as material and pervasive.
- The standards require internal auditors to consider the specific risks that are associated with fraud.
- A weakness of the standards is the lack of consistency in the requirements in the context of controls and governance in general. This is because just as internal auditors need to consider the specific risks of fraud, it is also important to assess the general and specific controls associated with fraud risks.

### **Practical aspects of internal audit in countering fraud**

Every year ACFE (Association of Certified Fraud Examiners) conducts an extensive survey. Survey respondents submitted fraud cases (1,921) from 138 different countries and territories that affected private, public, government, and nonprofit organizations in 22 different industry categories. This is the most authoritative study in the field of occupational fraud, based on which a report is issued (Association of Certified Fraud Examiners, Inc., 2024) with the results obtained. For the purposes of the study, some of the results regarding internal auditing will be presented here.

Figure 1 shows that the initial detection of fraud is most often through alerts (43%), 14% is revealed by internal audit, and 13% is revealed by management review.



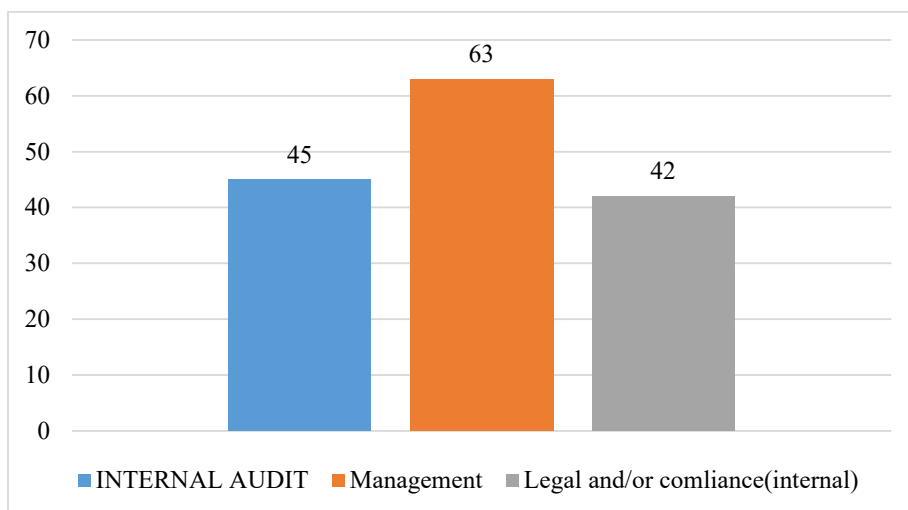
Source: Association of Certified Fraud Examiners, Inc. (2024). The diagram is made by the author

**Figure 1:** How is occupational fraud initially detected?

This result indicates a relatively low, at first glance, disclosure rate from internal audit. This is partly explained by the fact that fraud detection is not the main and primary duty of internal audit. Yet when fraud is present, it is a bad testimonial and a heavy sentence for both managers and internal auditors. What can „exonerate“ internal auditors is if they made recommendations that could have prevented the fraud, but those recommendations were ignored by management. But even in these cases „the bitter taste remains“.

The survey shows that the initial detection of fraud is due to alerts. Alerts are a specific antifraud control that should be the focus of internal auditing. According to the same survey, more than half of tips come from employees (52%). That is why internal audit must approach the assessment of antifraud controls in a complex way by evaluating not only the mechanisms for reporting signals, but the conditions and environment in general, the attitudes of employees, their protection and the preservation of their anonymity.

Figure 2 presents the percentages of those parties that were notified after the fraud was already detected.



*Source:* Association of Certified Fraud Examiners, Inc. (2024). The diagram is made by the author

**Figure 2:** Which parties were alerted to the fraud after it was discovered?

Quite logically, the management is in the first place (63%). In this case, the percentage for internal audit is relatively high (45%). This can be interpreted in two ways. On the one hand, it shows confidence in the internal audit, on the other hand, it confirms the existing opinion about the internal audit as a subsequent control, i.e. it follows the events. It would be good if it also performs preventive control functions, evaluating controls and anticipating possible fraud scenarios. Noteworthy is the percentage for the Compliance function, which is almost at the level of the internal audit. Compliance is a relatively new function that has clearly gained credibility. Internal audit, and the organization as a whole, would do well to collaborate with this function.

The third result, which can be called symptomatic and not at all a nice testimonial for internal audit, is the fact that 80% of the organizations that have been victims of fraud had internal audit functions. This result can be interpreted in two main ways – either internal audit has not been sufficiently effective in its assessments of controls, or its assessments and recommendations have not been taken into account.

For the purposes of this study, one of the most authoritative and interesting studies in the field of internal audit is also of interest, namely „Risk in Focus”, the annual survey of the European Confederation of Institutes of Internal Auditing (ECIIA). It identifies each year the hot areas for internal audit for the following

year. „Risk in focus – 2024“ (ECIIA, 2023) identifies Cybersecurity and data security as the hottest area for 2024. This is identified as the hottest area by internal auditors over the last 3 years. Human capital, diversity, talent management and retention is ranked second for the second year in a row. Fraud, bribery and the criminal exploitation of disruption are ranked 14 out of 16 areas. Below is the rating of this area over the years:

- 2019 5th place out of 10 possible, Anti-bribery & anti-corruption compliance.
- 2020 Anti-bribery & anti-corruption compliance.
- 2021 no survey.
- 2022 Fraud, bribery and the criminal exploitation of disruption 14 (15).
- 2023 Fraud, bribery and the criminal exploitation of disruption 12 (15).
- 2024 Fraud, bribery and the criminal exploitation of disruption 14 (16).

The conclusion that can be drawn is that fraud is undoubtedly identified by internal auditors as a hot area, although not at the top. According to the survey, this trend in position is expected to continue over the next three years. This trend hardly means that internal audit underestimates the fight against fraud. Rather, there are really pressing priorities, such as cyber security and human resources. In these priorities, a comprehensive solution can be applied, looking also at the fraud angle. E.g. HR Audit may also include an assessment of anti-fraud controls. When it comes to fraud, the human factor is central. It is this thesis that is explored and presented by Miroslava Peycheva in the book „Knowing fraud is in favour of managers and human resources auditors“ (Peycheva, 2017). Another possibility is that cyber audits (Bankova, 2020) include fraud in the scope especially in its technological aspect.

According to a study in Benelux, conducted in 2024, „Still most fraud is committed by own employees. 56% of companies and organisations experienced internal fraud (attempts)“, (Allianz Trade Benelux, 2024).

In the report to the Nations, very interesting results are presented, namely almost half of perpetrators (45%) did experience one of human resources-related red flags, with poor performance evaluations (14%), fear of job loss (12%), and being denied a raise or promotion (11%) cited as the most common (Association of Certified Fraud Examiners, 2024, p. 67). It can be added here that „Controls are often ignored and an aggressive policy is implemented, whether in the form of internal or external pressure“ (Bankova, 2017).

All the mentioned results show that due to the huge importance of the human factor, it is necessary for the internal audit to expand the field of assessment by including elements of the human resources audit (Peycheva, 2015), including also in the context of combating fraud. A broader view of the organizational culture, of the overall control environment, is needed. At the same time, it is important to evaluate soft controls related to employee satisfaction, their motivation,

attitudes, etc. Motivation is an important aspect in countering fraud. That is why internal auditors should encourage the application of various methods for its study (Peycheva, 2009). This confirms the need to apply integrated and complex approaches covering a wide range of processes, functions, values, people.

### **Opportunities and perspectives for internal audit in countering fraud**

Opportunities to improve the role of internal audit can be sought in several directions:

- Ensure the independence of internal audit to be able to report fraud risks without fear or embarrassment, and findings of missing or weak controls to mitigate them and this reporting should be at the highest management level.
- Strengthen and develop its own potential by continuously increasing the competence of internal auditors in the field of anti-fraud, both at individual and collective level. Given the growing digitization, it will also be imperative to develop competences in the field of technology.
- Improve audit methodology.

There is a need for systematic, integrated approaches that cover all fraud-sensitive processes, structural units, functions, job positions, etc., e.g. ethics, organisational culture, risk management, human resources management, the organisation's security system, etc. The application of a systematic approach and the use of models is important in countering fraud as „Implementing anti-fraud activities is much more than establishing whistleblowing; it must include effective monitoring of operations, effective internal audit, continuous risk analysis, and follow-up to unusual results.“ (Rittenberg, Miller, 2005, p. 9).

In its work, internal audit needs to follow the guidelines and positions of The Institute of Internal Auditors (IIA) related to anti-fraud. It is also advisable to use models and frameworks that may be specific and/or general complex (Peycheva, et al., 2018, pp. 81-121). As examples of a specific type of frameworks can be mentioned the „Fraud Triangle“ by Donald R. Cressey (Martin and Petro, 2007, pp. 41-45); 3D Fraud Risk Assessment Model (Dinev's SMARTGuide), (Dinev, 2012), the fraud models of W. Steve Albrecht (Dinev, 2012, p. 41), the 3C model (Dinev, 2012), Miroslava Peicheva's models for fraud in the field of human resources. To the general frameworks can be referred internal control and risk management frameworks that have a focus on fraud, such as the COSO-integrated framework for internal control, (COSO, 2013), COBIT (Control Objectives for Information and Related Technology, COBITRisk Assessment). Mihail Dinev's concept of control over the qualities of the system, as well as his overall control theory, can also be recommended to the general frameworks (Dinev, 2015).

- Internal audit can play a unifying and encouraging role in countering fraud. It represents the third line of defence (Institute of Internal Auditors, 2020) in the risk management and control system. In this role, it has the task of evaluating the first line of defence (management, internal control) and the second line of defence (monitoring and control functions such as financial control, risk management, compliance, quality control, etc.). In this way, internal audit can promote synergies between all these functions and the construction of a „united front“ against fraud. Interaction with the Compliance and Risk Management functions is particularly useful. Internal audit should promote the enforcement of a common anti-fraud programme involving all employees and managers with the clear understanding and commitment of senior management. „A fraud risk management program will not be successful without management first understanding the inherent fraud risks the organization faces“ (Anderson et al., 2017, p. 463).

Perspectives of internal auditing in anti-fraud stem from general perspectives of internal auditing. It is expected that the internal audit will undergo a significant transformation, mostly under the influence of increasing digitalization (Dineva, 2022). Advances in technology will certainly assist auditors in combating fraud. Artificial intelligence, data analysis, drones contribute to a more reliable audit methodology, incl. comprehensive sampling, more accurate analysis and forecasting. In support of this are the examples that follow. Looking at the benefits of chatbots, Lyuben Boyanov emphasizes that they can „help detect and prevent fraud by analyzing large amounts of text data for signs of suspicious activity“ (Boyanov, 2024).

One way internal auditors can use machine learning is to detect anomalies and identify emerging risks. For example, auditors have used the technology to detect irregular financial transactions and patterns of management fraud (Chan and Kim, 2020). Research results of scientists from the University of Chicago indicate that GPT-4 will change the future of financial analysis (Karashanova, 2020), according to Justin Offen, Principal, PwC US „Transaction monitoring solutions utilizing sophisticated algorithms and machine learning techniques can detect suspicious activities and patterns, helping to mitigate the risk of overbilling, kickbacks and collusion. Graph analytics can bolster the analysis by visualizing complex relationships between suppliers, employees and third parties.“ (PwC Research, 2024).

**In conclusion**, it can be summarized that modern technologies can improve the process of combating fraud. It should be borne in mind that they are a means, not a panacea. Anti-fraud is a complicated, responsible and complex process, requiring the participation of different people and functions. This process is influenced by many factors, among which are technologies, the effectiveness of



the internal control system, the risk management system, the company culture, tone at the top. Internal auditing is also an important factor. In order to support the fight against fraud, it must be independent and continuously improve, adapting to modern conditions. Digitization is changing the world, changing business. Fraud will also change. This will require strong integrative management and control systems, incl. internal audit. Internal audit also needs to change. In this process of change, leadership is essential „We lead our profession in the use of technology and will continue to update our audit approach...” (Sawyer et al., 2003, p. 868).

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