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Effect of Internal Audit on Prevention of Frauds, Errors and Irregularities in Corporate Organization

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Abstract

It is not possible for organizational activities to be 100% error free; likewise, the incidence of fraud is currently common in our society. This paper examines the role of internal audit in controlling errors, irregularities and fraud in corporate organizations. The various types of errors, irregularities, frauds as well as the problems of internal audit are discussed. Questionnaires were used to collect data from respondents. Questionnaires were distributed to 150 organizations in South West of Birmingham of which 106 returned the questionnaires. 5-Point Likert Rating was used to analyze the findings. The study revealed that the existence of internal audit department in a business organization is a good tool of corporate control of errors, irregularities and fraud.

Keywords: Fraud, errors, irregularities, internal audit, organization, misrepresentation, management.

1.0 Introduction

The existence of internal audit in any organization is a means of controlling the incidence of errors, irregularities and frauds. Fraud is an intentional distortion of facts and figures; According to Howard (2002), the major role and responsibility of internal auditors is prevention and detection of fraud.

Error is defined by Awe (2005) as unintentional mistakes in financial statements whether of a mathematical or clerical nature or whether in the application of accounting principles or whether due to oversight or misinterpretation of the relevant facts. Errors must be reduced to the barest minimum so as not to render the financial statement meaningless.

The issue of fraud has become a serious food for thought for many corporate bodies nowadays. (Robertson and Louwers (2002): stated that fraud consists of knowingly making material misrepresentations of facts with the intent of inducing someone to believe the falsehood and act upon it and, thus, suffer a loss or damage. This definition encompasses all the ways people can lie, cheat, steal and dupe other people. It is therefore very important for business organization to have a separate department, which is referred to as the Internal Audit department to keep watch and monitor the activities in the system. Oseni (1994) and Lav (2004) stated that internal audit plays a vital role in enhancing corporate performance in organizations.

1.1 Statement of the problem

Despite the existence of internal audit departments in business organizations, there are still cases of errors and fraudulent activities in organizations. Fraud is regularly reported in national newspapers.

1.2 Objectives of the study

The objectives of this paper are to assess the types of fraud which often occur in business organizations and to determine the impact of internal audit on control of errors irregularities and Frauds in business organizations.

2.0 Materials and Methods

Fraud can be seen as the intentional misrepresentation, concealment, or omission of the truth for the purpose of deception/manipulation to the financial detriment of an individual or an organization which also includes embezzlement, theft or any attempt to steal or unlawfully obtain, misuse or harm the asset of the organization (Bostley and Drover,2005).

Fraud is defined according to Millichamp (2000) as irregularities involving the use of criminal deception to obtain an unjust or illegal adventure. The Institute of Internal Auditor (IIA) (2001) defines fraud as “an array of irregularities and illegal acts characterized by intentional deception”. Robertson (2000) defines fraud “all means that human ingenuity can device and which are resorted to by an individual to get an advantage over another by false suggestions or suppressions of truth. Connelley (2003) stated that all definition of fraud have one thing in common - an element of dishonesty or deceit. Epstein & Geiger (1994), in his own view stated that though fraud occurs throughout the whole world, it is of special concern in developing countries.

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An error is different from fraud because there is no intention to make mistake deliberately but fraud involve an intention to distort facts and figures and a hidden motive to benefit from such. Lav (2004) view internal auditing as an independent, objective assurance and consulting activity which add value and improve an organization's operations. It helps an organization accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control, and governance processes. According to Oremade (1987) the risk of not detecting material misstatement resulting from fraud is greater than the risk of not detecting a material misstatement resulting from error, because fraud usually involves acts designed to conceal, such as collusion, forgery and deliberate failure to record transactions.

2.1 Types of Fraud

Altman and Hotchikiss (2006) stated that the types of fraud are: manipulation, falsification (including forgery), or alteration of accounting records or supporting documentation from which the financial statements are prepared.

Intentional misapplication of accounting principles relating to amounts, classification, manner of presentation or disclosure recording fictitious journal entries particularly close to the end of an accounting period, to manipulate operating results or achieve other objectives (Robertson 2000)

2.2 Types of error

The following types of error can be identified: error of omission, error of commission, error of duplication, misapplication of accounting policies, error in the interpretation of facts and compensating errors (Olatunji, Dada and Bankole (2002)

2.3 Internal Audit

According to Katz (2002) Internal audit independently reviews and evaluates the adequacy of the system of internal controls and makes recommendations to management to improve these controls. Young (2005) categorizes these controls into administrative and accounting controls. Administrative controls are the controls designed to promote operational efficiency, effectiveness and adherence to organizations' policies and procedures. Accounting controls are very important in safeguarding the organization's assets and ensure the accuracy of financial records internal audit department monitors the continuing validity of management control systems and effective compliance. The internal auditor is an employee of the organization and he acts as agent of the management for ensuring effective working of internal control system. Internal audit can be seen as the eye of the board or top management within the organization.

Internal audit is a review of operations and records; sometime continuous undertaking within a business organization so as to prevent errors, irregularities and frauds. Internal audit is defined by (Millichamp, 2002) as an independent appraisal function within an organization for the review of system of control and the quality of performance as a service to the organization. (Taylor and Perry's 1976) also define Internal Audit as a review of operations and records, sometimes continuous, undertaken within a business by especially assigned staff. Lav (2004) stated that the internal audit provides an independent and objective appraisal of activity is for the management.

2.4 Functions of Internal Auditor in corporate control of errors, irregularities and frauds

The internal auditor is the eyes of the management and ensures that the policy of the organization is strictly adhered to, to ascertain that there is proper authority for the acquisition or disposal of asset, to analyze and improve the system of internal check and also to ensure that there is compliance with the system of internal control in the organization. (Olatunji, Dada and Bankole 2000)

2.5 Qualities of Internal Auditor

An internal auditor is the eye of the board and the management. Therefore, he must be a man of high integrity, self-disciplined, independent and very objective. Olatunji, Dada and Bankole (2002) state that an auditor is a person who can avoid overzealousness, who brings wealthy, cautions skepticism to explanation advanced and who embraces thoroughness in any investigation undertaken. Internal auditor should have constructive ability, should be tactful and have analytical mind to analyze situations and come out with unbiased conclusion.

2.6 Problems of an internal auditor

Independence is an important principle in auditing. An external auditor is more independent than an internal auditor; the major problem of an internal auditor is the issue of independence. Olorode (2004) stated that the independence of an auditor is a cornerstone for the quality of his performance; however, it is practically difficult for an internal auditor to possess any reasonable degree of independence in mind and attitude because of the management influence on him in terms of reference and scope of work. Internal auditor is employed as an agent of the management for ensuring effective working of internal control system, so it is difficult to be 100% independent of his employer. As employees of the organization, the ability of internal auditors to exercise true objectivity has also been questioned.

Another problem is provision of necessary resources, some organizations fails to provide adequate resources in terms of material and human for effective performance of Internal Auditors' performance. Likewise when there is management override i.e. where the management abuse the authority conferred on them and acts at a variance to the established controls procedures in the system.

The questionnaire method was used for the study, the types of issues highlighted in the questionnaire include alteration of invoices, double payment of invoices, suppression of credit notes received, payment of ghost workers, and deliberate error on wage sheet misappropriation of cash takings, inflation of invoices and pilfering of stock items. Also the questionnaire contained issues on the various types of accounting errors that could arise in the organizations. The questionnaire was distributed to 150 organizations in South Western Birmingham out of which 106 returned the questionnaire. The data collected were analyzed using 5- point Likert rating.

3.0 Result and Discussion

3.1 Results

Table 1 shows the various types of irregularities identified by the organizations used for the study. The table shows the rating indices for alteration of invoices (1.49), double payment of invoices (1.16) suppression of credits notes received (1.24), payment to ghost workers (1.80) deliberate errors on wage sheet (1.75) and misappropriation of cash taking (1.90) which indicates that they seldom occurred. This desirable findings was due to the positive impact of the existence of internal audit. However, teeming and lading and pilfering of stock items shows slightly higher rating of 3.14 and 3.16 respectively. This still revealed that these two fraud or irregularities occur less often.

Table 2 shows the occurrence of errors. The rating indices for errors of omission, errors of commission, errors of original, errors of principles and compensating errors are 1.29, 1.32, 1.34, 1.92 aqnd 1.16 respectively. This indicates that these errors seldom occur in the organizations. Some explanations given in the questionnaire indicated that the low level of accounting error was due to good accounting personnel in the organizations complemented by good internal audit unit

The study sought to know the impact of the existence of internal audit department in the organizations used for the study on the control of fraud irregularities and errors. The result as shown in table 3 revealed the rating indices for fraud and irregularities (4.49) and errors (4.54). This is a desirable result which indicates that the existence of an internal audit department has positive impact in the control of fraud and irregularities in most organizations.

4.0 Conclusion

Internal audit is established to control and monitor the activities of a business organization and to control the occurrence of errors irregularities and frauds. An effective internal audit department has a positive effect on the curbing of incidence of errors and frauds in any organization. Though there are some problem which may render the existence of internal audit to be ineffective as it is expected to be, but a business organization that has no internal audit has greater exposure to fraudulent activities. Such organization would not have any check against error and fraud. It is expected of any organization to have a very effective internal audit department.

The following suggestions and recommendation are necessary for the smooth running of the operations and for the adherence to the laid down policy of business organization:

- Every organization should endeavor to have an internal Audit unit so that fraud and errors could be reduced to the barest minimum
- Efforts should be made by every organization to institute good control to eliminate teeming and lading and pilfering of stock which occur often in many organizations

- An experienced accountant of high integrity, preferably a professional Accountant, should head the internal audit department, though this depends on the size of the organization

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Appendix

Table 1: Occurrence of Fraud and Irregularities

Types of Fraud/Irregularity		5 Very Often	4 Often	3 Less often	2 Seldom	1 Rarely	Total Response	Weighted Score	Rx
Alteration of Invoices		2(10)	7(28)	9(27)	5(10)	83(83)	106	156	1.49
Double payment of Invoices		1(5)	-	3(9)	7(14)	95(95)	106	123	1.16.
Suppression of Credit Notes Received		1(5)	4(16)	3(9)	-	98(98)	106	128	1.21
Payment to Ghost Workers		9(45)	7(28)	4(12)	20(40)	66(66)	106	191	1.80
Deliberate Error on wage Sheet		11(55)	5(20)	8(24)	3(6)	81(81)	106	186	1.75
Misappropriation of Cash takings		7(35)	9(36)	4(12)	32(64)	54(54)	106	201	1.90
Inflation of Invoices		13(65)	11(44)	23(69)	25(50)	34(34)	106	262	2.47
Teeming and Lading in cash office		20(100)	20(80)	21(63)	40(80)	5(5)	106	333	3.14
Pilfering of Stock item		11(55)	17(68)	61(183)	12(24)	5(5)	106	216	3.16

NOTE: RATING			
	1	-Rarely	Mean Score = 3 + 1.5811
	2	-Seldom	High = 4.581
	3	-Less Often	Average = 3.0000

4 -Often Low = 1.4189
5 -Very Often
Rx = Rating Index (Weighted Average)

Table 2: Occurrence of Errors

Types of Errors	5 Very Often	4 Often	3 Less often	2 Seldom	1 Rarely	Total Response	Weighted Score	Rx
Errors of Omission	-	3(12)	8(24)	6(12)	89(89)	106	137	1.29
Error of Commission	1(5)	4(16)	3(9)	1(2)	97(97)	106	129	1.22
Error of Original Entry	2(5)	7(28)	5(15)	3(6)	89(89)	106	143	1.34
Errors of Principle	10(45)	11(44)	4(12)	20(40)	62(62)	106	203	1.92
Compensating	Errors	-	-	7(21)	3(6)	96(96)	106	123
1.16								

NOTE: rating
1 -Rarely Mean Score = 3+ 1.5811
2 - Seldom High = 4.5810
3 - Less Often Average = 3.0000
4 - Often Low = 1.4189
5 - Very Often
Rx = Rating Index (Weighted Average)

Table 3: Impact of Internal Audit on the Control of Fraud, Irregularities and Errors

Types of Errors	5 High Psitive Impact	4 Positive Impact	3 No impact	2 Negative Impact	1 High Negative Impact	Total Response	weighted score	Rx
Fraud and Irregularities	51(255)	26(104)	39(117)	-	-	106	476	4.49
Errors	67(335)	12(48)	13(39)	1(2)	-	93	423	4.54
Fraud and Irregularities	51(255)	26(104)	3(117)	-	-	106	476	4.49
Errors	67(335)	12(48)	13(39)	1(2)	-	93	423	4.54

NOTE: RATING 1 High Negative Impact Mean Score = 3+1.5811

2 -Negative Impact High = 4.5811
3 -No Impact Average = 3.0000
4 -Positive Impact Low = 4189
5 -High Positive Impact