

## ENHANCING ASSETS' PROTECTION THROUGH AN ADEQUATE MONITORING OF INTERNAL CONTROL SYSTEM BY INTERNAL AUDIT

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*The assets are established into a company as very important and strategic resources that are contributing at the creation of the needed premises to conduct the daily-basis activity and also to reach present and future planned objectives. Recent studies like COSO's Fraudulent Financial Reporting 1998-2007 have highlighted an increasing fraudulent activity against assets therefore the efforts of fighting against fraud must be supplemented in order to preserve the existence and value of those resources. Internal controls are processes implemented in order to give a reasonable assurance that the company will not become a fraud victim. Even so, a lot of internal controls are paying a heavy tribute to their lack of efficiency and update. Thus, for a correct functioning, internal controls must be monitored and assessed permanently in order to preserve their strength and ability to fulfill their mission. This approach will deliver more added value because rather than being corrected after they have already occurred, the frauds related with the assets will be prevented, detected and reported at a timely moment, thereby the incidence and value of those criminal activities will decrease significantly. Furthermore, because not only the process of monitoring is important but even the entity conducting this activity we believe that internal audit is the most appropriate to undertake this responsibility. Thus, through this material we opened a discussion about how important permanent monitored and updated internal controls are in order to assure a proper assets protection and why internal audit, rather than the management, should be the most eligible to undertake this responsibility. Also we provided some suggestions regarding the main activities that must be taken into consideration by an internal audit professional when is being involved in a monitoring process of internal control system. We do believe that this paper will be the starting point for new discussions about the future activities and resources that must be invested in order to assure that internal audit's independence, objectiveness and professionalism will deliver a proper degree of security against frauds.*

*Keywords: internal audit, monitoring, internal control, assets, fraud*

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### **Introduction**

Because of the current difficult economic circumstances caused by the global recession, the assets are becoming scarce considering the fact that sometimes are more expensive to purchase and much difficult to be obtained and/or replaced. Unfortunately, preserving the value and the existence of the assets often involves fighting against fraud or conducting activities to prevent fraud from occurring. Those activities are neither cheap nor a downhill job, on contrary sometimes undertaking such a responsibility might look like as a preparation for a Sisyphus's work. Therefore a well-balanced management and an efficient control of the assets is imperative to assure the capability of the company to operate not only in near but also in the remote future.

In order to fulfill its mission, internal audit will have to develop new and efficient ways to fight effectively against fraud and preserve the value and existence of company's assets. One starting point could be the assessment and monitoring of internal control system, an activity meant to give assurance that internal controls are in place and are not deteriorated.

### **Previous Studies in the literature**

The internal control system is necessary to provide a reasonable assurance regarding the company's capacity to achieve its objectives. Nevertheless, a function more independent and objective must be implemented in order to provide a satisfactory level of safety and surveillance of the already existing control system. Thus internal audit adds value through improving the control and monitoring environment within organizations to detect fraud (Coram, Ferguson and Moroney 2006: 2).

Because of its key role in corporate governance new challenges are arising related with the potential of internal audit to assure an adequate assets protection and to detect, prevent and deter fraud in comparison with the solution provided by the outsourcing of this activity.

Some scholars found out that financial statements users do not perceive a difference between internal audit insourcing and outsourcing (Lowe, Geiger and Pany 2001: 4) while others stated that companies that outsource believe that an external provider is technically more competent (Carey, Subramanian and Ching 2006: 5). Even so, it is recommended not to exclude totally the internal audit function in the benefit of outsourcing. A good advice is to strengthen the internal audit or to use a partial insourced audit because there is a significant positive relation between an organization having an internal audit function and the number of value of self-reported frauds. For those organizations with internal audit, partial or full insourcing increased the likelihood of fraud detection when compared with organizations that outsource the entire function (Coram, Ferguson, Moroney 2006: 3).

It is obvious that internal audit is imperative to assure that the company will operate properly but in the same time the quality of internal audit and its ability to reach its objectives are close related with the quality of internal control system. Thereby, the viability of internal control system must be assessed, tested and monitored permanently in order to identify and change the obsolete components with new and genuine internal control procedures that are delivering the expected results.

### **Methodology**

Through this paper we intend to propose a discussion on the theme of how important the activity of monitoring the internal control system through internal audit is in order to assure a proper assets' protection. First we will circumscribe the relation between internal control and internal audit and also explain why, in our opinion, internal audit should be the first choice to be considered when deciding whom is going to monitor the internal control system. Furthermore we will provide an insight regarding the nature and evolution of the main fraud techniques used against assets in accordance with the information from COSO's 1987-1997 and 1998-2007 Fraudulent Financial Reporting. Nevertheless, based on the suggestions from COSO's Guidance on Monitoring Internal Control Systems issued in 2009 and our previous research, we will provide some ideas regarding the main activities that should be considered by an internal auditor when deciding to monitor the internal control system within a company.

### **The role, importance and the relation between internal control and internal audit**

The vast majority of the companies have already implemented internal control systems and still cases of misappropriation of the assets are discovered each year. Therefore, a question arise if the internal controls are indeed effective activities providing a reasonable assurance regarding companies' potential to reach their objectives or if companies can get "clean" attestations on their internal controls without in fact having effective control structures, much the same way companies like Kimm or WorldCom could get "clean" opinions on financial statements that turned out to have glaring errors (Locatelli 2004: 13).

During the years, internal control has gradually evolved from traditional meaning of an activity of verifying and inspecting a certain objective to a modern sense of: to master, to govern, to lead (Lenghel, Popa, Oprean: 11). Therefore for all members of a company is very important to have guidelines in order to understand the importance and the way an efficient internal control system should be accomplished. Thus organizations like COSO (The Committee of Sponsoring Organizations of the Treadway Commission) play a very important role in providing to executive management and governance entities on critical aspects of organizational governance, business ethics, internal control, enterprise risk management, fraud, and financial reporting.

According with COSO, internal control is a process effected by an organization's structure, work and authority flows, people and management information systems, designed to help the organization accomplish specific goals or objectives. Thus, internal control should yield the premises to optimize the allocation and usage of resources through an efficient management, to assure the assets' security, to survey the way the laws and regulations are being respected, to supervise the implementation of an accounting system in agreement with regulation, to prevent and identify frauds and nevertheless to produce, organize and provide relevant and useful information at timely moment.

COSO's internal controls pattern is build considering 5 components: control environment, risk assessment, control activities, information and communication and monitoring.

Even if is the last one listed, monitoring is essential in order to design and implement a genuine internal control system able to satisfy the existing requirements. Truth is that unmonitored internal controls tend to become anachronistic over time because are not updated, revised and implicitly connected to the existing circumstances and activities conducted within the company. An appropriate monitoring will enhance the chances to identify and correct internal control deficiencies on a timely basis, addressing them in a proactive, rather than reactive manner and also it will produce more accurate and reliable information.

Internal controls are critical but their performance and quality must be monitored and assessed by an entity more independent and objective. As a natural consequence, internal audit, a superior level of examination and surveillance must be developed. According to the definition provided by IIA (The Institute of Internal Auditors) internal auditing is an independent, objective assurance and consulting activity designed to 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. From the definition issued by IIA it is obvious that internal audit is close related with internal control and in one stage internal control becomes the object of an internal audit.

Nevertheless, internal audit depends of the quality and the way internal controls are being respected and conducted in the company because when it comes to start an internal audit, the auditor has 2 main choices: either to test and verify directly a large amount of transactions and operations, which could be very costly and time consuming, or to assess the potential of internal control system and according to that to decrease the work volume. If this is the case, internal auditing can rely on the controls to reduce the amount of direct testing it would otherwise be required to perform (Locatelli 2004: 14). In addition, because of the increasing size of the operations of a business it became increasingly difficult for auditors to efficiently rely only on direct and substantive testing. As a result, understanding and defying internal controls look on increasingly greater importance (Locatelli 2004: 14).

Therefore internal audit must be directly involved in the activity of assessing and monitoring internal controls because an efficient internal control system has a positive impact on internal audit's work.

## **The number and nature of frauds related with assets**

The cases of frauds related with assets have increased, according to COSO's Fraudulent Financial Reporting, from the period of 1987-1997 to 1998-2007. Thereby, from 1987 to 1997 the overstatement of the assets (excluding accounts receivable overstatements due to revenue fraud) was noticed in half of the 204 sample companies. At the same chapter, at the end of 2007 an increase was recorded, with 51% of the 347 selected companies. Also, a growth was identified considering only the overstating of existing assets or capitalizing the expenses. Thus in 2007 this fraud technique was used in 46% of the fraud related companies while at the end of 1997 only 43% of the companies using fraud had this problem. Nevertheless, the occurrence of misappropriated assets rose with 2%, from 12% at the end of 1997 to 14% in 2007.

Thus, the most common fraud related with the assets is the misstatement of asset accounts. Furthermore we will present the numbers of the main techniques used to misstate the asset accounts as they were enumerated in COSO's survey. In addition to the information provided by COSO we will also explain the way each of those frauds might occur.

The most encountered fraud scheme, regarding the misstatement of asset accounts, was **inventory** with a total of 51 of 173 cases (29%). Inventory is one of the most common methods used by the employees to remove assets from accounting books before or after they are stolen. Some inventory fraud schemes may include: counting nonexistent inventory or sold merchandise that is being warehoused for customers, ignoring the value of obsolete, damaged or slow moving inventory, operating changes in inventory's accounting methods or overvaluing existing inventory.

**Accounts/Receivable** frauds with 43 cases (25%) were mentioned on the second place. This fraud scheme usually appears when the perpetrator is adjusting the entry to a perpetual inventory and cost of sales accounts even if there is no sales transaction in the accounting records to prove those entries. As a consequence, the perpetrator is "fixing" the problem by entering a debit to accounts receivable and also a corresponding credit to the sales account in order to be sure that the missing goods appeared as they were been sold.

**Property/ Plant and Equipment (PP&E)** were signalized in 24 cases (14%). This fraudulent approach may imply the recognition of expenses as acquisition of PP&E with the main purpose of delaying the entire immediate expense. Other techniques may include the reducing or delaying of the depreciation or overrate PP&E's value.

In 19 cases (11%) the fraudsters appealed to **cash/ marketable securities** schemes. Those assets are susceptible to be stolen because of their intrinsic features including a high rate of liquidity, marketable securities are extremely liquid as they tend to have maturities of less than a year. As for the cash the most common frauds include skimming schemes, attacking the receipts process, in which money is stolen before it is recorded in the victim organization's accounts and billing schemes, attacking the payments process comprising methods like false invoicing via shell companies, false invoicing via non-accomplice vendors and personal purchases made with company funds.

**Loans/ Notes Receivable/ Mortgages** were identified in 13 cases (8%). Those techniques include actions meant to deliberately omit relevant information regarding a mortgage loan application with the purpose of obtaining a loan or a larger loan that would have been obtained if the lender or borrower knew the truth.

**Investments** problems were also noticed in 12 cases (7%). For example, a common used scheme is overvaluing the investments when there isn't any readily available market or in the case of transactions made with related parties.

And nevertheless not listing **prepaid expenses** with a purpose of making a company's profit performance look better than it actually is, was used in 11 cases (6%).

### **Monitoring the quality of internal control system through internal audit**

It is obvious that in compliance with the information provided by COSO, fraud not only continues to exist but is starting to become a more complex and worsen phenomenon. This is a signal of how important control systems are in order to prevent fraud from occurring. As it was stated before not the mere existence but the performance and viability of internal control matters and those are given by a suitable activity of updating through constant monitoring.

Furthermore we will discuss about the main concerns that should be taken into consideration by internal audit during a monitor activity in order to strengthen the internal control system and implicitly to protect the existence and value of the assets.

***Assess the level of involvement manifested by the managers regarding the implementation of internal controls.*** The purpose of this activity is to identify if there is any established foundation for the activity of monitoring and if not to create the needed monitoring awareness among managers. The integrity starts at the top and the integrity of the managers is an essential factor in establishing strong internal controls. The managers at all levels of the company must lead the way to ensure internal controls are updated and respected. Also, a critical element is the attitude of managers regarding the way they cooperate and work with the subordinates. The relationship between management and employees must be professional and correct. Managers must impose to all of their subordinates to apply the procedures of internal control and are forbidden to implement a control based only on blind trust. In addition, managers are not allowed to hide any criminal activity of their subordinates. Every manager must be aware that any hidden fraudulent activity can become in a long run a festering wound for the company affecting not only its image but also its capacity to exist and to function effectively.

***Identify the factors of pressure that can lead to fraud.*** Pressure is the factor that is engaging an individual to commit fraud. This can comprise almost everything starting from medical bills, expensive tastes to addiction problems but the core issue comes always from a significant financial need or problem. Even so, there are cases in which fraud is committed simply out of greed. Regarding the thinking of a fraudster, one will always believe that his problem must be solved in secret and even if he considers or not that his crime is justified there will be few cases of self-denunciation. This is not only because the perpetrator knows he could be punished but also because fraud is seen as a crime of betrayal and often goes underreported precisely because it is so personal and embarrassing. Furthermore both managers and employees can become fraudsters if there is the rationalization, opportunity and pressure to perpetrate fraud. According with COSO's Fraudulent Financial Reporting 1998-2007, the high leadership of a company was directly involved in fraudulent activity: in 72% of the cases the CEO, in 65% the CFO and in 83% of cases either the CEO or CFO. In comparison, the lower level employees were engaged in only 10% of frauds and the controllers in 21%. For the normal employees common source of pressure may come from medical problems, drug or alcohol addiction, civil lawsuit, criminal conviction, dissatisfaction at the working place or simply greed. In addition with those, the high percentage of executives involved in fraud cases is explained by the fact that often managers and executives hold on their shoulders a lot of pressure that is constraining them to commit frauds. In their case the motivation for perpetrating fraudulent activities might be given by several reasons such as: the need to meet internal and external earning, the attempt to conceal the company's deteriorating financial condition, the need to increase stock price and nevertheless the desire to increase management compensation based on financial results.

***Build relevant scenarios that could potentially occur resulting in a material impact on assets.*** This implies a more proactive rather than reactive approach of the risk of fraud existing within the company. Internal auditors should create a database containing the most eligible fraud scenarios that could take place considering the existing conditions created by the managers' attitude and behavior and also by the pressure factors. For each fraud scenario there must be a



description of the way it could be perpetrated within the company, the individuals that might be involved and the types of assets that might be affected.

***Test, assess and improve the capacity of internal control system.*** According with the level of involvement proved by the managers and the existing pressure-factors the internal control system must be assessed and his potential diagnosed. Based on the previous documented fraud scenarios, any internal controls that could prevent or deter the fraud related with the assets must be updated or created in order to satisfy the existing requirements. Nevertheless when updating or creating internal controls one should not forget that the driving principle behind strong internal controls is segregation of labor. In any given situation, the more record keeping duties that can be segregated the better. If one person is responsible for both maintaining the record and the asset, there are many opportunities for procrastination, abdication of the task and theft (Heinke 2010: 52).

***Assessing the results of the new and/or updated internal controls procedures and correct the anachronisms.*** The purpose of monitoring is to improve and update continuously the internal controls. There is no point in conducting a monitoring activity if is not continuing and with the purpose of constantly improving the already existing control system. Thus a permanent oversight and diagnose of the way updated or new internal controls are running and behaving is imperative in order to test the effectiveness of changes made according to monitor's findings. Nevertheless the controls that are not delivering the expected results must be reassessed and strengthen in order to make them eligible for achieving their purpose.

#### ***Conclusions and further research***

The war against fraud is becoming sharper as the limited resources and a possible lack of credibility from stakeholders, employees and general public caused by potential fraud scandals may affect the image, performance and financial position of the company. As frauds against assets multiply, internal audit will be demanded to expand its objectives comprising also activities that could deter fraud. Because of this for the internal audit of tomorrow it will be impossible to ignore the value of any instruments or processes that can streamline its work reducing the total amount of cost and raising the benefits. Therefore the activity of monitoring and updating the control system will be imperative in order to help internal audit give a proper answer to the future requirements. As we stated in this paper we recommend internal audit to undertake the monitoring quest due to its objectiveness, independence and professionalism. Still there are at least 2 things that impose further research. Fraud is not an accounting problem but a social phenomenon. Even if internal audit function has the privilege of being subordinate to the highest management level in an organization as it was shown in COSO's surveys in the majority of cases the high leadership was involved in fraud schemes therefore the potential of internal audit to apply the needed measures in order to update and strengthen the internal control can be affected. Further research regarding the way the independence of internal audit can be enhanced is needed. On the second place, as any other activity, internal audit is hamstrung by a limited budget. The total amount of money invested in an audit function varies according with company size, industry type, inventory, operating flows and nevertheless the audit committee review regarding internal audit work and budget. Thus, a balance between the costs involved in a monitoring activity and the benefits from providing a continuous internal control monitor must be achieved in order to raise the effectiveness of the overall controlling effort conducted in the company.

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