The critical role of Internal Auditing in addressing bank fraud: A conceptual framework

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Abstract
The recent global financial recession highlighted the critical role that the banking system plays in the modern economy. Banks are complex financial institutions that operate in a constantly changing business environment and deal with high levels of risk, while facing fraudulent actions in regular basis. In order to address these problems, banks engage in various internal audit techniques such as the implementation of controls and prevention tools, the usage of anti-fraud methods and data mining. The aim of this paper is to highlight the crucial role of internal auditing in addressing bank fraud. This is achieved by initially providing a review of both theoretical and empirical literature which helps in determining the value of internal auditing and then by proposing a conceptual framework in order to justify its interconnection with bank fraud, and also to serve as a guide for all future reference. The results confirm the fact that internal audit can play a major role in risk assurance and bank fraud management thus, ensuring banks' normal and uninterrupted operation. The paper also provides some useful insights for future application of internal audit methods thus, laying the ground for a fruitful dialogue among the various stakeholders.
Keywords: *Internal audit, banking system, fraud, risk, loss* ***JEL:*** *M42*

1. Introduction

The recent global financial crisis, which had its roots in the banking sector, highlighted, except from the existing regulatory gaps, the lack of proper and efficient internal audit functions within the banking institutions in order to mitigate the resulting negative effects. The burst of the credit crunch and the following financial recession resulted in the dramatic increase of bank frauds all over the world, a fact that strengthened the need for the implementation of internal audit techniques. Moreover, the internal audit function plays a crucial role in the ongoing maintenance and assessment of a bank's internal control, risk management and governance policies thus, adding value and assisting in the achievement of the management's goals.

From the above mentioned it is made clear that internal audit is the key player in addressing bank fraud and its significance in the operation of modern complex financial institutions is taken for granted, in spite of the fact that often is not properly exploited. At first, the two main terms are defined and then a conceptual framework is introduced in order to show the interaction among them and stand as a reference point from all the stakeholders. Afterwards, an extensive review of both theoretical and empirical literature is provided in order to support this correlation and provide useful conclusions. And this is achieved by analyzing, apart from the theoretical research contributions, a number of recent related corporate global surveys and studies that justify the theoretical background. Several suggestions are finally proposed for banks to get the best out of internal audit. The main goal of this paper is to emphasize on the importance of internal audit in addressing bank fraud and lay the ground for future research.

2. Internal Audit & Banks

The general definition of Internal Audit is provided by the Institute of Internal Auditors (IIA) as:

"An independent, objective assurance and consulting activity designed to add value and improve an organization's operations. The internal audit activity 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."

Internal Audit in banks particularly, is a department, independent of line management, whose prime responsibility is to review the quality and effectiveness of the controls within the banks, to manage and mitigate risk and protect the assets.

According to Basel Committee on Banking Supervision (BCBS) an effective internal audit function independently and objectively evaluates the quality and effectiveness of a bank's internal control, risk management and governance processes, which assists senior management and the Board of Directors in protecting their organization and its reputation.
The Committee's Principles for Enhancing Corporate Governance require modern banks to have an internal audit function with sufficient authority, stature, independence, resources and access to the board of directors. As a result, independent, efficient and qualified internal auditors are vital in contemporary banking corporate governance. Moreover, banking supervisory authorities must be satisfied by the effectiveness of a bank's internal audit function by requiring effective policies and practices to be followed and that management takes appropriate corrective action in response to internal control weaknesses identified by internal auditors. An effective internal audit function provides vital assurance to a bank's board of directors and senior management (and bank supervisors) as to the quality of the bank's internal control system. In doing so, the function helps reduce the risk of loss and reputational damage to the bank.

3. Bank Fraud

Fraud on the other hand is an aspect of corruption and it occurs in organizations where governance structures are weak. Fraud encompasses a wide range of illicit practices and illegal acts involving intentional deception or misrepresentation.

At this point, before we proceed to the determination of bank fraud, it is necessary to provide the two most common and comprehensive general definitions of fraud.

The Institute of Internal Auditors' International Professional Practices Framework (IPPF) defines fraud as: "… any illegal act characterized by deceit, concealment, or violation of trust. These acts are not dependent upon the threat of violence or physical force. Frauds are perpetrated by parties and organizations to obtain money, property, or services; to avoid payment or loss of services; or to secure personal or business advantage." Fraud impacts organizations in several areas including financial, operational, and psychological. While the monetary loss owing to fraud is significant, the full impact of fraud on an organization can be unbearable. The significant losses to reputation, goodwill and customer relations for a company can be really devastating, threatening even its own survival.

The Association of Certified Examiners in the USA defines fraud as the "use of one's occupation for personal enrichment through deliberate misuse or misapplication of employing organizations resources and assets".

However, in the perspective of the financial industry and specifically the banking sector, fraud remains a huge issue, especially these turbulent days, mainly driven by the recent financial crisis. Banking fraud therefore is defined as the use of deliberate misrepresentation in order to fraudulently obtain money, assets or other property owned or held by a financial institution. Moreover in criminal law, bank fraud is an intentional deception made for personal gain or to damage the financial institution. It is distinct from simple bank robbery or theft, because the perpetrator usually commits the fraud in secret, hoping that it will not be noticed until he has had ample time to move on. It usually requires some sort of technical expertise as well. For reasons like this, bank fraud is one of the offenses referred to as the white-collar crime. As fraud can be perpetrated by any employee within an organization or by those from the outside, it is important to have an effective fraud management program in place to safeguard organization's assets and reputation. While senior management and the board of directors are ultimately responsible for a fraud management program, internal audit can be a key player in helping address bank fraud. By providing an evaluation on the potential for the occurrence of fraud, internal audit can show an organization how it is prepared for and is managing these fraud risks. In today's automated world, many business processes depend more and more on the use of technology. This allows for people committing fraud to exploit weaknesses in security, controls or oversight in business applications to perpetrate their crimes. However, technology can also be a major factor of combating fraud. Internal audit needs to view technology as a necessary part of their toolkit that can help prevent and detect fraud. Leveraging technology to implement continuous fraud prevention programs helps safeguard organizations from the risk of fraud and reduce the time it takes to uncover fraudulent activity. This helps both catch it faster and reduce the impact it can have on organizations.

3.1 Causes of bank fraud

The effects of fraud generally lead to the reduction of the assets and increase of the liabilities of any type of company. In banks particularly, this may result in the loss of potential customers or crisis of confidence and trust of banking by the public and in the long run end up in another failed bank situation. An analysis made of cases brings out broadly the following major elements responsible for the commission of frauds in banks.

a. Active involvement of the staff-both supervisor and clerical either independent of external elements or in connivance with outsiders
b. Failure on the part of the bank staff to follow meticulously laid down instructions and guidelines and low compliance level (the degree to which procedures and prudential practices framed by the Regulatory Authorities to prevent frauds are followed)
c. Lack of staff training in prevention of bank frauds
d. External elements perpetuating fraud on banks by forgeries or manipulations of cheques, drafts and other instruments.
e. There has been a growing collusion between business, top banks executives, civil servants and politicians in power to defraud the banks, by getting the rules bent, regulations flouted and banking norms thrown to the winds.

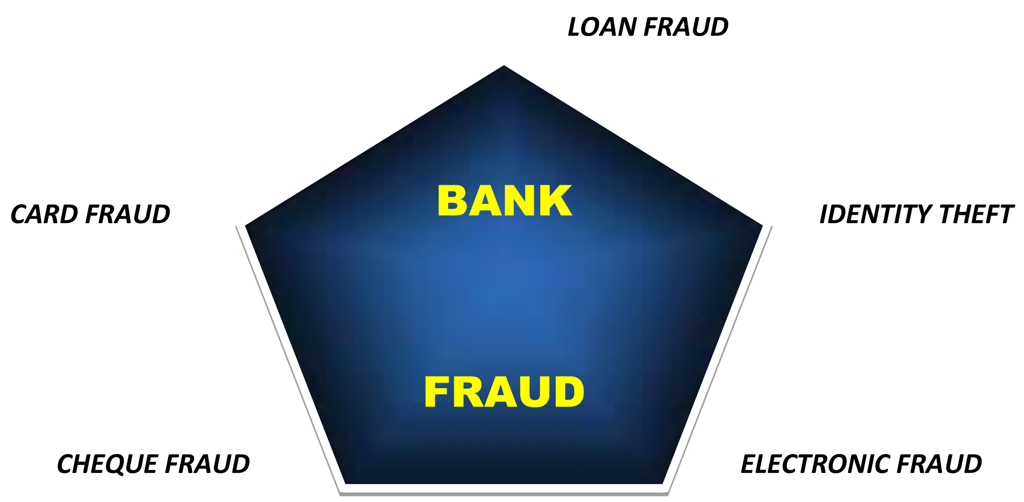
3.2 Types of bank fraud

After the clarification of the term and the determinants of bank fraud the main question that arises is which are the biggest threats the banking system faces in our days. Fraud can be generally classified as internal or external. Internal fraud occurs when employees identify an opportunity to commit the act of fraud. An external fraud is committed when third parties (outsiders) such as customers and suppliers defraud institutions. In some instances, these parties may be collaborating with internal staff in order to achieve their goals. Concerning bank fraud, there are four main types, as identified by the literature:

1. Card fraud (debit & credit)
2. Cheque fraud
3. Electronic fraud
4. Identity theft
5. Loan/Mortgage Fraud

For the purpose of having a single, concentrated figure to classify the major types of bank fraud, as seen above, the following Bank Fraud Pentagon is introduced:

Figure 1: The Bank Fraud Pentagon



At this point, a brief description of these bank fraud types is given in order to clarify the terms.

1. Card fraud (debit & credit)

Credit and debit card fraud is a crime whereby a credit or debit card can be reproduced in order to use the credit balance to obtain a certain financial advantage. The creation and/or alteration occur when the information contained on the magnetic strip of a credit/debit card is reproduced with the use of cutting-edge technologies. This type of fraud is known as 'skimming' and can take place during a legitimate transaction at a business. A frequent type of this crime is the "ATM skimming" which occurs when an ATM is compromised by a skimming device, a card reader which can be disguised to look like a part of the machine. The card reader saves the users' card number and pin code, which is then replicated into a counterfeit copy for theft. Credit or debit card fraud can also occur when a card is lost or stolen and used by a third party to purchase goods with those cards or to remove cash from the cards. Credit or debit cards can also be intercepted in transit while being sent to its owners.

2. Cheque fraud

Cheque fraud is the use of a bank cheque to get financial advantage by:

- altering the cheque (payee/amount) without authority
- theft of legitimate cheques and then altering them
- using false invoices to get legitimate cheques
- duplication or counterfeiting of cheques
- depositing a cheque for payment knowing that insufficient funds are in the account to cover the deposited cheque
- depositing a cheque into a third party account without authority.

The three main types of cheque fraud are the following:

a) Counterfeit cheques: cheques which are not written or authorized by legitimate account holders. The existence of this type of cheques is supported by the new technologies, allowing the fraudsters to use printers, copiers, and proper software so as to make clone cheques with high resemblance to the original ones.
b) Stolen cheques: cheques not signed by account owner, rather stolen, usually out of the glove box of cars or homes. The signature is then forged and cheque used as pleased.
c) Altered or Forged Cheques: these cheques are properly issued by the account holder but have been intercepted and the beneficiary or the amount on the cheque has been altered or new information has been added.

3. Electronic fraud

Electronic crimes are very serious and involve the utilization of information technology for unlawful reasons. These crimes either use computers or attack computers. There are many different types of electronic frauds, and all of them attack in a slightly different way. The most common are:

- Phishing
- Viruses and Trojans
- Spyware and Adware
- Card skimming
- Job and employment scams
- Phishing over the phone
- Phishing by SMS
- Other mobile scams

4. Identity theft

Identity theft is where the personal details are obtained to get some sort of financial or other benefit, leaving the owner of that identity often in large debt with a negative credit history and in some cases with legal implications.

This kind of information can be obtained in many ways:

- Theft, including theft of mail from your mailbox at home
- By going through your garbage bins
- Telephone, Fax and Mail scams
- Internet.

The following can be used to assume an identity: Date of birth, utilities bills (phone, gas, water and rates notices) and address. However in the modern banking financial institutions there are also the following disciplines of fraud.

5. Fraudulent loans

Fraudulent loans take many different forms. The victims may be individuals or group of people or institutions, and these case financial institutions. Fraudulent loans schemes generally prey on vulnerable consumers. The situation was people, groups of people and institutions turn to be in need for money for emergency purposes.

In the western world, mortgage fraud is, if not the commonest loan frauds one of the most common form of loan fraud that has severe negative effects and has proved very costly. The victims can be banks or individuals and the latter sometimes can perpetrate fraud without even knowing. ”Creative Financing” is a term that has been known in the mortgage industry for a long time now which often forces consumers to commit fraud without even realizing it.

Other types of loan fraud may include applying for loan with a fake identity, forging loan documentation, or even posing as a financial institution in order to collect down payment on an alleged loan and disappearing after receiving the cash.

3.3 The effects of bank fraud

Beyond financial (monetary) losses fraud has other negative consequences that impact an institution reputation, customer loyalty and the confidence of the shareholder. Moreover in the greater impact, the fraud cost is passed on to the customer. The individual who fall victim to fraud can experience mental, psychological, financial, social and physical damage. The impact of fraud can also be very damaging to co-operate victims where small/medium scale businesses are most times unable to recover from the financial or reputational damage caused. However, most large companies literally feel the impact through the increase cost of doing business. Today, despite electronic tracking and improved security practices for deterring fraud, the threat still exists and bank fraud still occurs on regular basis. Fraud as have been mentioned earlier on is a crime, and is becoming difficult to pin down, however, with the right management controls, practices and policy frame work, it can be mitigated. While financial institutions are increasingly spending more resources on the management of fraud and it allied, the traditional approach of using transaction monitoring systems can only work well for detecting individual point of sales fraud in real time. The financial institutions need an integrated framework, together with most comprehensive plan, new and modern fraud detection and prevention. This management approach needs to protect fraud at the point and time of transaction, accurately detect incidents in transaction, span all the ways customers interact with the institution and provide structured oversight for the fraud management program.

4. The role of Internal Audit in addressing bank fraud: A Literature Review

After defining and understanding bank fraud, the next step is to examine the theoretical and empirical evidence concerning the role of internal auditing in addressing fraud in general, and bank fraud specifically. This is achieved by an extensive and thorough review of the existing research and occupational literature. It should be pointed out that in spite of the fact that there is an extensive research on the role of internal audit in fraud confrontation, the relative literature on the banking sector is both recent and restricted. Major interest in addressing bank fraud has steadily increased since the past decades and especially during the recent financial crisis, when banks faced significant losses and realized the ambiguous benefits of the internal audit function.

Initially, Woods (1998) investigated fraud in the Australian Banking Industry and highlighted the fact that the member banks of the Australian Bankers' Association developed a common database in order to exchange information on fraudsters on an industry-wide basis to assist in the detection of fraud. This system (a similar one was introduced in the United Kingdom a few years ago) resulted in a significant reduction in fraud losses. He also showed that such a database may also be expanded in time to record the number and monetary losses arising from fraudulent activities taken against financial institutions. This would bring to the surface the areas of greatest risk to banks and indicate fraud trends.

Then, Smith, J.R., Tiras, S. L, & Vichitlekarn, S. S. (2000) examined the interaction between internal control assessments and substantive testing in a model of fraud detection. The purpose of their study was to test a two-stage model of the auditor-manager interaction in which the auditor assesses the possibility of fraud in the first stage and conducts substantive tests in the second stage. They also examined the allocation of audit resources across these two distinct facets of the audit and their findings showed that the probability of undetected fraud remains the same, but the allocation of some audit resources to internal control assessment may provide cost savings for the auditor.

Siddiqui and Podder (2002) examine the effectiveness of financial audit of banking companies operating within Bangladesh. For the purpose of this study, the audited financial statements of 14 sample banking companies have been analyzed. The study identifies seven sample companies that have actually overstated their profits. Hence, the research explores the level of independence, objectivity and competence of the auditors assigned for auditing banking companies.

James, K. L. (2003) examines whether internal audit reporting structure and internal audit sourcing arrangement affect financial statement users' perceptions of ability of the internal audit function to prevent financial statement fraud. A survey of lending officers finds that in-house internal audit departments that report to senior management are perceived as less able to provide protection against fraudulent reporting compared to in-house departments that report solely to the board of directors' audit committee. Results suggest that increases in perceived audit expertise may occur with outsourcing, but such increases may not significantly enhance user confidence in the internal audit function because users perceive outsourced teams to have less in-depth knowledge of the company than in-house internal audit departments.

A year later, Green BP. and Reinstein A. (2004) studied the effects of regulation and increased public scrutiny on financial statement fraud and examined how the characteristics of bank fraud have changed over the past two decades The results showed that while the frequency of frauds did not significantly change over time, the magnitude of each fraud event has declined. This may imply that public regulation and scrutiny may have little effect on the frequency of fraud, but does affect fraud strategies.

Patterson Evelyn R. and Smith J. Reed (2007) provide a theoretical investigation of the effects of the Sarbanes-Oxley Act of 2002 on auditing intensity and internal control strength. They propose a model of strategic auditing in which an auditor can use resources for both internal control tests and substantive tests, while a manager can choose the strength of internal controls and the amount of fraud. The findings justify that control tests are a valuable tool for the auditor when control strength is informative about the likelihood of fraud. It is also proved that Sarbanes-Oxley has the desired effect of inducing stronger internal control systems and less fraud, but does not necessarily induce higher levels of control testing.

In 2008 there were several studies concerning internal audit and bank fraud. Karagiorgos, T., Drogalas, G. and Dimou, A. (2008) explored the effectiveness of internal control systems in the Greek Bank Sector and found interactions between components of internal control system and internal auditing within the Greek banking system. They also pointed that these results do not indicate specific mechanisms to enhance the effectiveness of internal auditing but provide a solid basis for further research that may lead toward a better understanding of how the components of internal control system can improve the performance of Greek banks.

At the same time Khanna and Kaveri (2008) examined the implementation of risk-based internal audit in Indian Banks. In order to achieve the goals of the survey, a structured questionnaire was sent to 43 banks in India, both in the public and private sectors. A total of 25 banks, all public sector banks and six private sector banks responded to the questionnaire mailed. The paper concludes that banks have made sufficient progress in introducing risk-based internal audit by understanding the methodology for risk assessment, audit procedures and implementation of audit report.

Boţa Avram (2008) investigated the evolution of the approaches of fraud from internal audit's point of view, by showing value of internal auditors in fraud prevention and detection and showing differences in approach between organizations that choose to insourcing or outsourcing internal audit. The conclusions drawn were that internal auditors are considered to be more and more important and the value and responsibility in activity of preventing and detecting fraud seems to be bigger,. Outsourcing of internal audit may lead to better independence of internal auditor and insourcing internal audit could has advantage that they know the environment and the culture of the company.

Coram et al. (2008) assessed whether organizations with internal audit function are more likely to detect and self-report fraud than those without internal audit function. They also assessed whether organizations that use an in-house internal audit function are more likely to detect and self-report misappropriation of assets fraud than organizations that completely outsource their internal audit functions. They concluded that organizations with internal audit function are more likely to detect and self-report fraud than those that don't have internal audit function, and organizations that having some in-house internal audit function are more effective in detective and self-reporting fraud than completely outsourcing internal audit function. They concluded that the internal audit function within an establishment is a fundamental part of its corporate governance.

In 2008 also, Ogidefa reported that fraud is an anti-economic process and must properly be dealt with. Fraud was also referred to as a virus which spreads from the banking sector to other economic activities and organization even the government and that for any economy to be balanced an antifraud virus should be injected to the banking industry to completely eradicate fraud from the system.

DeZoort and Harrison (2008) found that external auditors perceive more responsibility for detecting fraudulent financial reporting than they do for misappropriation of assets and corruption.

Asare, S. K., Davidson, R. A. and Gramling, A. A. (2008) examine internal auditors' fraud risk decisions in response to variations in audit committee quality and management performance incentives. Using an experimental approach, they find that internal auditors acting in an either a self-assessment role or a due diligence role were sensitive to alterations in management performance incentives, linked them to fraud risk assessments and changed their audit plans accordingly. With respect to audit committee quality, internal auditors in both roles were sensitive to variations in quality and linked the variation in quality to fraud risk, but did not alter the scope of their planned audit effort. As a result, they neither linked the variations in quality to fraud risk nor to planned scope.

Palfi and Muresan (2009) examined the importance of a well-organised system of internal control in regard with the bank sector. The sample was based on 25 credit institutions of Romania and the survey's results reveal that the continuous collaboration, based on periodical meetings, among all banks' structures, characterizes an effective internal audit department.

In 2009, Abiola investigated some practical means of minimizing the incidence of fraud in banks. It was revealed that so many factors contributed to the incidence of fraud in the banks amongst which are poor management of policies and procedures, inadequate working conditions, bank's staff staying longer on a particular job, and staff felling frustrated as a result of poor recommendations.

Abu-Musa (2010) investigates the existence and adequacy of implemented security controls of computerized accounting information systems in the Saudi banking sector. The results of study reveal that the vast majority of Saudi banks have adopted adequate security controls and the results also enable bank managers and practitioners to better secure their computerized accounting information systems and to utilize information technology security for their banks' success.

Rahahleh (2010) indicated that developed countries called for attempts to regulate the internal audit as well as giving it more attention as a tool for achieving monitor and control to reduce the financial and administrative illegal practices.

Salameh R., Weshah G. and Nsour M. (2011) investigated the effectiveness of internal audit units in fraud prevention in the Jordanian banking industry. The main findings indicate that internal audit units are perceived effective in fraud prevention and that in-house internal audit units are proved more reliable than outsourced internal audit functions. One of the main reasons for these results is that in-house internal audit units have more in-depth knowledge about banks culture, policies and procedures than outsourced auditors.

Law, P. (2011) examine empirically the organizational factors that are associated with the absence of fraud in Hong Kong. Factor analysis was first employed and then logistic regression was performed so as to analyze the survey responses of 253 Chief Financial Officers as long as a total of 20 semi-structured interviews. The results indicate that audit committee and internal audit effectiveness, the tone at the top managerial level, and ethical policies are positively associated with a lack of fraud within organizations. The findings also show that neither auditors' prior success in fraud detection nor the type of auditor employed is an influential factor in the absence of fraud.

Ester Gras-Gil, Salvador Marin-Hernandez and Domingo Garcia-Perez de Lema (2012) examine the relationship between a firm's internal audit function (IAF) and the quality of its financial reporting. Since the introduction of regulations on corporate governance, numerous national and international bodies have emphasized the fundamental role of the IAF in the financial reporting process. The results show that the greater involvement of internal audit in reviewing financial reporting leads to improved quality financial reporting.

More recently, Kristo E. (2013) examined the role of internal auditors in the Albanian banking system and the findings showed the absolute necessity of the internal audit. It also highlighted that there is still room for improvement of some specific competencies of internal audit.

Petraşcua D., Tieanub A. (2014) highlight the important role of internal auditing in preventing the commission of frauds in any economic entity. They draw the conclusion that all companies need internal audit not only in terms of business efficiency (in the sense of a good management, of reducing costs and maximizing profit), but also from the perspective of the benefits it entails in countering fraud and especially in increasing future added value.

Ahmed I., Madawaki M. and Usman F. (2014) tried to identify ways of reducing or preventing frauds and forgeries by analyzing their causes and effects in a study focused on the Central Bank of Nigeria (CBN) and some selected commercial banks in Gombe. They concluded that frauds and forgeries in banks has been on the upward trend despite the control measure put in place by more acute in commercial banks than in merchant banks. The study also suggested that banks ought to adopt a stronger internal control system and adequate internal control measures must be put in place to safeguard the assets of the bank against theft and misuse.

Finally, Halbouni S. S. (2015) investigates internal and external auditor perceptions regarding their responsibilities related to preventing, detecting, and reporting fraud in the United Arab Emirates. This study features a survey of 53 auditors and also explores the procedures that internal and external auditors follow so as to detect fraud during an audit. From the internal auditors' side, the results indicate that they are primarily responsible for identifying incidents of fraud and that their principal contribution is that are primarily responsible for identifying fraud and are consequently more concerned about reporting incidents related to fraud.

After the literature review, three recent empirical occupational surveys concerning fraud, conducted by the professional leaders in the audit sector, are noted in order to showcase the significance of internal audit in the modern world.

In the annual "Report to the Nation on Occupational Fraud and Abuse" by the Association of Certified Fraud Examiners (2014), it has been estimated that a typical organization loses 5% of its revenues to fraud each year. This translates to a potential projected global fraud loss of nearly $3.7 trillion.

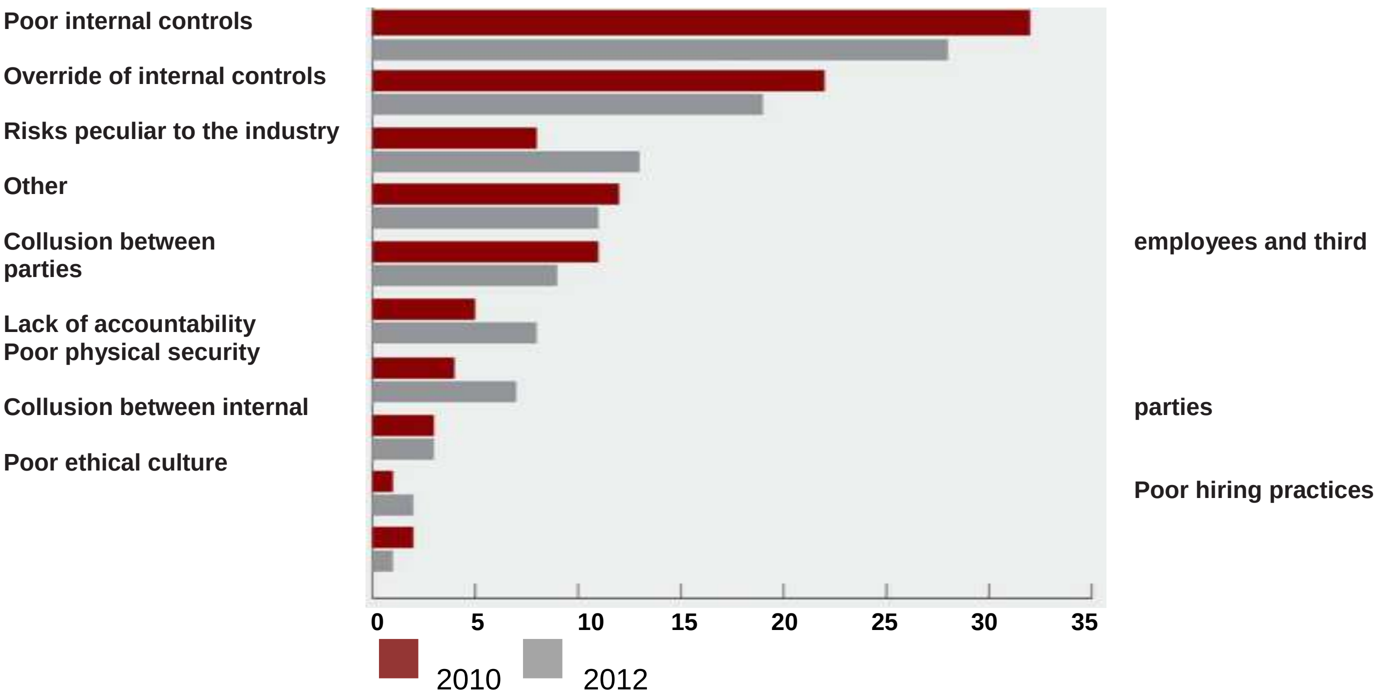
Deloitte's "India Fraud Survey Report" (2014) indicated that internal audit continues to remain in the top spot as a channel to detect fraud. Survey respondents attributed the prevalence of fraud risks to the lack of efficient internal controls/compliance systems, diminishing ethical values and inadequate due diligence of employees/third parties. In the main question set "How are fraud incidents detected in your organization? (responses were ranked uniquely from 1 to 6, with 1 being the least common and 6 being the most common practice used to detect fraud)", the following five answers were given, sorted from the most to the least common (in parenthesis the score):

1. Internal Audit review (4)
2. Through Whistleblower hotline (3.7)
3. IT controls (3.5)
4. By accident (3.2)
5. Statutory Audit (3.1)

It is obvious that the internal audit function is prevailing among the answers. The survey also showed that whistleblower hotlines and IT controls/Data Analytics are rapidly gaining ground as fraud detection methods. But even these are directly related to the internal audit operation.

In another recent survey concerning fraud conducted by KPMG (Australia Fraud Survey 2013), which also included an analysis of current and previous survey data between 2002 and 2012, indicated that 53% of all losses due to major frauds - the largest frauds experienced by surveyed firm respondents - were committed by people inside the organization. It is worth noting that there was an 82% increase in major frauds suffered by respondent organizations since the last fraud survey in 2010. As for the contributing factors that led to the major frauds over the last few years, weak or nonexistent internal controls and the override of them were by far the biggest factors, accounting for 28% and 19% respectively of the cases in 2012, as seen in the following figure:

Figure 2: Most important factors contributing to the largest fraud incidents



Source: KPMG Australia 2013

From the above figure it is made clear that the internal audit function plays a critical role in addressing fraud through the control mechanisms it engages for facing such activity.

5. Internal Audit & Bank Fraud - A conceptual framework

After the review of the literature, it's more than necessary to designate and justify the correlation among the internal audit function and bank fraud. For this purpose, the following conceptual framework (**The Internal Audit - Bank Fraud Conceptual Framework**) is introduced in order to both justify the theoretical interconnection among internal audit and bank fraud, alongside with the major related terms, risk and loss, and also to serve as a guide for all future reference.

Figure 3: The Internal Audit - Bank Fraud Conceptual Framework

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The above framework shows the interaction between internal audit and bank fraud along with two major related issues, risk and loss. Modern banks are very complicated financial institutions that operate in a highly risky environment. Moreover, due to the recent global financial crisis that resulted in a long time recession and opened the Pandora's Box for banks, fraud incidents occur more often and imply even bigger losses. The major types of bank fraud, the "bank fraud pentagon" as introduced before, are nowadays an everyday phenomenon that has penetrated in all the corporate aspects. The main implications of fraud are of critical importance as they result in huge economic losses and more significantly affect banks' goodwill that can lead, depending on the magnitude of the impact, even to bankruptcy. This stems from the fact that fraudulent actions have negative effects on bank reputation and customer loyalty, two issues that play a crucial role particularly in banks. Additionally, in cases that fraud is passed on customers, the effects are multiple.

In addition to fraud, risk is a key factor in the banking transaction cycle. The most common type of risk is the operating, which is the risk of financial loss from any operational failure. An operational failure encompasses a wide range of possible events, actions and inactions i.e. system failures, violations of policy, law and regulation. Of course, it also encompasses direct and indirect acts of excessive risk-taking. As a result, operational risk incorporates fraud incidents which in turn lead to losses.
The bank industry also faces certain legal risks that are not very common outside of the financial services industries. Beside the obedience to specific laws concerning fair and honest lending, banks are also compelled to play a major role in monitoring potential illegal activities on the part of customers. In particular, banks are required to be on the lookout for signs of money laundering, a term that generally refers to the process of transforming the proceeds of crime into ostensibly legitimate money or other assets through a financial institution. There are strict "know your customer" rules (KYC) that are imposed by the supervising authorities in each country in order to prevent banks from being used, intentionally or unintentionally, by criminal elements for money laundering activities. But despite the fact that anti-money laundering (AML) is one of the key priorities nowadays, these illicit actions have managed to penetrate into the financial system, with the International Monetary Fund (IMF) estimating them in the range of two to five percent of the worldwide global economy. Consequently, such actions cause banks to have serious legal issues. Moreover, as discussed before, bank frauds are often passed on to the customers so in such cases banks face legal actions by them. In both cases, these legal risks result on huge amounts of losses.
Finally, a common type of risk within banks that is closely related to fraud is the reputational one, which is a threat or danger to the good name or standing of a business or entity. Reputational risk can occur through a number of ways, directly as a result of the actions of the company itself or indirectly due to the actions of an employee or employees. It can also occur through peripheral parties, such as suppliers and external parties. Reputational risk is a hidden danger that can pose a major threat to even the survival of the biggest and best-run companies. So banks, as large corporations with customer-oriented approach and subject to client trust, are strongly affected by fraudulent actions. Whether such illegal actions affect customers or the banks themselves, the results in the reputation are more or less the same, as the bad news spread widely, particularly concerning financial institutions that deal with peoples' money and their performance has a major impact on the real economy. The following two recent studies justify the negative effects of bank fraud on reputation:
Barclays Global Investors research officer Jason Perry (2005) examined the results of a large sample of financial companies in Europe and the US, run between 1994 and 2008 for his paper "Measuring Reputational Risk: The Market Reaction to Operational Loss Announcements" which shows that fraud is found to be the event type that generates the most reputational damage. Moreover, in a study held by Cummins D., Wei R. and Xie X. (2011) concerning US banks, for the period 1978-2010, internal and external fraud represents a substantial 40.6% of the operational loss events for commercial banks and 21.3% for investment banks.
The 'fraud circle" as described above, that includes the fraud occurrence, the involved risk and the consequent loss is within the scope of internal audit. As depicted in the conceptual framework, internal audit is directly related to fraud, risk and loss as it is responsible for addressing them. The audit function in banks utilizes anti-fraud techniques and loss prevention tools while performing risk assessment thus, being an integrated framework for addressing bank fraud.

More specifically, concerning anti-fraud and loss prevention methods employed by internal auditing and according to the latest "Report to the Nation on Occupational Fraud and Abuse" ACFE (2014), the most common ones can be summarized to the following:

- Rewards for whistleblowers;
- Job rotation/mandatory vacation;
- Surprise audits;
- Formal fraud risk assessments;
- An anti-fraud policy;
- Fraud training for employees;
- Fraud training for managers and executives;
- A hotline;
- Employee support programs;

- An independent audit committee;
- Management review;
- An external audit of internal controls over financial reporting (ICOFR);
- Internal audits;
- Management of certification of financial statements;
- Code of conduct; and,
- External audit of financial statements

So it is up to bank administrations to effectively exploit the above control mechanisms in synergy with their internal audit departments in order to be in a stronger position concerning the prevention of losses and fraud addressing.

As for risk assessment, one of the three cornerstones of the internal audit function, it comprises of the evaluation of risks related to the value drivers of the banking organization, covering strategic, financial, operational, and compliance objectives. The assessment considers the impact of risks to shareholder value as a basis so as to define the audit plan and monitor key risks. This top-down approach enables the coverage of internal audit activities to be driven by issues that directly impact shareholder and customer value, with clear and explicit linkage to strategic drivers for the banks. The principles of contemporary enterprise risk management require not only that organizations perform a risk assessment but that they implement a process to address potential risks, putting in place the necessary internal control environment: information and communications, certain objectives, adequately implementing risk responses through control activities, and monitoring how effectively objectives are achieved. The pace of change in today's banking environment along with the useful lessons derived from the recent global financial crisis, call for a risk assessment process that is dynamic and involves continuous monitoring of risk exposures. As a result, banks need to have a specified, solid and integrated risk assessment plan in use so as to be able to take the best out of internal auditing.

6. Concluding Remarks & Proposals

As the role of internal audit continues to evolve, bank managements are increasingly counting on internal audit functions in their efforts for managing fraud risks and keeping their organizations protected. The internal audit responsibilities nowadays include not only to monitor and detect but also to investigate fraud incidences whenever they arise. The evolving role of internal audit in bank fraud risk management in matters of preventing, detecting and investigating fraud has amplified as a result of economic uncertainty and increased focus of certain organization's management on fraud risks. In the aftermath of major banking collapses following the recent financial crisis, the critical role of the internal audit function, particularly in the "fragile" banking system, emerged as a fundamental part of their managerial practices.

As a result, internal audit, in order to ensure the banks stability, to protect the banks' assets, to prevent and detect frauds and improve the internal control system, faces new challenges with regard to the expertise, meeting the international and local professional standards and being updated with the existing regulatory requirements.

The following proposals are provided so as to enhance the internal audit profession inside banks and improve its efficiency in the endless fight against fraud:

- ❖ fraud risk management should be an integral part of banks' corporate governance policy and strategy.
- ❖ fraud risk management should also be a component of the bank corporate structure, corporate culture, employee behavior and a reference point in the relations with customers, shareholders, partners, authorities etc., whose assistance in the fight against fraud is not only desired but a prerequisite.
- ❖ addressing fraud requires the existence of methods and techniques for the prevention of fraudulent actions to the extent possible so as to minimize the risk of frauds and their consequences for the bank.

- banks' exposure to fraud should be periodically assessed by both using internal and external instruments for identifying, mitigating and controlling of existing or potential fraud incidents (risk assessment).
- The in-depth investigation of bank fraud should lead to a clarification of the causes and development of an account report of the actions taken, the findings identified and proposed actions to address future potential fraud risks.
- bank fraud reporting procedures (whistleblowing) must be clear and make it easy and harmless for the tipster to provide the required information. In this direction, the offering of awards for some inside information provided by whistleblowers and the allowance for online submissions as well as anonymity create a "safety net", necessary in order to detect and prevent bank fraud.
- internal auditors should have continuous and comprehensive training programs so as to get the sufficient knowledge in fraud prevention and detection in banking industry and stay up to date with the best professional practices.

All the above proposals aim at developing an environment where management and employees are aware of fraud and its negative effects and understand the value of internal audit in addressing such illegal activity. Effective treatment of the phenomenon of bank fraud requires the active participation of all in the process of creating a strong environmental prevention and control, planning and implementation of all activities to control fraud prevention and participation in continuous improvement of control mechanisms.

Conclusively, internal audit continues to play a critical role in addressing bank fraud, especially following the burst of the financial crisis and its proper operation must be top listed in modern banking institutions' business plans.

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