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The Role of an Effective Auditing System in Managing the Financial Crisis

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Abstract: *The financial crisis that occurred in the past decade did not occur suddenly. Scholars must analyze the fundamental factors that led to the financial catastrophe. Regarding corporate governance, our focus will be on enhancing internal control and internal audit. Studies have identified specific warning indicators that suggest the impending arrival of a financial crisis. However, the underlying problem can be attributed to inadequate financial detection methods and a lack of comprehension regarding the importance of the internal audit role in the internal control system. Internal audit is a fundamental pillar of corporate governance. The purpose of our study is to investigate the perception of financial auditors regarding the impact of their understanding of internal controls on the production of accurate and reliable financial reports, as well as its potential to enhance the audit procedure. Internal audit can improve the transparency and quality of the financial position through thorough investigation and in compliance with research findings. In order to prevent any adverse impact on the decision-making process, individuals who utilize financial information should accurately analyze the financial reports. Furthermore, research indicates that the internal audit report holds significant importance and serves as an opportunity for the top management of firms. The results obtained from the aforementioned studies may vary across different countries..*

Keywords: ACFE (Association of Certified Fraud Examiners), financial crisis, fraud, internal audit, and internal control

I. INTRODUCTION

The relevance of internal controls and internal audit has greatly increased during the past ten years. This study aims to offer survey evidence of the internal control's necessity, ability to stop fraud, and ability to raise the caliber of financial reports. According to the IFRS 2011 handbook, the purpose of financial reporting is as follows: General purpose financial reporting's goal is to offer financial data about the reporting institution that may be used to decide whether to give it resources and to determine whether its management and governing board have used those resources in an effective and efficient manner (Bruce, Danie, Tapiwa, & Raymond, 2011). Many scholars and standard-setters have stressed the significance of accurate financial reporting. The audit intern serves a critical role in preventing errors and frauds. The financial reports must accurately reflect the company, as was previously indicated, in order to make efficient and effective use of the resources offered. Companies that provide accurate financial reporting should consider the role of auditors.

Accounting scandals, such as those involving Enron in 2001, WorldCom in 2002, Qwest Communications, Adelphia, Global Crossing, Nortel, and Parmalat at the start of the twenty-first century, complicated the financial world and drew attention to its murky nature. After this type of financial crisis, external auditors have come under fire, but scholars have realised the value of internal audit and that it cannot be overlooked.

Internal auditing is described as an impartial, objective assurance and consulting activity aimed to provide value and enhance an organization's operations by the Institute of Internal Auditors (IIA, 2011). By applying a systematic, disciplined approach to review and enhance the efficacy of risk management, control, and governance procedures, it aids a company in achieving its goals. According to studies, there has been a 10% rise in staffing and resources for internal audit since the accounting scandals. When compared to earlier crises, the frequency of conversations and

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information sharing between the audit committee and internal audit department has increased by 25%. 2009 (Atanasiu& A).

By keeping an eye on organisational risks and ensuring that organisational procedures are efficient and effectively controlled, the internal audit function serves a special role in corporate governance (IIA, 2003). Internal audit and internal control are components of corporate governance, and they can be viewed as the cornerstone of the financial system in order for it to function properly. It goes without saying that if the top management verifies and assesses the internal audit reports, it makes sense. Otherwise, the organisation begins to sag if the senior management doesn't have time to review reports and ignores them. This study seeks to demonstrate, based on this claim, the importance of internal audit in the internal control structure system for the financial markets. If the internal control function is effective, it will help with the preparation of the financial reports and help to prevent any irregularities.

II. REVIEW OF LITERATURE

According to numerous sources (e.g., AICPA 2007; Beck 1986; Bierstaker et al. 2006; Heier et al. 2005; Hooks et al. 1994; Mautz and Mini 1966; PCAOB 2008; Rae and Subramaniam 2008; Wales 1965; Wells 2008), an efficient internal control system (ICS) is the primary method of preventing, detecting, and correcting fraud and errors. However, what exactly an effective ICS is is mostly an assumption made by ex post forensics, a type of induction, carried out by practitioners. (Barra, 2010)

Recent academic research has demonstrated that an effective internal audit system may stop financial statement fraud. By engaging in financial statement fraud, management may try to employ fabricated accounting methods to make the company appear financially successful. When examining financial statements, auditors ought to be somewhat sceptical. To recognise typical fraud techniques, taxonomies of financial statement fraud are also developed (Rezaee, 2009).

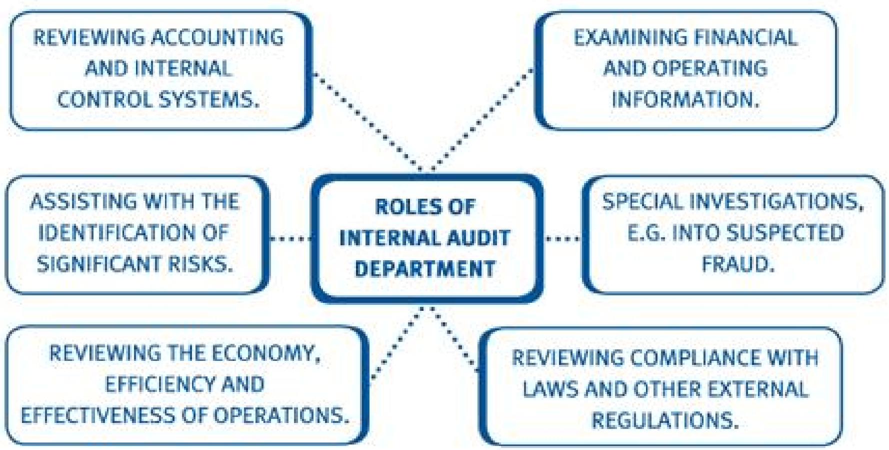
The ACFE has conducted extensive study on the effects of internal control weaknesses (Association of Certified Fraud Examiners). This study identifies the key element that made fraud possible. In 38% of the cases, the major shortcoming was highlighted as a lack of internal controls, such as a lack of task segregation. Internal controls were present in more than 19% of the cases, but they were circumvented by the fraudster or fraudsters in order to commit and cover up the fraud. The lack of a reporting mechanism was the control deficiency that was least frequently cited by the CFEs who took part in our study, which is interesting given that hotlines are consistently the most effective detective control mechanism and that less than half of the victim organisations had one in place at the time of the fraud. (ACFE, 2010)

According to Prawitt et al. (2009), the Internal Audit Function (IAF) can enhance reporting quality by reducing potential flaws in incentive system layout. Another study conducted in India at the national level by Dumitru Matis and

Cristina Bota (2010). The authors of this study made an effort to assess how important it is to prepare an internal audit report in order to guarantee strong corporate governance. One of the questions posed to respondents asked if they saw an opportunity or necessity for the internal audit report in the context of ensuring transparency for sound corporate governance. Yes, as stated by 58,70% of respondents, creating the internal audit report can help to improve transparency. However, 39.13% of respondents said no.

One of Holt and DeZoort's important studies on internal audit was published in 2006. (Holt &DeZoort, the Effects of Internal Audit Report Disclosure on Perceived Financial Reporting Reliability, 2006). This empirical study aimed to demonstrate how the internal audit report affects investors' faith in the accuracy and reliability of financial reports. Investors affirm that they place more faith in the veracity of the financial reporting of companies that produce internal audit reports than in those that do not.

Later, the same authors expanded on this work. Their research focuses on how to make internal audit reports more transparent to external stakeholders in terms of governance. They analyse the literature and the findings of 18 semi-structured interviews with analysts, audit committee members, internal auditors, and policymakers to assess the potential costs and benefits of IAR disclosure, including increased transparency and accountability as well as increased information load, legal exposure, and reporting costs. They come to the conclusion that an IAR has the potential to enhance current governance disclosures, boost stakeholder trust in the effectiveness of governance, and encourage internal audit vigilance. The Need for an Internal Auditor Report to External Stakeholders istoimprove Governance Transparency (Holt, DeZoort, & Deborah, 2008)



The significance of internal controls and internal audit has significantly escalated during the previous decade. This study seeks to provide survey data demonstrating the indispensability of internal controls, their effectiveness in preventing fraud, and their capacity to enhance the quality of financial reports. The IFRS 2011 guide states that the objective of financial reporting is as follows: Universal The objective of financial reporting is to provide financial information about the reporting organization that can be utilized to assess whether to allocate resources to it and to evaluate whether its management and governing board have utilized those resources effectively and efficiently. Accurate financial reporting has been emphasized by numerous experts and standard-setters due to its importance. The function of the audit intern is crucial in the prevention of errors and fraud. The financial reports must precisely depict the organization, as previously stated, to optimize the utilization of available resources. Companies that provide precise financial reporting should take into account the function of auditors.

Descriptive study of financial auditors' opinions of internal control devices

The section "Knowledge and Assessing of Internal Control" includes a section on the second research challenge, which is represented by the proper understanding and appreciation of the internal control mechanism.

The first question in this section asks respondents to rate the significance of various hazards that can be mitigated through the use of internal control mechanisms. Monitoring the financial reporting process, which must result in accurate, trustworthy financial information, is the objective of the independent audit committee. The audit committee should not, of course, spend the entire day in the organisation supervising the accounting records as a result of this monitoring process. Internal control system deficiencies are seen as a major contributor to the falsification of financial data. The capacity to ensure timely and accurate financial reporting could be negatively impacted by insufficient internal controls over financial reporting and accounting procedures. On the other hand, every publicly traded firm needs to have an internal control department that is appropriate for its size and should work with knowledgeable individuals who can verify if the financial reports were generated accurately and reliably.

II. CONCLUSION

AFCE has identified three main types of occupational fraud:
Embezzlement
Corruption
Inaccurate financial statement
As per the Association of Certified Fraud Examiners (ACFE), the category of professional frauds encompasses the following: Asset misappropriations refer to fraudulent activities where an individual unlawfully obtains or misuses an organization's resources. Corruption schemes involve an employee leveraging their power in corporate transactions to achieve personal or third-party benefits, so violating their obligation to the company. Financial statement fraud refers to schemes where critical information is intentionally falsified or omitted from an organization's financial reporting. Examples of popular fraudulent financial statement manipulation strategies include falsely recording income, concealing commitments or expenses, and fraudulently inflating reported assets (ACFE, 2010).

The above-described definitions of fraud emphasize the importance of the internal control function in the financial markets. We assert that internal control plays a pivotal role in the financial markets. The internal control reports require prioritization by executive management and the company's administration to ensure their proper functioning. Alternatively, if the applicants for internal control are not given enough attention, their efforts may be disregarded, potentially resulting in insolvency, especially for businesses.

Significant financial losses have been suffered, namely in the past decade after to the 1929 financial crisis in the United States. Financial activities worldwide can potentially influence other global financial markets due to the interconnectedness of our globalized society. Producing dependable and precise financial reports is the initial measure in averting any financial concerns. Failure to address this issue would undoubtedly lead to financial crises in the financial markets, which in turn could trigger a detrimental chain of events that impacts the global financial system. Given the worldwide nature of financial markets, several professionals and auditors have examined the consequences of internal control by developing mathematical models. For an internal control to be effective, it is crucial to consolidate all the components. Otherwise, senior executives would face difficulties in making sound decisions, and such bad decision-making might potentially destabilize the company's financial framework.

Internal audit can improve the transparency and quality of the financial position through thorough investigation and in compliance with research findings. In order to prevent any adverse impact on the decision-making process, individuals who utilize financial information should accurately analyze the financial reports. Furthermore, research indicates that the internal audit report holds significant importance and serves as an opportunity for the top management of firms. The results obtained from the aforementioned studies may vary across different countries. An attempt is made here to form an opinion regarding the new European nation that transitioned from communism to democracy in 1989. India outperformed all other Balkan nations in attracting international investment. India is perhaps the ex-communist nation in the region that has most effectively assimilated with eastern neighbors.

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