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THE ROLE OF INTERNAL CONTROL AND INTERNAL AUDIT IN DETECTING FINANCIAL FRAUD RISKS

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Abstract. *Financial fraud remains a material threat to organizational value, financial reporting reliability, and stakeholder trust. Evidence from global fraud surveys indicates that losses are often significant (median loss of US$145,000; 22% of cases exceed US$1 million) and schemes tend to persist for extended periods (median duration of 12 months), highlighting detection gaps and delayed response mechanisms (ACFE, 2024). This article examines how internal control and internal audit jointly contribute to identifying (and reducing) financial fraud risks, with emphasis on practical detection pathways: controls design, monitoring, data analytics, and tip-based mechanisms. Using a structured synthesis of authoritative frameworks and professional standards (e.g., COSO-based fraud risk guidance, GAO's fraud risk management framework, The IIA guidance and standards, and auditing standards addressing fraud), the study develops an integrated detection model and an operational control–audit mapping. Results propose a three-layer detection architecture-(1) preventive and detective internal controls, (2) continuous monitoring and analytics, and (3) independent internal audit assurance and advisory work-supported by governance, whistleblowing, and escalation protocols. The discussion outlines implementation implications, common failure modes (control absence and override), and a pragmatic maturity approach for organizations seeking measurable improvements in fraud detection.*

SCIENCE AND SOCIETY-
FAN VA JAMIYAT- НАУКА И ОБЩЕСТВО
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1. Introduction

Financial fraud risk is not merely a compliance issue; it is a governance and performance risk that can distort financial statements, misappropriate assets, and undermine organizational resilience. A persistent theme across professional literature is that fraud frequently thrives where internal controls are weak, missing, or overridden. For example, the ACFE reports that "more than half" of occupational fraud cases involve either lack of internal controls (32%) or override of existing controls (19%) (ACFE, 2024).

From a risk-management perspective, effective fraud detection requires more than periodic checks. It requires an organizational culture and structure that commits to combating fraud, a repeatable fraud risk assessment process, control activities that prevent and detect, and monitoring and adaptation loops. These elements are consistent with the GAO Fraud Risk Management Framework, which emphasizes prevention, detection, and response as "interdependent and mutually reinforcing," embedded in a continuous monitoring cycle (GAO, 2015).

Within this ecosystem, internal control provides the first line of defense through process design and embedded checks, while internal audit provides independent assurance and advisory support to improve the effectiveness of governance, risk management, and controls. The IIA's guidance explicitly links COSO's internal control view of fraud risk (including Principle 8, which requires considering "the potential for fraud" in risk assessment) with the design of a robust fraud risk management program (IIA, 2024).

SCIENCE AND SOCIETY-
FAN VA JAMIYAT- НАУКА И ОБЩЕСТВО
ILMIY-TAHLILIY JURNAL

Issue - 1(2026) / ISSN 2992-913X Available at www.uznauka.uz

Research objective and questions

Objective: To develop an integrated model showing how internal control and internal audit jointly detect financial fraud risks, and to translate that model into practical control and audit procedures.

Research questions:

Which fraud detection mechanisms are most strongly supported by professional frameworks and standards?

How should responsibilities be allocated between internal control functions and internal audit to reduce detection gaps?

What operational indicators and audit procedures are most effective for common fraud schemes?

2. Methods

This study used a framework-based qualitative synthesis to explain how internal control and internal audit contribute to detecting financial fraud risks and to translate professional guidance into implementable practices. Authoritative sources were purposively selected on the basis of institutional credibility, direct relevance to fraud risk management and assurance, and cross-sector applicability. The evidence base included global occupational fraud survey data to capture empirical patterns of loss severity, scheme duration, and detection channels, alongside leading fraud risk management and internal audit frameworks and fraud-related auditing standards. The analytical process followed three steps: first, recurring detection constructs were extracted (governance tone, fraud risk assessment, preventive/detective controls, whistleblowing, monitoring/analytics, investigation and remediation, and independent assurance). Second, these

Issue - 1(2026) / ISSN 2992-913X Available at www.uznauka.uz

constructs were classified by function (prevention, detection, response) and by ownership across the "three lines" (management controls, risk/compliance oversight, and internal audit). Third, the study synthesized the classifications into an integrated detection architecture and practical mappings linking common fraud schemes to observable indicators, control activities, and internal-audit test procedures.

3. Results

The evidence synthesized in this study indicates that financial fraud risk detection is most effective when internal control mechanisms (embedded in processes) are reinforced by an independent internal audit function and supported by reporting channels and monitoring tools. Across 1,921 investigated occupational fraud cases spanning 138 countries/territories (January 2022–September 2023), reported losses exceeded US$3.1 billion, the median case loss was US$145,000, and 22% of cases generated losses of at least US$1 million; importantly, the median scheme duration remained 12 months, implying that many organizations detect fraud only after a full operating cycle (or longer), which increases loss severity and remediation cost.

Patterns in fraud "root causes" strongly support the centrality of internal control and internal audit to detection. More than half of cases were associated with either a lack of internal controls (32%) or override of existing controls (19%), which is consistent with the classic control-failure pathway in which weak design, weak operation, or management override delays detection until a tip, reconciliation anomaly, or external trigger emerges.

SCIENCE AND SOCIETY-
FAN VA JAMIYAT- НАУКА И ОБЩЕСТВО
ILMIY-TAHLILIY JURNAL

Issue - 1(2026) / ISSN 2992-913X Available at www.uznauka.uz

Fraud category statistics further clarify where detection mechanisms should concentrate. Asset misappropriation was the most prevalent category (present in 89% of cases) but had the lowest median loss (US$120,000), indicating high frequency but comparatively lower severity per event. Corruption appeared in 48% of cases with a median loss of US$200,000, while financial statement fraud was least frequent (5%) yet most severe (median loss US$766,000). This distribution implies that internal controls in high-volume transaction cycles (procure-to-pay, payroll, treasury, expense claims) are pivotal for early anomaly detection, while internal audit must explicitly target low-frequency/high-severity reporting risks such as journal-entry manipulation, estimation bias, and governance override scenarios.

Detection channel data indicates that “soft” mechanisms (especially tip reporting) materially outperform purely procedural mechanisms in initial discovery, reinforcing the need for control environments that encourage reporting and protect whistleblowers. Tips accounted for 43% of initial detections, while other channels such as document examination (6%), account reconciliation (5%), and accidental discovery (5%) were materially lower. Automated transaction/data monitoring represented 3% of initial detections, which suggests that many organizations still underutilize analytics as a primary discovery channel; however, this does not diminish analytics value, because analytics can reduce duration and losses when designed as continuous monitoring rather than ad hoc testing.

A control-architecture result of particular operational value is the consistent association between anti-fraud controls and improved outcomes. In the analyzed data, common controls included codes of conduct (present in 85% of cases),

SCIENCE AND SOCIETY-
FAN VA JAMIYAT- НАУКА И ОБЩЕСТВО
ILMIY-TAHLILIY JURNAL

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external audits (84%), and internal audit departments (80%). The presence of these and other anti-fraud controls is associated with lower median losses and shorter fraud duration, with duration reductions reported in the range of 14% to 50% when anti-fraud controls are in place. This relationship supports a complementary design in which internal control provides preventive/detective checks and internal audit validates effectiveness, tests override vulnerability, and pressures the system toward continuous improvement after incidents.

The results also show that fraud impact is not uniform by organizational type, industry, or perpetrator authority. Median loss by organization type was US$150,000 for private companies, public companies, and government organizations, while not-for-profit organizations had a lower median loss (US$76,000) and an “other” category showed a higher median loss (US$212,000). Industry-level dispersion was substantial: mining showed the highest reported median loss (US$550,000), followed by wholesale trade (US$361,000) and manufacturing (US$267,000), whereas retail (US$48,000) and education (US$50,000) were the lowest. Finally, perpetrator authority correlated strongly with severity: owners/executives represented 19% of cases but produced a median loss of US$500,000, compared with managers (41% of cases; median loss US$184,000) and employees (37% of cases; median loss US$60,000). These gradients are directly relevant to internal audit planning because they justify heavier audit attention to management override controls, governance processes, and high-discretion areas (e.g., vendor onboarding approvals, master data changes, journal entries, estimates).

SCIENCE AND SOCIETY-
FAN VA JAMIYAT- НАУКА И ОБЩЕСТВО
ILMIY-TAHLILIY JURNAL

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Table 1. Key quantitative results supporting the internal control–internal audit detection model

Evidence area	Metric	Practical implication for internal control and internal audit
Scale and persistence	1,921 cases; 138 countries/territories; >US$3.1B total losses; median loss US$145k; 22% ≥US$1M; median duration 12 months	Detection typically lags; prioritize earlier signals (tips + monitoring) and shorten "time-to-detect" through continuous controls and audit-led validation.
Control failure modes	Lack of internal controls 32%; override of controls 19%	Invest in control design/operation and override-resistant controls; internal audit should specifically test override pathways and access rights.
Fraud categories (frequency; median loss)	Asset misappropriation 89%; US$120k. Corruption 48%; US$200k. Financial statement fraud 5%; US$766k	Controls must cover high-volume transaction cycles; internal audit must target low-frequency/high-severity reporting risks and governance override.

SCIENCE AND SOCIETY-
FAN VA JAMIYAT- НАУКА И ОБЩЕСТВО
ILMIY-TAHLILIY JURNAL

Issue - 1(2026) / ISSN 2992-913X Available at www.uznauka.uz

Initial detection channels	Tips 43%; document examination 6%; account reconciliation 5%; by accident 5%; external audit 3%; automated monitoring 3%	Strengthen hotline governance, protection, and triage; increase the role of analytics as a management-owned monitoring control validated by internal audit.
Anti-fraud controls in place (examples)	Code of conduct 85%; external audit 84%; internal audit department 80%; hotline present in 71% of cases; anti-fraud policy 60%	A layered system is common, but performance depends on execution quality; internal audit should assess whether controls are merely "present" or actually effective.
Duration impact of controls	Fraud duration reduced by ~14% to 50% when anti-fraud controls exist	"Time-to-detect" is a measurable KPI; use it to evaluate controls monitoring and internal audit follow-up effectiveness.
Median loss by organization type	Private US$150k; public US$150k; government US$150k; not-for-profit US$76k; other US$212k	Sector context matters for control investment; internal audit plans should reflect exposure and transaction complexity.
Industry	Mining US$550k;	Risk-based audit

Issue - 1(2026) / ISSN 2992-913X Available at www.uznauka.uz

dispersion (median losses)	wholesale trade US$361k; manufacturing US$267k; retail US$48k; education US$50k	planning should weight industries (or activities) with higher loss severity and control complexity.
Perpetrator authority (share; median loss)	Owner/executive 19%; US$500k. Manager 41%; US$184k. Employee 37%; US$60k	Management override and high-discretion approvals are critical audit targets; strengthen governance and independent review controls.

4. Discussion

4.1 Why internal control alone is insufficient

Internal control is necessary but often insufficient due to two structural realities:

Control absence: processes grow faster than controls; new products, digital payments, and decentralized operations expand the attack surface.

Control override: even well-designed controls can be overridden by management or collusive behavior-consistent with survey evidence that override is a major contributor to fraud occurrence (ACFE, 2024).

Therefore, detection requires independent challenge and monitoring beyond routine process checks.

4.2 The distinct contribution of internal audit

Internal audit enhances fraud detection through independence, risk-based scope, and systematic evaluation:

SCIENCE AND SOCIETY-
FAN VA JAMIYAT- НАУКА И ОБЩЕСТВО
ILMIY-TAHLILIY JURNAL

Issue - 1(2026) / ISSN 2992-913X Available at www.uznauka.uz

Independent assurance: Internal audit evaluates whether fraud risks are identified, prioritized, and addressed, rather than assuming management's view is complete.

Testing operating effectiveness: Fraud often exploits gaps between "policy" and "practice." Internal audit tests real operation of controls, including exceptions and override logs.

Fraud lens on risk assessment: Standards increasingly emphasize fraud-focused risk assessment and responses (IAASB, 2025).

Program maturity: Internal audit can benchmark fraud risk management against leading practices (e.g., GAO's commit–assess–design/implement–evaluate/adapt cycle) and recommend staged improvements (GAO, 2015).

4.3 Practical implementation priorities

Organizations seeking measurable improvement should prioritize:

Tips + protection + triage: Because tips dominate detection channels, hotline governance and non-retaliation controls are not "soft controls"; they are detection infrastructure (ACFE, 2024).

Override-resistant controls: strengthen audit trails, maker-checker controls, and independent reconciliations in high-risk cycles (payables, payroll, revenue, journals).

Analytics with ownership: embed analytics into process ownership, then have internal audit validate coverage and false-negative exposure.

Closed-loop remediation: ensure investigations produce root-cause fixes and control redesign, not only disciplinary outcomes.

4.4 Limitations

SCIENCE AND SOCIETY-
FAN VA JAMIYAT- НАУКА И ОБЩЕСТВО
ILMIY-TAHLILIY JURNAL

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This study is based on synthesis of authoritative sources and does not present organization-specific empirical testing. Future research could validate the proposed model using fraud case datasets, (ii) pre–post analytics deployment outcomes, or (iii) internal audit finding trends across sectors.

5. Conclusion

Financial fraud risk detection is most effective when internal control and internal audit operate as complementary mechanisms within a coherent fraud risk management program. Survey evidence indicates that fraud remains costly and persistent, with many cases tied to control absence or override and frequently detected through tips-underscoring the need for strong governance, speak-up mechanisms, and continuous monitoring (ACFE, 2024).

The article's key contribution is an integrated three-layer detection architecture and practical control–audit mappings that translate frameworks into operational steps. Internal control embeds preventive and detective checks; continuous monitoring and analytics accelerate anomaly detection; and internal audit provides independent assurance, tests real operating effectiveness, and drives maturity improvements aligned to leading practices (GAO, 2015; IIA, 2024).

For implementation, organizations should focus on tip governance, override-resistant controls, analytics ownership, and closed-loop remediation. When these elements are integrated, fraud detection becomes faster, more reliable, and more resilient to evolving schemes.

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SCIENCE AND SOCIETY-
FAN VA JAMIYAT- НАУКА И ОБЩЕСТВО
ILMIY-TAHLILIY JURNAL

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