

THE IMPACT AND REALITY OF FRAUD AUDITING EVOLUTION OF AUDITING: HOW THE RECESSION IS CHANGING THE INDUSTRY

The recession has significantly affected all of our lives, personally and professionally. All internal auditors have dealt with a changing work environment and perception dynamics in the past three years. The role of internal audit continues to evolve with the changing economic landscape. In this session, learn value-added auditing, how to employ SOX knowledge to stretch operational auditing into new areas, and how to reduce unnecessary expenses.

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Danny M. Goldberg is the Professional Development Practice Director at Sunera, an international Corporate Governance, Risk Management, and Regulatory Compliance firm. Prior to joining Sunera in January 2011, Danny founded SOFT GRC, an advisory services and professional development firm. Danny has over thirteen years of audit experience in the Dallas/Fort Worth area, including five as a CAE/Audit Director at two diverse companies. He has the rare experience of being an integral part of/leading the Year One SOX Compliance efforts at three companies in the DFW area. Additionally, he has assisted in leading the establishment of three internal audit/SOX departments.

Prior to founding SOFT GRC, Danny was the Director of SOX Compliance and Corporate Audit at Dr Pepper Snapple Group, where he led the Year One SOX Compliance efforts. Prior to his tenure at Dr Pepper, Danny started the internal audit department at Tyler Technologies, a publicly traded technology company.

Prior to his experience at Tyler, Danny was also part of the Year One SOX Compliance team at Tenet Healthcare, where he assisted the end-to-end compliance efforts. Danny began his career at Arthur Andersen and is a graduate (BS – Accounting, 1997, MS – Finance, 1998) of Texas A&M University.

Danny has served on the board of directors of a nonprofit organization and an audit committee of a large independent school district in DFW. Danny currently serves on the Dallas Chapter Leadership Board of the American Lung Association and is the IIA Dallas Chapter Program's Committee Co-Chairman for the 2011–2012 year.

Danny is accredited as the professional commentator on the publication *BNA Tax and Accounting Portfolio, Internal Auditing: Fundamental Principles* (Accounting Policy and Practice Series), which is authored by renowned audit scholars Curtis C. Verschoor and Mort A. Dittenhofer—co-author of *Sawyer's Internal Auditing*.

He has also published numerous articles in trade magazines over the past four years, including:

- ❑ *ISACA Journal* (“General Auditing for the IT Auditor: An Overview,” May 2011)
- ❑ *The Audit Report* (“11 Hot Topics for 2011,” March 2011)
- ❑ *Dallas Business Journal* (“The Yes Man Phenomenon,” January 2011)
- ❑ *New Perspectives* (“Sell Your Work: How to Deliver Best Practice Audit Reports,” December 2010)
- ❑ *Internal Auditor* (“CAE’s as A/C Members: It Just Makes Sense,” October 2010)
- ❑ *The Audit Report* (Cover Article—“How the Recession is Changing Internal Audit,” June 2010)
- ❑ *ISACA Journal Online* (“Is It Time to Automate SOX?,” December 2009)
- ❑ *Internal Auditor* (“The SOFT Approach to Auditing,” August 2007)
- ❑ *Internal Auditor* (“A Focus on High-Risk Controls,” December 2007)

Danny is a well-known speaker across the nation and has spoken at numerous IIA and ISACA sponsored events. He has spoken on a number of subjects over the past four years, and has taught everything from one-hour lunch seminars to all-day seminars (all speaking events are accredited as CPE hours). Major conferences that Danny has/will speak at in 2011 include:

- ❑ 51st Annual Chicago IIA Spring Seminar (featured presenter)
- ❑ Michigan Association of CPAs’ Annual Healthcare Conference
- ❑ 22nd Annual ACFE Fraud Conference
- ❑ Texas Society of CPAs’ Texas School District Accounting and Auditing Conference
- ❑ News Media Internal Auditors Annual Conference (featured presenter)
- ❑ 2011 IIA Omaha District Conference
- ❑ 2011 IIA Midwestern Regional Conference

Danny is a Certified Public Accountant, Certified Internal Auditor, Certified Information Systems Auditor, is Certified in the Governance of Enterprise Information Technology, and has obtained his Certification in Control Self-Assessment. He is married with a son and daughter and lives in Plano, Texas.

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Introduction

The recession has significantly affected every facet of our lives over the past four years. It has changed many aspects of our personal and professional lives. One cannot fully understand how significantly the recession has changed internal audit without revisiting the past four years.

The U.S. recession that began in December 2007 ended in June 2009, making the 18-month slump the longest since the Great Depression, according to the National Bureau of Economic Research (NBER). Yet the NBER also cautioned that its findings bear no relation to the current state of the economy and do not represent a forecast about the future. If another downturn occurs anytime soon, the NBER said, it would constitute a separate recession. The NBER, founded in 1920, is a non-profit group entrusted by the government with determining when recessions begin and end. The Cambridge, Massachusetts-based group includes leading economists in business, academia, and trade unions. The group said the economy bottomed out in June 2009, followed by a slow expansion. Previously, the longest recessions in the modern era lasted 16 months—one in 1973–75 and another in 1981–82.

I have found it difficult to state that the recession ended in June 2009. I believe there is full agreement that the economy did bottom out in mid-2009; however, we have seen elements of recovery but no notions of full-fledged recovery.

Think about what has changed in our lives and the lives of our companies over the past four years. Many staples of our lives have disappeared, including:

- ❑ **Blockbuster:** While Blockbuster was growing exponentially and opening retail stores and hamstringing its customers with late fees, Netflix

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wooded millions of movie fans by mailing them DVDs and offering streaming video, and Redbox set up convenient kiosks offering overnight movies for a buck.

- ❑ **Bennigan's:** In late July 2008, all company-owned restaurants, about 150 locations, were closed when the owner, S&A Restaurant Group, filed for Chapter 7 bankruptcy. The franchised restaurants in the chain remained (and remain) in business, but they are few and far between. After the closure of the S&A Group, all remaining assets of the company were purchased by a private equity group to allow the franchisees to keep running, with the intent of reopening the closed owned-and-operated locations as franchised locations.
- ❑ **Circuit City Stores, Inc.:** it was an American retailer in brand-name consumer electronics, personal computers, and software. The company opened its first store in 1949 and pioneered the electronics superstore format in the 1970s. Circuit City liquidated its final American retail stores in 2009 following a bankruptcy filing and subsequent failure to find a buyer.

This presentation has been refreshed since first created in mid-2009, but the recurring theme throughout all audiences is that all of us have been affected by the recession in some way or another.

A Pew Research study in mid-2010, entitled “How the Great Recession Has Changed Life in America,” showed that “more than half of the adults in U.S. labor force (55 percent) have experienced some work-related hardship—be it a spell of unemployment, a cut in pay, a reduction in hours, or an involuntary move to part-time work. In addition, stock market bubbles have shrunk the wealth of the average American household by an estimated 20 percent, the deepest of such declines in the post-World

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War II era, according to government data."¹ Pew reports: "Whether by choice or necessity, many Americans have already significantly scaled back their pre-recession borrow-and-spend habits. According to government data, household spending has gone down, savings rates have gone up, consumer credit has remained stable, and mortgage debt has plunged during this recession."²

Many companies have seen the significant effect of the recession on their bottom line and have made minor adjustments to combat it. For example, many retail companies over the past three years have limited the use of gift boxes during the holiday season to cut down on unnecessary costs. Additionally, many large companies that compete with private label products have seen a significant hit in revenue due to the consumer movement toward cheaper products. Dean Foods, for example, makes both products and saw a significant shift to private labels and decreased in revenue even though it makes both.

Now, let's look at the jobless rates over the past 30 years compared to 2011. In March 2011, the jobless rates dropped to 8.9 percent, the lowest in nearly two years. When factoring in the number of part-time workers who would rather be working full time and those who have given up looking for work, the percentage of "underemployed" people dropped to 15.9 percent in February, which is also the lowest in nearly two years. Obviously, there are signs of improvement, but let's look at these stats in comparison to previous years and as realistically as possible. In general, this stat tells us that approximately 1 in every 6 Americans are out of work. Again, that is the lowest rate in numerous years. When we

¹ Forbes.com, "How the Recession has Changed America's Spending," July 8, 2010

² *Id* at 1

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look at the unemployment rate compared to previous years, 2009 was easily the worst year. Comparing this year to prosperous times (2000 at 4.0 percent) and similar times (1980 and 1985 at 7.2 percent), we can see that we have incurred significant unemployment issues. Many prognosticators are very optimistic and believe we have seen the worst of the recession. I am a bit more pessimistic and believe we have hit the new economic norm.

What is the new economic norm? It is the economy's current status in the United States in 2011. In my opinion, it will be 10-15 years before we see prosperous times here in North America like we did in the early part of the 21st century. Many factors contribute to this theory, including:

- ❑ **Job Market:** The industry has been significantly over-hiring due to SOX and other booms over the past ten years, and the market has right-sized itself. Organizations took the cutbacks a bit far and have begun to hire, but in a more conservative manner than in previous years.
- ❑ **Conservative Hiring Practices:** Anyone who has been a prospective employee recently and has gone through the interview process knows how lengthy this process has become. Hiring for upper-level roles might take three to six months and numerous rounds of interviews. Companies are discovering that, even though this extends the hiring process, this is an appropriate amount of time to vet candidates, and this will be closer to the norm going forward rather than the exception.
- ❑ **Tumultuous Economic Times:** There are signs of economic recovery, but times are changing and passing certain companies by. There will still be bankruptcies in addition to issues in the Middle East. All of these factors will continue to negatively affect our economy.

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The Recession's Effect on Internal Audit

As shown by the statistics throughout this presentation, the recession has had a significant effect on internal audit and its effectiveness and role in the coming years. Many organizations have completed the vicious cycle of reductions in force (RIFs) and have completed this process in a rush and ineffective manner. Many RIFs are completed in this fashion. Most are not well thought out and become ineffective.

How are most RIFs implemented? In a very reactive manner, most companies begin to cut staff due to decreases in revenue and issues that have occurred, not issues that will occur. Most cuts are made across the board, to keep it "even" for all areas. This is asinine the wrong approach. RIFs should be well thought out and planned for, similar to succession planning. If organizations implement a well-thought-out RIF, risks are addressed and significant roles that are lost are covered by other employees. In the other instance, RIFs are completed across the board to acquiesce shareholders and many duties and responsibilities fall through the cracks. The RIF now has become a deterioration of the current control environment and increased the company's risk profile. Cost savings become a main priority and risk increases. In the grand scheme of things, is this the best idea or should risk be weighed against cost savings?

Many surveys and polls over the past three years have shown that internal audit was affected by the recession, but not to the same extent as many other industries. Auditors are still very valuable and needed regardless of the economy. Now, how can internal audit continue to add value in the current economy?

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How Can IA Help Due to the Recession?

What are auditors? Are we overhead costs or are we revenue generators? Obviously, as compliance and risk management specialists, we are categorized, in most cases, as overhead. Is it possible for auditors to become revenue generators? Auditors can become revenue enhancers by working inside the organization to cut costs and help the company become more efficient and effective. Auditors can continue to become more valuable by:

Timely Refreshment of the Audit Risk Assessment (ARA)

Best practices have historically stated that the audit risk assessment should be refreshed at least annually, as audit departments must continue to adapt to the changing dynamics of their organization. That being said, when management and/or the audit committee asks how often we refresh the audit risk assessment, the answer should be continuously. The ARA is an ameba; it is constantly moving and changing. It is important to be proactive rather than reactive in our assessment of organizational risk.

Increased Focus on Fraud

Over the past four years, most companies have seen an increase in fraud occurrences by customers (retail) and employees. Many surveys and studies have verified this significant increase, as outlined below:

- A survey by the Association of Certified Fraud Examiners found that U.S. businesses lost \$994 billion to fraud in 2008/2009 alone—and that does not include losses due to the Madoff scandal. More than half of the respondents reported increased

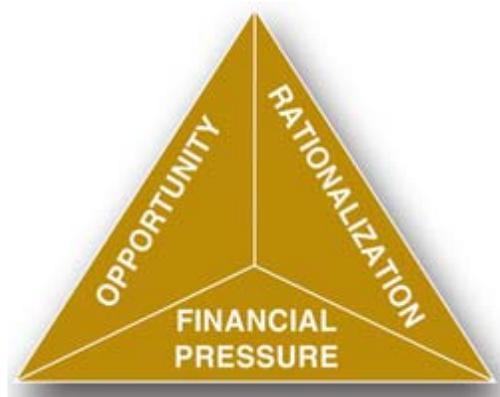
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fraud losses in the past year, and 80 percent expect fraud to increase.³

- Fraud broke the £2 billion barrier in 2009 and is set to triple over the next three years, according to experts. New research from business advisors BDO LLP found that the amount lost by businesses and the public sector to frauds increased last year by 76 percent, with both the number and size of frauds increasing dramatically during the recession.⁴
- A report by credit rating agency Experian shows that mortgage fraud attempts increased by 14 percent to 32 in every 10,000 applications in 2010. First-party fraud, where an individual falsely portrays his personal circumstances to obtain services to which he is not entitled, accounted for 97 percent of cases.⁵

As depicted in the fraud triangle below, potential fraudsters are influenced by all three elements of the fraud triangle. In the times of economic recession, all three elements of the fraud triangle are more prevalent than in normal economic times, as shown below:



³ <http://mcgladrey.com/Real-Estate-Advisor/Fraud-a-Growing-Threat-During-the-Recession>

⁴ http://www.lloyds.com/News-and-Insight/News-and-Features/Business-Risk/Business-2010/Fraud_to_thrive_beyond_the_economic_downturn

⁵ <http://get-easily-mortgage.com/uk-mortgage/mortgage-fraud-rises-following-recession>

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- **Opportunity:** As companies go through Reductions in Force (RIFs), most are not well thought out, and it leaves the door open for increased risk due to a breakdown in the control structure. People are let go and their roles and responsibilities tend to fall through the cracks. This increases the opportunity for fraud.
- **Financial Pressure:** Obviously, employees are under increased financial pressure during a recession. There are inherently less jobs, no raises or pay decreases, and even furloughs. Many employees are just trying to make ends meet, which again increases financial pressure and the opportunity for fraud.
- **Rationalization:** Rationalization is always prevalent with perpetrators of fraud. This helps to ease the guilty conscience and make fraud acceptable in the perpetrator's eyes. In difficult economic times, it is much easier to rationalize committing fraud since we are attempting to just make ends meet.

How has this increase in fraud affected internal audit? Internal audit has spent more time and effort on fraud and fraud investigations. Fraud investigations are difficult to predict and can take a significant amount of time and effort. Internal audit should integrate as many anti-fraud procedures as possible into the normal audit process. The fraud risk assessment should have a focus on planning and an increase in fraud training and education for auditors.

Increase Value-Added Services

How does internal audit continue to become a revenue enhancer inside its organization? IAD should focus on

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increasing services that are perceived to add more value to the organization, including:

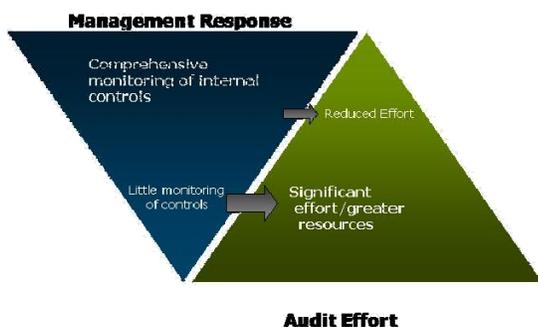
- **Operational Auditing:** Internal auditors can continue to increase value in their organization by focusing on operational auditing. Operational auditing focuses on the efficiency and effectiveness of company operations. If internal audit is able to identify cost-cutting measures, we slowly but surely become “revenue enhancers.”
- **Six Sigma:** In principle, Six Sigma and Lean Six Sigma are similar to operational auditing. Six Sigma is a rigorous and systematic methodology that uses information (management by facts) and statistical analysis to measure and improve a company's operational performance, practices, and systems by identifying and preventing “defects” in manufacturing and service-related processes in order to anticipate and exceed expectations of all stakeholders to accomplish effectiveness.⁶ Operational auditing does not have the statistical focus of Six Sigma, but the focus is similar: efficiency and effectiveness in operations. Many organizations have separate Six Sigma groups. IAD should integrate the Six Sigma group with their operational audits or begin to integrate these principles into their current audit approach.
- **Continuous Auditing/Monitoring (CA/CM):** Continuous auditing and continuous monitoring tools have been around for 10+ years, but most audit departments have not adopted a continuous approach. Many organizations have ACL but have not implemented or fully integrated the product. Other organizations have not had the appropriate buy-in from the organization to fully reap the

⁶http://www.isixsigma.com/index.php?option=com_glossary&id=77&Itemid=27

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benefits of CA/CM. Let's think about this logically: Would we rather audit a year in the past or current information? The audit timeline has previously been very lengthy. Let's say your focus is calendar year 2010. So IAD is auditing from January 2010 through December 2010. This data is not available until most likely February or March 2011. The audit could take four to eight weeks and another 30 days (optimally) to issue the audit report. Now we could be into June or July when the audit report is finally issued. At this point, we must ask: Does management even care about the audit results at this point? The audit is still relevant, but its overall impact is minimized due to the staleness of data. CA/CM allows audit departments to audit real-time and give more relevant data to management. Additionally, as shown in the figure below, the role of continuous auditing is directly related to management's continuous monitoring of controls. This can only help increase the viability and overall approach of IAD.



- **Integration of Audit Approaches:** Above, we discussed the concepts of continuous auditing and monitoring. Another similar concept is continuous improvement. Audit should always focus efforts on operational auditing and continuous improving of

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current processes and procedures in place. Auditors would be somewhat hypocritical if they do not implore the same approach internally and continue to improve the current audit process. That being said, IAD should continue to integrate audit approaches. Operational procedures should be integrated into Sarbanes-Oxley compliance procedures. Fraud procedures should be a part of every audit. Always continuing to improve the audit process should be a goal of internal audit at all times, regardless of current economics.

Above, we outlined some of the ways internal audit departments can continue to increase their value in their organizations in the current economic environment. Now, let's focus on how the recession has changed the future direction of internal audit.

Where Is IA Headed Over the Next 10 Years?

Over the past 30 years, the dynamics of internal audit have changed significantly. Gone is the police mentality, where auditors were the internal enforcers of the organization. IAD still has this role but these goals are met by utilizing a much different methodology. IAD is a partner with the organization and is viewed as an independent, internal consultant. By 2020, many of the below changes will continue to infiltrate their way into internal audit due to numerous governance changes and the continued effects of the recession and economic crisis.

- ❑ **Transparency:** This is truly a key term in today's modern internal auditing. Transparency breeds trust and an honest approach to auditing. This also breeds a more effective and efficient audit, as auditees will appreciate this approach to auditing and be more open to assisting in the audit and the change the audit will drive.

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❑ **Audit Team Compilation:** The days of working in audit silos are in the past. In the future, there will not be a clear delineation between general and IT and fraud auditors. All audit team members will be expected to be multi-faceted auditors. When planning for the year, one team will be able to cover all facets of an audit.

❑ **IFRS:** The International Financial Reporting Standards (IFRS) most likely will replace Generally Accepted Auditing Standards over the next five years. In fact, the current standards are converging to IFRS as we speak today. What is the difference between adoption and convergence?

- **Adoption** would mean that the SEC sets a specific timetable when publicly listed companies would be required to use IFRS as issued by the IASB.⁷
- **Convergence** means that the U.S. Financial Accounting Standards Board (FASB) and the IASB would continue working together to develop high quality, compatible accounting standards over time.⁸

Internal audit will be pulled into the implementation of IFRS in organizations. As auditors, we should be ready to assist our organization in any way possible and be ready for these major accounting changes.

❑ **The Resurrection of Operational Auditing:**

Operational auditing will continue to become increasingly important in organizations. So important, in fact, that we mention it twice in this presentation.

❑ **The Rise of Audit Flex Time:** As noted previously, the audit department must continue to re-assess risk as information arises. That being said, how can we alter the audit plan to continue to adjust to the changing risk profile? By identifying a significant percentage of audit flex time. Auditors should keep the audit plan flexible.

⁷ www.ifrs.org

⁸ *Id* at 7

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When creating the annual audit plan, auditors should identify 25–30 percent of the plan as flexible time, meaning they should identify audits that will take place if circumstances stay the same. Historically, most audit departments limit flex time to 5–10 percent. In the changing economic times, the audit plan must become more flexible and dynamic.

- ❑ **The Rise of the CRO/CCO**—Throughout this presentation, there has been one recurring theme: more efficient and effective operations, whether it be discussing processes inside an organization or in internal audit itself. The organizational chart in many companies is also beginning to evolve, inclusive of the role and structure of internal audit. Obviously, internal audit must stay independent and objective. That being said, there are many similar functions in large organizations, including:
- Internal Audit
 - Risk Management
 - Regulatory Compliance
 - Governance
 - SOX Compliance
 - IT Compliance

Functionally, each has their own specialty and focus. On the other hand, there are many crossovers and similarities between each function. This has given rise in some organizations to the Risk and Compliance Department, which encompasses all functions noted above. This capitalizes on the similarities, can minimize time in the field as one audit team can cover all issues at one site and decreases organizational confusion on the number of audits occurring throughout the year. As we continue to evolve, look for an increase in Chief Risk or Compliance Officers, which will oversee this new organization.

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Conclusion

As organizations continue to adjust the new economic norm that is today's current state, internal audit must continue to evolve with these changing dynamics. The recession has altered the course of internal audit, both currently and in the future, and auditors must continue to provide increased value for their company.

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