INTERNAL AUDIT IN THE RETAIL INDUSTRY:  
A PRO-ACTIVE APPROACH TO REDUCE SHRINKAGE

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Lowes-Manhattan Menswear Pty. Ltd.

Whilst forming an internal audit/loss prevention discussion group in New South Wales, the first question asked of directors of retail organisations was "Do you have an internal audit function? One of the first answers received was "Yes—we think so"!

A view held by some is that internal auditors are just "spare" people or "clerical odd job men". We must demonstrate this to be wrong.

The traditional role of internal auditors is generally seen as that of identifying errors that have already occurred and reviewing procedures that are already in place. This "after the fact" auditing does have its place. However, "future" issues must also be addressed. By adopting a pro-active approach and directly addressing the causes of weakness that expose our organisations to loss by fraud and theft, internal audit in retail can really make an impact. In the June 1991 issue of "Internal Auditor", C. M. Thompson Jnr observed:

In many organisations internal auditors have the education, training and experience to detect, investigate and document fraud [and theft]. In addition internal auditors are objective and independent of the areas they review. Internal auditors frequently are in the best position to quietly gather the facts with the least disruption. (Thompson, C. M. Jnr 'Fraud the challenge facing Internal Audit, Internal Auditor June, 1991, p73).

Retail internal auditors must have an expanded role into loss prevention. This is particularly important in a chain store environment where the number of stores may be large, the size small and the locations widespread. This makes the use of traditional store detective methods somewhat
ineffective. It is in these situations particularly that the educational and preventative aspects of loss prevention must be brought very much to the fore. As the internal audit manager of a retail chain you could very well be looked upon as the "expert" in loss prevention.

The development of the internal audit department (IAD) in Lowes has been a major success, particularly with regard to lowering the shrinkage level which has shown a reduction of some 60 per cent since 1988. The IAD works in many areas of the organisation. However, this discussion is devoted to matters relating to the retail outlet.

The organisation

Lowes-Manhattan Menswear employs just over 1000 staff and operates 110 menswear retail outlets throughout New South Wales, Queensland and the A.C.T catering to the "middle" market. Our Head Office is in Sydney. The stores typically:

- Are of 2000 square feet
- Are staffed daily by three (full time equivalents)
- Carry $200,000 stock at cost

We also operate three larger "departmentalised", stores of some 8000 square feet in area. The business is of a discount nature and the stores are always full to capacity with merchandise.

Cash register system

Each store has two to three personal computer based cash register systems with ancillary equipment including bar-code scanners, printers and a modem. Each store runs their system as a separate entity from Head Office. The store's registers consolidate via a communication cable daily and are subsequently "dialled" each night by one of eight Head Office computers. Selected information is passed to and fro between Head Office and the stores, e.g. new prices and bar-codes to the stores and sales information and stock balances etc. to Head Office. Information also communicated by the stores daily which is scrutinised by the IAD includes:

- Bankings
- Cash discrepancies
- Refund details
- Void details
- Stock adjustments
Security devices

Some 40 per cent of stores are currently provided with electronic article surveillance equipment (EAS). We utilise "Knogo" brand radio frequency equipment consisting of slim line pedestal type transceivers placed to cover all exits. Approximately 20 per cent of the merchandise is "tagged" in each store. Surveys indicated that external theft of this particular merchandise was responsible for some 80 per cent of the value of all merchandise stolen.

The perceived vulnerability of merchandise is regularly reviewed by the IAD and "tagging" adapted accordingly.

All stores will be EAS equipped by December 1994. Locking devices, cables, security cameras and mirrors are also used selectively.

Staffing the retail internal audit department

Our IAD currently consists of a manager and three auditors. Our auditors are not transient nor are they drawn from line management positions "just for the experience".

The auditors must be methodical, diligent and have an "eye for detail". However, given that our work is largely of a practical and operational nature, formal accounting qualifications are not a pre-requisite. Drawing from our own senior store management brings a manager's perspective to the department and importantly the auditor will have a great degree of credibility amongst his fellow employees.

As we strive to work "with" our people, the balanced character of the auditor is of great importance. Whilst wishing to foster a healthy relationship between auditor and Auditee to ensure a good two-way communication flow, the auditor must also have the capacity to keep that "one step away" to maintain his objectivity. It is noteworthy that the majority of actionable internal dishonesty matters have been brought to the attention of the department by staff.

The auditor cannot be daunted by the concept of illegal activity, in fact he must want to expose it. However, "internal auditors must develop a mind set that keeps them alert to the fact of fraud (or theft) without submitting to paranoia" (Anne Graham 'Putting a face on fraud', Internal Auditor, December, 1991, p4).

Our auditors are not regarded as "bean counters" but as members of the Management "team' who genuinely contribute to the well-being of the
organisation. Catching people who have made errors is not our goal nor is it viewed as a measure of our performance.

The Audit/Loss Prevention Committee

An important early development was the establishment of our audit and loss prevention committee. A fellow retail internal audit manager recently described how his audit committee was ineffective because with some 270 retail outlets firstly there was too much to discuss and secondly the committee members were not all familiar with specific locations or store operations!

Thankfully our committee members are fully acquainted with our stores and operations. The committee comprises of the following:

- The Managing Director
- The Finance Director
- The Operations Manager (Associate Director)
- The Personnel Manager
- The Stores Administration/Audit Manager
- The Senior Internal Auditor

We find this committee to be a vital part of our loss prevention initiative. It is, some might say, a "luxury" to have this key high management together at these meetings, it certainly ensures that timely and authoritative decision are made. We also have the facility to report directly to the Managing Director.

In some instances internal audit and/or loss prevention departments may report to too low a level "boss" therefore restricting their effectiveness. No matter how well intentioned the department may be, it must be supported by high level back-up.

Scope of IAD regarding fraud and theft

In Lowes Menswear the IAD fully investigates theft and fraud including:

- Determining the facts
- Identifying the offender(s)
- Determining the extent of the loss
- Documenting the case
- Attendance at interviews
- Reporting to management
- Reporting to police
- Attendance at Court
For specific tasks an "outside" security consultancy is utilised where necessary.

**Communicating our findings**

Each year at each store we conduct the following:

- Four "Full" 60 point audits—inclusive of most aspects of branch operations and health and safety matters
- Two "Short", 20 point audits—security and cash related issues
- Two "Cash only" audits

This equates to some sixty audits each month, covering some 2300 specific points. Given this amount of information it is extremely important to communicate in a meaningful manner. We utilise what we term as a "benchmark" system.

Each month schedules are produced showing audit results as they have been "scored" out of 100. Each section of the audit is given a particular "weight" for example

<table>
<thead>
<tr>
<th>Section</th>
<th>Weight</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash handling and banking procedures</td>
<td>20%</td>
</tr>
<tr>
<td>Refund and exchange procedures</td>
<td>20%</td>
</tr>
<tr>
<td>Electronic article surveillance equipment management</td>
<td>20%</td>
</tr>
</tbody>
</table>

Many variations of the schedule may be produced, for example

- Performance of an individual store compared to Company average
- Performance of a particular region compared to Company average
- Progression or regression of a particular store
- Progression or regression of a particular region

We find that this method conveys our findings to higher management and other interested parties in a far more "palatable" manner than to have them wade through copious amounts of paperwork or have lengthy discussions regarding individual performances. This method clearly identifies areas of concern. For example, a branch may have a problem with uneven cash exchanges or another new store has failed to grasp EAS management. Relevant action can then be taken: re-training or re-auditing etc. Future performance is reviewed utilising the benchmark schedules. Audit findings are fully discussed with the Auditee and their comments and opinions noted. The schedules are circulated to regional managers for discussion with store
managers and we find that the competitive instinct encourages managers to have their stores perform well.
The "Compliance" aspect

"After the fact" auditing does have its place. The compliance audit program is an integral part of loss prevention in our organisation.

Lowes-Manhattan falls into the chain operation category, therefore it is difficult to utilise "orthodox" loss prevention methods. This being so, the full audit of our store operations proves to be our "base for betterment".

Over the past five years our "full" store audit has had additions and deletions and has been bent and re-shaped, in fact it has expanded overall from twenty to sixty points. All elements of the "cutting edge" of our loss prevention initiatives are included for review. Some might consider that our audit program is at saturation point. However, we consider that it is one of our major "tools". Certainly the following is achieved:

- The effectiveness of our general procedures is reviewed
- The effectiveness of all our loss prevention initiatives is reviewed
- The auditors are constantly looking for or being advised of areas of concern
- The auditors develop a "culture" for two way communication
- The auditors are very regularly out there "in the real world" (Networking)!
- The auditors spend time assisting, particularly new store management

The audit is regularly adapted to change and is certainly not geared for just finding errors.

Audits by request

Not all of our work is initiated by the Audit Manager or the Audit Committee. We respond to many requests from executives and store management to act in a "consultancy" type of role to investigate or to help with problems. We pride ourselves on being able to give definitive answers to questions relating to store operation policy and procedure. Approximately 10 per cent of our work is requested and we feel that this is a reinforcement of the fact that we are fully part of the "team".

Taking the mystery out of auditing

To outline the role that internal audit plays in our organisation and to discuss how our findings are reported at regular intervals, the department holds short meetings with groups of new managers, senior staff,
management trainees and cadets. Never wishing to miss an opportunity, loss prevention policies and procedures are also discussed at an early stage with new employees. When dealing with new and particularly with junior staff we find that speaking in numbers that they can easily understand to be very important. We touch on Company and State statistics relating to shrinkage but we bring figures down to a more understandable level e.g. "dollars lost per store" or "garments stolen each week". These meetings also further develop the concept of internal audit being part of the management team.

**Getting under the bonnet**

Don't just get under the bonnet, be a part of the engine! A common complaint that is heard from loss prevention executives is that "those people" who write policy that impact on loss prevention e.g. refund policy etc. are less than competent.

To which the response would be "get involved and do something about it" (very easy to say I know!). The retail audit or loss prevention department must "get its hands dirty" in this regard. Activities into which our department has major input or reviews include:

- Production of procedures manuals
- Programming of point of sale systems
- Staffing matters
- Loss prevention education
- Provision of security devices
- Store design and layout
- Damage and mark-down control
- Managers' Meetings
- Regional Managers' Meetings

**Procedures and programming**

The input of internal audit into the writing of policies and procedures or programming point of sales systems etc. may upset the audit "purist" who might claim that our independence or objectivity is impaired. In answer we would say that in our organisation there are many critics and if something was felt to be amiss in any way the Managing Director's telephone would run hot.

Who audits the auditors?

1) The audit committee
2) A peer review of our IAD both internally and by external auditors.
3) A thousand plus employees!

Policies, procedures and programming that are "tight" with regard to loss prevention is the base upon which to build.

**Staffing matters**

Staff screening is a more routine loss prevention exercise. However, in a situation where these controls are missing, it is the IAD who must "pick up the slack" and ensure that they are introduced.

Staff promotion and movement may prove to be a more difficult area for internal audit to impact upon, it's a great area for 'stepping on toes'. However, having convinced management that your comprehensive audit program is the most full and impartial review of store management performance that is earthly possible, you are well on the way!

This is an area where the "benchmark" audit schedules in our organisation have proved very useful. The "full" store audits, having been scored consistently and strictly within guidelines do prove to be a useful component in store management assessment.

**Loss prevention education**

In our organisation it is the IAD that organises or conducts the loss prevention seminars. These are held for all store managers, senior staff and trainees.

It should be stressed that we are not training our staff to be de facto store detectives. They are educated comprehensively regarding the law and arrest etc. However, prevention is the theme to the seminars.

The seminars are tailored for our organisation and for the specific level of staff in attendance "Refresher" courses are conducted at approximately eighteen month intervals.

If the three elements for good sales are location, location and location then our catchcry for good shrinkage results is awareness, awareness and awareness!

**Store design and layout**
The IAD is involved with the review of layouts of both existing and new sites regarding their sensitivity to shrinkage.
Areas that are examined include:

- Fitting room design and placement
- Cash and wrap placement
- Exit locations
- Vision of aisles
- Placement of vulnerable merchandise
- Provision of security devices

**Damage and markdown control**

Although loss through damage or markdown is not necessarily crime related, it is important to have close control over these factors as they may 'cloud the issue' thereby making identification of crime related loss difficult.

Our IAD keeps all records relating to damage and markdown for year-end analysis of "known" and "unknown" loss etc.

An IAD authorisation is required prior to any "writing off" of merchandise. Random inspections by the IAD are conducted of merchandise so written off.

**Attendance at management meetings**

By attending management meetings the IAD keeps abreast of all current issues in the organisation, also regular attendance at regional and store management meetings is a way of getting off the sidelines and lifting the department profile.

**The proof of the pudding**

So much for the theory. Table 1 provides Lowes-Manhattan shrinkage results for the years 1988-1993.

**Table 1**

Lowes-Manhattan Menswear Shrinkage Results

<table>
<thead>
<tr>
<th>Year</th>
<th>% Of Sales</th>
<th>% Change</th>
</tr>
</thead>
<tbody>
<tr>
<td>1987/88</td>
<td>2.17</td>
<td></td>
</tr>
<tr>
<td>1988/89</td>
<td>1.82</td>
<td>-16.12</td>
</tr>
<tr>
<td>1989/90</td>
<td>1.06</td>
<td>-41.76</td>
</tr>
<tr>
<td>1990/91</td>
<td>1.01</td>
<td>-4.72</td>
</tr>
<tr>
<td>1991/92</td>
<td>0.97</td>
<td>-3.96</td>
</tr>
</tbody>
</table>
The overall reduction achieved since 1988 is 61.3 per cent. With further initiatives we are hopeful that this encouraging trend continues.

**Key dates**

May 1988   Expansion of Internal Audit role  
March 1989 Commencement of Loss prevention education  
July 1992   Introduction of EAS.

**Internal or external theft**

There have been many estimates as to the internal theft, external theft or "paperwork" breakdown of loss. It is very difficult to assess. However, we would place external theft as the largest element followed by internal theft with "paperwork error" being the lowest element.

**Professional or opportunist**

Every retailer would know the difficulties involved in combating the "professional" thief or gang. Whilst making every effort that we can, we find that being a "chain" operation we must address the bulk of our efforts towards preventing "opportunist" fraud or theft be this committed externally or by employees.

Not all fraud or theft may benefit the employee at the time, it may in some organisations be possible for managers to "improve" their figures in order to gain "bonuses" or even promotion. In these cases obviously the internal controls need close scrutiny.

The employee fraudster or thief perhaps "hides" behind the perceived trust of his employer which may have been built up over a number of years. It is important to have a clear statement of policy that offenders will be dealt with consistently regardless of their position or "length of service. Our two main weapons against internal theft and fraud are:

- The development of a good "morale" and "culture" in the organisation.
- An extremely tight framework to prevent opportunity.

**Known and unknown loss**
Like most retailers, the "known" or accountable part of annual shrinkage in our organisation is low (approximately 6 per cent). As our systems are developed we are confident that a more accurate figure can be achieved. Two recent developments have greatly assisted us in knowing the "what" in what stock is missing, these being:

1) Cyclical stock-counting by store management with hand held computers and the subsequent comparison and adjustment to our records at bar-code level.

2) Electronic data interchange (EDI). 70 per cent of our merchandise is automatically replaced by our suppliers or warehouse via EDI. The replacement is based upon units sold not on a re-order point, therefore "out of stock" situations quickly indicate that the disappearance of the merchandise has occurred in some way other than the proper one—by selling it!

As some 90 per cent of our stock is bar-coded to size and colour the "what" which has gone is not too hard to identify. However, the "how" we are still working on!

**Perceived reasons for shrinkage improvement**

The following are some reasons why we believe shrinkage in our organisation has reduced markedly:

- Improved employee education in loss prevention
- Greater awareness by staff and management
- Good Company morale
- Improved security devices
- Improved audit activity
- Improved damage/mark-down control
- Improved stock-taking procedures and equipment
- Improved POS equipment and programming
- Electronic data interchange
- Improved internal controls
- Improved staff screening

**Conclusion**

Not all retail organisations may be inclined towards this level of internal audit involvement in their loss prevention activity nor perhaps is it necessary in its entirety. However, in a department store situation the void
between "those people" that write the procedures and the loss prevention department can be filled with an effective internal audit department.

In a "chain" situation, particularly of smaller outlets, the retail internal audit department, in the absence of a specialist department should be the 'experts' in loss prevention.

Internal audit in our industry must go beyond "ticking and flicking". By involvement of internal auditors in areas of the business that may have been seen as off limits and by a pro-active and co-operative approach, the benefits to your organisation can be great.

It's time for retail internal auditors to take a proactive and non-traditional approach to help reduce shrinkage.

Internal audit "involvement with objectivity" is in fact possible and will pay.