Tips on Avoiding Internal Audit Failures

- Process review or audit by 3rd party specialists or an independent internal department not involved in the buying process is important. Checks & balances within procurement decision making team may be inadequate.
- Operational auditors must be willing to speak to people involved in the operation process, not just people directly handling documents.
- Staff morale is always a key barometer of how well a firm is run. Speaking to the staff to understand their version of the story is an essential part of any internal review – it is not enough simply to match vouchers. Talking to staff helps pick up warning signs and clues about things going wrong.
- The ultimate control mechanism rests with employees collectively. Usually, most of your staff are good and honest.
- Market price monitoring by a 3rd party helps check if all is okay. An experienced procurement investigator may discreetly check with the same and alternative suppliers whether you get best prices.
- Avoid appearing aloof. To manage the process well, head office reps here must be very visible, very hands-on, and not appear remote or uninterested.
- The culture gap is a major barrier causing control failures. Senior execs must be willing to speak to lower-level staff, not just rely on the word of direct subordinates.

Internal Audit and Compliance Issues

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ChinaWhys

- Regular reviews of corporate governance issues and internal compliance are essential for maintaining quality internal systems. Different types of internal audit serve different objectives. All companies are required to undergo annual statutory audits, and for most multinationals such audits are often conducted by the “Big 4” international accounting firms. The objective of a statutory audit is to ensure financial statements faithfully reflect a firm’s performance based on general accepted accounting principles.
- However, other types of internal audits can help gauge whether or not a business is operating smoothly – notably the trouble-shooting audit, or “forensic audit”. Forensic auditors differ from financial auditors in that they are not following a strictly prescribed process and check list. They approach the audit with the attitude or suspicion that the target company has violated compliance standards in some way. They act like a detective, think like a criminal and check for the methods used by fraudsters. This requires experience.
- Crucially, forensic auditors focus on actions by employees: who did what, when, where, and how – not all of which is documented. By examining paperwork and conducting interviews, forensic auditors have to pull together the pieces of the jigsaw puzzle, connecting seemingly unrelated pieces of information in order to see the whole picture.

Typical tricks:

Phantom Distributors and Vendors

More often than believed, senior sales managers sometimes inject a phantom distributor (in which they or a family member have an interest) into the sales chain, sidelining real distributors/end customers in order to take a slice from the sales pie. In a typical case, forensic auditors evaluating the purchasing system of a global retail chain in China identified dozens of phantom vendors owned by employees who were massively inflating all transactions. The team helped to clean house through large-scale dismissals and replacement of staff, and to enhance integrity by tightening supplier and employee controls with background screening, ethics policies and pre-qualification procedures.

Joint Venture Fraud

Local joint-venture partners also defraud their foreign partners. In a typical case, forensic auditors were appointed by a publicly-listed European manufacturer to conduct a procurement review of its China JV in parallel with a discreet market investigation. Profits had fallen dramatically – the official reason being that expenses from the previous year had been booked to the current year to reduce tax. However, an internal review revealed that a company linked to the ex-general manager was both a supplier and distributor, selling high and buying cheap from the JV. The firm had failed to issue official invoices for a total of RMB12 million – of which RMB6 million did not appear on the books and RMB6 million was entered on the balance sheet as advances to the supplier. Both had been charged to the current year, wiping out the profit. The rogue supplier was run by an ex-employee who was well paid by the ex-GM to run this side business for him.

Bypassing the Sales Loop

Special auditors were engaged by a European construction equipment maker to investigate its sales staff. It was found that sales staff had colluded with subcontractors to make components illegally for sale using the company’s distribution network. The team successfully obtained evidence, including a purchase of knockoff products from a company owned by sales staff.

Reverse Process Flow Fraud

A distributor filed claim for RMB10 million against a multinational household goods company for non-delivery of goods. Through internal and external investigation, a special audit team discovered that a former employee had colluded with the distributor to take goods out of the warehouse before the sales actually took place. The goods taken out were used as a pledge by the former employee in his other business venture. When the venture failed, he defrauded the multinational.