

Internal Auditors' Important Role During an Economic Downturn

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The internal auditing function, when operating effectively, is a crucial component of any organization. Internal auditors present shareholders and other stakeholders with a unique offering; not only do they play a role in corporate governance through the detection of fraud or errors of the financial statements, they also assist management in creating a more effective, efficient and profitable organization. Although internal auditors always play an important role in company success, the magnitude of their two main tasks is increased when the economy takes a turn for the worse.

During rough economic times, many organizations feel the effect of poor economic performance by way of decreasing sales and reduced profitability. In turn, employees often feel immense pressure to lead the company into a quick recovery and return financial results back to pre-recession levels. Through their consulting role, internal auditors can perform audits wherein the efficiency and effectiveness of the company's operations are assessed. Internal auditors should be knowledgeable about their organization's business model, including key company objectives, the processes and procedures employed to accomplish them and the potential risks involved. The economy, one of the potential risks that internal auditors should be evaluating, becomes increasingly important during a period of economic downturn. Once identified, recommendations on how to mitigate risks can be made to the board and management. Through their involvement in this process, internal auditors are able to help management in achieving company objectives in light of a newly depressed economy.

When tactics that are truly beneficial to the company fail, management will likely feel an increased pressure to turn to less ethical means to get the numbers up. The financial incentives offered

to management for good performance on the financial statements and meeting analysts' targets, once leading to the collapse of Enron, WorldCom, and other major companies through massive frauds, are still present in today's corporate environment. Thanks to some of the repercussions of such scandals, such as the development of the Sarbanes-Oxley Act of 2002 and the resulting creation of the Public Company Accounting Oversight Board, various associated governance issues have since been mediated. However, the temptation and incentive to "cook the books" is still there – and at an increasingly prominent level when the economy is headed towards a recession. This is where the second role of internal auditors comes into play. With a properly-operating internal auditing function present within a company, the first line of defense against such unethical behavior comes in the form of the function's proactive role. According to the IIA's Standard 2120.A2, internal auditors must "evaluate the potential for the occurrence of fraud and how the organization manages fraud risk." Internal auditors do this through a fraud risk assessment wherein they identify and assess fraud risks followed by developing strategies to mitigate such risks.

Although these initiatives are certainly effective in deterring organizational fraud, they are by no means foolproof. When these prevention methods fail, internal auditing has a second role in fraudulent activity: detection. Internal auditors can increase the level of fraud detection within their organization by recommending that certain mechanisms are in place, such as whistleblower hotlines and various process controls like regular, periodic reconciliations and physical inventory inspections. To imagine how effective a properly-developed and operating internal audit function could be in detecting fraud, consider the example of the massive WorldCom scandal. Although the organization's internal auditing function left much to be desired in its governance role, the fraudulent activity that shareholders, the board, the media and even external auditors failed to recognize was eventually discovered by the hard work and dedication of WorldCom's internal auditors. While considering this situation, imagine what a properly-designed and effectively-operating internal auditing function is capable of!