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## Risk Management, Loss Prevention and Internal Audit: How a Team Approach Can Help Reduce Loss and Enhance Profit

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### The state of internal controls

According to the National Retail Federation, U.S. retailers lost more than \$37 billion worth of merchandise last year, due primarily to theft by shoplifters or employees, who were responsible for approximately 80 percent of the total loss. That amounts to 1.6 percent of the \$2.3 trillion worth of goods sold.

These staggering loss statistics are a great concern for retailers – from the board of directors and senior management to store personnel. Due to recent government regulations such as the Sarbanes-Oxley Act of 2002 (SOA), the emphasis on internal controls compliance for retailers has moved out of the boardroom and onto the floor of every store in the retail industry.

SOA has had a significant impact on all retailers' loss prevention (LP) and internal audit (IA) departments. After several prominent corporate financial scandals made headlines, Congress enacted SOA as a way to help protect the financial holdings of shareholders and employees. SOA contains major reforms for public companies required to perform auditing, financial recordkeeping and reporting functions. It places the responsibility for financial compliance on a company's board of directors and senior executives – and there are criminal penalties for conflicts of interest, noncompliance and fraud. In addition, SOA requires, among other things, the use of ethics programs and protection for whistleblowers.

Every loss control executive should become intimately involved with his or her company's SOA compliance efforts. Currently, most public companies are focused on Section 404 compliance, which is the assurance of internal control over financial reporting. Certification of Section 404 compliance is to be included in every public company's annual report. However, many corporations are not documenting everything they should, such as their LP activities.

Due to the increased emphasis on internal control, many retailers have developed a store compliance process to monitor, quickly identify and remediate potential risks. Whether it is reducing shrink or complying with SOA, a thorough, store-level compliance process is essential for protecting, substantiating and reporting on company assets and the processes for monitoring them.

### Loss control enhanced by synergy among partners

An effective store compliance process benefits from synergy (i.e., the sharing of resources and information) among the three most influential departments in loss control: risk management, loss prevention and internal audit.

When comparing these functions, it is important to recognize that all three share a common direction. They each manage risk, try to minimize losses and evaluate the cost of loss control. In order to understand how they can work together as a team to develop a solid store compliance process, let us define each function and then demonstrate how they can work together as a thoroughly integrated compliance team.

## What are the responsibilities of each department?

Loss prevention, risk management and internal audit are responsible for growing internal controls and boosting profitability. *Risk management* is responsible for identifying and assessing exposures to loss. This includes risk identification, risk analysis, control, financing and administration. *Loss prevention* is based on asset protection, namely, people (customers, associates), property (fixtures, facilities), cash, product (displayed, stocked, warehoused) and the corporate brand. The LP strategy includes prevention, detection, investigation, resolution and recovery. Meanwhile, *internal audit* integrates its services into the corporate hierarchy so that senior management and the board of directors have measurable assurances that internal controls are adequate and effective. Their approach is to create and implement a comprehensive audit program at the corporate and store level.

## Who reports to whom when it comes to loss control?

Generally, risk management stands alone and functions independently from loss prevention and internal audit. Risk management may report to internal audit, but that is rare. Usually, it reports to human resources, finance and sometimes, legal. All share in loss reduction responsibility, but the most tightly aligned departments are loss prevention and internal audit. Unlike risk management, LP and IA are physically present in the stores, examining, testing, gathering statistics, and detecting loss on a daily, monthly and yearly basis, depending on asset reduction reports and store benchmarks.

## The five elements in the risk management process

The risk management process includes five important elements: risk administration, identification, analysis, financing and control.

- *Risk administration* is the implementation and monitoring of risk management policies and procedures. These activities include planning, policy development, implementation and monitoring.
- *Risk identification* is the process of examining and determining the potential sources of loss. Common yardsticks include surveys, checklists, inspections, financial guidelines, financial statements, evaluating contracts, and policy and compliance review.
- *Risk analysis* determines how much risk exists by analyzing loss exposure, projected losses, performing a cost and benefit analysis, and deduction or retention analysis.
- *Risk financing* is the insurance element. It is concerned with the acquisition of funds to pay for those losses.
- *Risk control* reduces the potential, number, gravity or volatility of current and future losses through avoidance, reduction, prevention, segregation, physical transfer, disaster recovery, claims management and litigation management.

## Coming together for consistent loss control and compliance

Risk management, loss prevention and internal audit should meet regularly, explore common areas of responsibility, and take the time to learn about each other's jobs, especially how and where they converge and overlap. Effective communication among departments is essential for avoiding any waste of effort, personnel, resources and finances, and most importantly, any redundancy of oversight in the review and analysis of a particular risk.

Once a partnership is formed, new ways can be found to divide duplicate tasks and leverage resources among the three departments, such as having LP and/or IA staff members assist with risk management's store inspections, which ultimately could be incorporated into a store audit. In addition, loss prevention could use the insurance resources of risk management for their safety awareness and emergency preparedness projects.

Obviously, all three departments should share information, reports and statistical data. Loss prevention and internal audit reports and analyses can provide risk management with insights into theft losses and

other fraudulent activities in the stores. Conversely, risk management's loss runs can help identify safety or property risks that loss prevention and internal audit can address. Submitting the loss prevention and internal audit reporting of all loss exposures through risk management to their insurer will go a long way toward reducing subsequent premiums. In addition, they could share the responsibilities of threat assessments, security surveys, physical security, burglar and fire alarm testing, and regulatory compliance.

- *Threat assessments* are critical. Team up, divide the workload and minimize duplication of resources. Risk management should use LP and IA to save unnecessary travel and other expenses. LP reports and statistical information can aid all three areas immensely.
- *Security surveys* can be altered to fit all three areas. Risk information can be collected during in-store surveys and audits by LP or IA staff, which, if yielding an optimistic result, can be used to influence underwriters to reduce premiums. Security surveys also can be used to identify areas that need attention and further analysis.
- *Facility security* poses significant implications to risk exposure. Have risk management get the proper input from their property insurance company before building. Proper attention to details – sprinkler systems, alarms, access control and construction materials – can save considerable money, help mitigate risk and prevent losses.
- *Alarm system testing* is an area often overlooked. Use LP field staff to conduct some of the tests to save costs. Compliance with local and federal fire safety codes could result in reduced premiums or discounts, and will create a safer environment for customers and associates.
- *Safety and compliance with the Federal Reserve Board* is essential for ensuring regulatory transparency. The more compliant a company is, the less exposure it is likely to have to any regulatory agencies (e.g., OSHA, EPA and others). Safety programs help minimize risk and can result in significant savings. Share accident information, claims and loss runs with all loss control departments to emphasize the importance of safety. LP and IA should work closely with risk management resources to analyze claims data and look for trends. Develop safety programs to deal with the causes of accidents that occur most often. Use risk management's insurance broker, whose staff should be available to assist with analysis and program development – usually at no charge.
- *Emergency readiness* should result in fewer losses, particularly fewer catastrophic losses. Risk management should share procedures and make them available in all work areas. Safety drills should be conducted periodically, and performance feedback provided to staff.

## Information technology tools

Most retailers have achieved a great deal of success with an exception-based reporting system, which has enabled them to be more effective in monitoring, understanding and dealing with exceptional behavior that is unwarranted or unwanted. Mobile audit software and physical security systems also have progressed and become more effective at providing information that can be used by retailers to prevent loss. These systems have enabled retailers to improve their control environment, allowing them to not only hold and reduce shortages, but improve their control performance throughout the company as well. Ultimately, this leads to enhanced profitability.

## How can efforts be integrated across all areas of involvement?

Identify commonalities and opportunities to integrate and share resources such as staff, data mining and analysis services. Also, attempt to uncover patterns, trends and potential penetration points across an array of organizational risks.

Forensic investigations and field audits are imperative. Try to leverage common technology platforms and field teams to conduct a wider breadth of store audits covering loss prevention, safety and other regulatory compliance issues (e.g., OSHA, EPA). Conduct investigations into accidents, near-accidents

and theft cases. Include burglar and fire alarm system testing and management as part of the company's overall emergency preparedness program.

Utilize current technology, including a shared incident reporting database for accident claims and theft cases. Rely on CCTV as a critical tool for preventing internal and external theft, and also reducing liabilities by exposing fraudulent injury claims. In addition, consider establishing a shared anonymous hotline for corporate fraud, harassment and regulatory compliance, as well as an awareness program about coordinated risk prevention and management efforts among key departments, and common brand and cost synergies.

## About Protiviti

Protiviti ([www.protiviti.com](http://www.protiviti.com)) is a leading provider of independent risk consulting and internal audit services. We provide consulting and advisory services to help clients identify, assess, measure and manage financial, operational and technology-related risks encountered in their industries, and assist in the implementation of the processes and controls to enable their continued monitoring. We also offer a full spectrum of internal audit services to assist management and directors with their internal audit functions, including full outsourcing, co-sourcing, technology and tool implementation, and quality assessment and readiness reviews.

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Creative Options ([www.creativeop.com](http://www.creativeop.com)), a Protiviti company, is a world-class specialty communications firm. We have built our reputation on designing communication tools that measurably reduce loss. From employee awareness to mobile audits, we are widely recognized for bringing innovative communication solutions to retail.

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