

# A new strategic position: Redefining internal audit in an economic downturn

## A changing world

Government and business leaders were caught unprepared for the global financial crisis, which has evolved into a worldwide economic deceleration. In the short term these conditions have shattered the confidence of many organizations that reacted to urgent concerns around credit, liquidity, revenue and costs.

More and more organizations are now expecting internal audit to think beyond financial controls and compliance. Management and audit committees expect internal audit to be a significant contributor in addressing the present challenges and providing assurance on how well risks are being managed. However, in order to achieve this objective, many audit departments will need to review their processes and transform themselves first.

## How can internal audit refocus to add greater value?

Before audit departments can start finding solutions to improve the effectiveness of their organization, they will need to focus on the following issues within their own processes:

### Cost containment focus

The annual audit plan for many departments is based on a risk assessment of the organization's processes. While a risk-based approach should still drive the department's plan, it is important that the department also consider areas where significant cost containment is possible. Wasteful expenditure may be the biggest risk for

many organizations right now, and their survival may depend on identifying ways to contain cost. Internal audit should fine tune its audit plan to focus on cost containment, which may translate to a fewer number of more in-depth audits.

### Using the right tools

Auditing a process to identify cost containment potential is different from auditing to assess effectiveness of controls. While both can be achieved within the same audit, internal auditors need to change their approach to provide realistic cost containment recommendations. They will need to audit smarter using better tools and leveraging technology. A good example is the use of Audit Command Language (ACL) or other Computer Assisted Audit Techniques (CAATs) to enhance the depth of audit analysis and efficiency of the audit process overall. For instance, while auditing key cost centers to identify opportunities to reduce costs, it is important that the auditors base their recommendations for cost containment on the data set as a whole, rather than a small sample of transactions. This will help internal auditors to provide recommendations based on empirically-tested evidence rather than just a broad understanding of the process and to create a compelling cost benefit analysis for their recommendations.

### Reporting and communication strategy

In addition to enhancing how audit work is performed, there is an opportunity for audit departments to improve upon how they report findings and communicate

the value of audit activities. Audit departments should focus more on incorporating purposeful analysis and quantifying cost savings and value created within the audit report. This will provide enhanced clarity and visibility on the value that internal audit brings to the table. Going a step further, many leading audit departments are using periodic (e.g. quarterly) dashboard reporting to senior management to demonstrate the business value realized through the internal audit program. For many organizations, this will necessitate a reevaluation of the communication and reporting strategy for the department.

### Securing the right talent

Implementing change requires the right skill sets. Each audit team should have at least one person with deep process understanding, good financial analysis skills and a strong knowledge of business models and strategy. This is important as teams strive to create value added cost benefit analysis for their recommendations to stakeholders.

### Finding value in the audit plan

Once internal audit processes have been reevaluated, audit departments can begin to develop an audit plan to help address emerging risks and provide recommendations to meet the evolving needs and expectations of the organization and key stakeholders. The audit plan should reflect the impact of the economic downturn and incorporate a cost containment view for the organization.

## Insurance companies can utilize their internal audit function to monitor the credit ratings and financial performance of reinsurers and other significant counterparties.

Internal audit should consider the following within the audit plan:

### Capital adequacy

Compliance with capital adequacy requirements is extremely important for insurers, particularly given the recent pressures on capital arising from the soft market conditions and poor investment performance. Insurers should also set specific solvency benchmarks which should be used as a yardstick to measure performance.

The internal audit team can assist management in setting and reviewing targets relating to solvency margins as well as required capital to ensure that management is inline with the insurance regulator and internal goals, while maximizing their investment surplus of capital. Ongoing monitoring is critical and should involve highlighting potential deviations from set benchmarks and recommending practical solutions to bring the company's capital to an optimum level.

### Liquidity and cash management

A significant fallout from the global economic crisis has been the availability of credit. Despite bold measures that many governments are taking, credit remains scarce. New lines of credit are far more expensive in 2009 than they were during early 2008. In this scenario, it is critical to ensure that an insurer's cash management is optimal. A thorough review of the effectiveness of cash forecasting, liquidity and an assessment

of potential illiquid investments could yield significant savings. Similarly, a review of accounts payable processes, treasury processes around banking and the effectiveness of accounts receivable processes often yields cash flow improvements.

### Addressing fraud risk

The current economic climate is changing the nature and scale of fraud and integrity risks that organizations face. As a result, many senior executives expect to see more fraud within their organizations over the next few years. The risk of fraud is much higher during a downturn due to two reasons: first, the pressures and incentive to commit fraud is more prevalent as meeting internal targets and budgets is often more difficult during a downturn; and second, with many organizations downsizing people there is a higher potential for compromise in the segregation of duties. There is also greater potential for external fraud risks for the same reasons mentioned above; however, external risks are more difficult to identify and address.

For insurers, fraud risk lies in many areas ranging from policyholders making fraudulent claims, employees who are under financial pressure due to reduced incomes or investment losses and even business partners such as Third Party Administrators who may have cash-flow issues of their own.

While regulators have focused on addressing fraud risks within SOX, it is

now critical that internal audit ascertain the depth of anti-fraud measures that are in place and perform preventive in-depth reviews for areas that have higher exposure.

### Capital projects

When the economy recedes capital projects tend to be scaled back. However, as organizations step back from their capital expenditures, internal audit should be evaluating the processes behind this strategy.

Are management decisions based on sound economics, or are they a short-term reaction to the current economic condition and stakeholder pressure? Does the net present value of the project reflect the economic cycle (i.e. do the long-term cash flows from the project reflect a future upturn in the economy, or are they solely based on current prices)? Are organizations putting in adequate processes to enable a smooth restart of the project to leverage past work?

While economic feasibility is important, the present market conditions provide an unprecedented opportunity for low costs. For those organizations that are continuing with their existing projects, this would be a good time to review contract compliance and economics. A thorough review of contracts at this time may yield significant cost savings.

### Foreign exchange exposure

Many insurers are exposed to foreign exchange fluctuations. The financial crisis has resulted in extraordinary foreign exchange fluctuations for most currencies, and we will likely see continued fluctuations in the near future as each nation struggles with its fiscal policies and implements strategies to stimulate their economies.



This uncertainty has left many companies with the daunting task of managing their financial risks. Internal audit can add value by reviewing an organization's foreign exchange strategy around hedging and mitigating foreign exchange related risks in this ever changing environment.

### Monitoring Credit Ratings

Another impact of the economic downturn has been the number of organizations that have regressed from a solid credit rating to bankruptcy in a matter of weeks. Insurance companies can utilize their internal audit function to monitor the credit ratings and financial performance of reinsurers and other significant counterparties. Where there is a significant change in the financial position of major reinsurers, red flags

should be highlighted to management. Ongoing monitoring of the financial soundness of counterparties can be undertaken by the internal audit teams to ensure that recoverability of receivable balances are not called into question.

### Reviewing overall HR Strategy

In the light of the financial crisis, internal auditors should consider whether management has performed a cost benefit analysis specific to the company's overall HR strategy. To eliminate costs, some insurance companies have established shared services centers as well as outsourcing certain functions for example, their policyholder customer relationship function and call centers. Layoffs have occurred as companies try to manage their costs. Insurers need to consider the long-term impact of layoffs,

as the cost of replacing these resources when the economy rebounds could be much higher than the anticipated short-term savings.

### Conclusion

Audit committees are looking to internal audit to make a more significant contribution towards the success of the organization's core business strategy. The upside to the current economic crises is that organizations now have an opportunity to realign their processes and make them more cost effective.

Looking forward, audit departments that maintain alignment with the changing risk profile of their organization and the evolving needs and expectations of their key stakeholders will be more successful. During this critical economic time, internal audit can add strategic value and become more relevant than ever before.

**To read the full report of *A new strategic position – redefining internal audit in an economic downturn*, please visit [www.pwc.com/ca/publications](http://www.pwc.com/ca/publications) or contact:**

**Dorothy Sanford, FCA**  
Partner  
416 869 2353  
[dorothy.a.sanford@ca.pwc.com](mailto:dorothy.a.sanford@ca.pwc.com)

**Rani Turna, CA**  
Partner  
416 869 2911  
[rani.turna@ca.pwc.com](mailto:rani.turna@ca.pwc.com)

**Claire Cornwall**  
Partner  
416 869 2867  
[claire.cornwall@ca.pwc.com](mailto:claire.cornwall@ca.pwc.com)



**Mixed Sources**  
Product group from well-managed forests, controlled sources and recycled wood or fiber  
www.fsc.org Cert no. SW-COC-002586  
© 1996 Forest Stewardship Council



The pages of this document are printed on Supreme Silk 100 lb. text which is a coated stock containing 10% post-consumer waste.