

# A new strategic position\*

Redefining internal audit in an economic downturn



*In these unprecedented times, organizations are faced with unfamiliar challenges. The imperatives for audit departments have now changed in this current economic landscape.*

#### **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.

Concerns about the prospect of a recession in the US and the European economies mounted during 2008. By autumn a deep economic winter seemed imminent. The trigger came in mid-September, when US investment bank Lehman Brothers filed for bankruptcy, due to nearly US\$60 billion in bad debts, and Merrill Lynch, another investment bank, announced it would be acquired by Bank of America

to avoid a similar fate. At the same time, American International Group, one of the world's largest insurance organizations, received a US\$75 billion credit facility from the government. The International Monetary Fund has expressed fear that 2009 might be the worst year for the industrialized economies since World War II.

The current economic crisis has had significant impact on consumer demand, consumer confidence, stock markets, commodity prices and labour demand in almost every industry and country around the world. Organizations are working hard to come up with innovative action plans to survive the next few years. While regulatory compliance (i.e. Sarbanes-Oxley and Bill 198) has dominated corporate agendas over the last three years, the focus for organizations in the near future will largely be on operations and managing risks more efficiently.

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, for example procurement/contracting for maintenance or capital spend. 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.

## Industry knowledge and interaction with peers

Now more than ever, it is critical to develop good industry knowledge and build a network for formal or informal knowledge sharing with peers. The challenges that many industries face are common, and interaction with peers can provide significant insight into different solutions that may be available. Senior management no longer seeks general recommendations but looks to internal audit to provide unique recommendations based on a good understanding of the industry.

## Fine tune engagement planning

Considering the growing pressure on audit departments to do more work with the same or reduced resources, it is critical not only that the right areas are selected, but also that audit projects are effectively planned, well focused and efficiently executed. Audit departments would benefit from taking into account the following actions as part of their planning process (i.e. prior to launching fieldwork):

- Performing an analysis of cost structures and dollar expenditures;
- Obtaining cost data and performing data analysis to focus efforts on the areas with the most potential for increasing efficiency or containing costs; and
- Incorporating this analysis into the audit program to ensure that an appropriate balance between the focus on controls compliance and cost containment is achieved within the audit.

## 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.

## Hire the right skill sets

Implementing change requires the right skill sets. If audit departments are staffed with compliance auditors hired during the Sarbanes-Oxley (SOX) years and who may have little operational auditing knowledge, a reevaluation of the staffing model is important. Each audit team should have at least one person with deep process understanding and good financial analysis skills.

## 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.

Internal audit should consider the following within the audit plan:

### Procurement and contract review processes

The prices of most commodities have sunk to levels that we have not seen in the last five to six years. Steel and cement prices have come down by more than 50% since July 2008. Oil prices are one-third of 2008 levels. These changes have had a cascading effect on the prices of all raw materials. Given the reduction in demand, many third-party vendors are more amenable to larger discounts and renegotiation of contracts. As a result, it is important that internal audit considers the following:

- Is procurement reviewing existing contracts for potential cost savings?
- Have suppliers been approached to reduce prices in light of lower raw material prices?
- What is the financial impact of cancelling old contracts and entering into new ones, given the current price dynamics?

Aside from examining contracts, internal audit can also analyze operating expenses and focus on fuel costs, labour costs and variable overheads. Audits in these areas could result in substantial savings.



## **Working capital**

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 very critical to ensure that an organization's working capital 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 working capital improvements.

## **Human resource strategy**

One of the biggest impacts of the downturn has been the number of recent layoffs. While many organizations are considering layoffs as a means to manage their costs, it is important that they think through their human resource (HR) strategy as they go through workforce realignment. Although many organizations may be inclined to reduce costs by eliminating the most expensive resources, they also need to focus on performance in addition to costs. Organizations 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. This issue has a high strategic impact on many organizations, especially those operating in knowledge-based sectors such as information technology, healthcare and the services industry.

An HR strategy review should also consider the impact of layoffs on controls. In an increasingly automated environment, segregation of duties would be adversely affected if supervisory positions are eliminated. The audit should also examine if management has a well laid out policy regarding layoffs and whether a cost-benefit analysis has been conducted.

## **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. In some parts of the world bribery and corruption are pervasive in business, yet not every organization has the experience to manage that risk.

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.

*An audit plan that is reflective of the impact of the economic downturn and focuses on cost containment will ultimately add value and contribute to the strategic direction of the organization.*

### **Sustainability/Environmental compliance**

As each organization struggles to maintain or increase their market share within a globally deflating economy, developing innovative strategies to capture the customer's attention are important. Creating sustainable and environmentally-friendly products is one way to do that. From automakers and oil companies to household cleaning products and consumer goods manufacturers, being eco-friendly is the new way to create a niche in the market. While many internal audit departments do not traditionally look at their organization's sustainability strategy, reviewing the strategy and its implementation may be more relevant now than ever before.

It is equally important to ensure that an adequate environmental compliance framework exists within the organization to avoid being in the crosshairs of increasingly active environmental regulators.

Climate change is quickly moving from a niche concern, applicable only to large carbon emitters to a mainstream, strategic business opportunity. It is an emerging business risk that internal audit needs to consider. There are financial audit opportunities as a result of evolving regulation through cap and trade systems and carbon taxes requiring companies to have robust systems and processes to monitor new assets and liabilities. Climate change also presents operational and strategic audit opportunities in that it impacts all businesses in terms of potential changes to product mix, energy reduction opportunities and changing supply chain dynamics.

### **Capital projects**

When the economy recedes capital projects tend to be scaled back. For example, with reduced operating margins for future projects and questionable long-term viability for construction projects, the oil sands industry in Canada has been particularly hard hit. 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 shareholder 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**

The advent of globalization in the last part of the 20th century has led to greater international trade for many organizations, which has increased their exposure to foreign exchange fluctuations. This financial risk has come to fruition for many organizations as the financial crisis has resulted in extraordinary foreign exchange fluctuations for most currencies. Furthermore, 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 to mitigate foreign exchange related risks in this ever changing environment.

## **Asset maintenance and utilization**

The adequacy of asset maintenance programs is a critical business issue for capital intensive organizations. Faced with liquidity problems, organizations may overlook or under spend on predictive/preventive asset maintenance. This could not only lead to higher repair costs, but also result in significant capital expenditures for equipment replacement. It is imperative that organizations get their maintenance strategy right at this point in time. Investing some internal audit time to review asset management and maintenance processes can yield short-term cost

savings and will provide greater assurance on the overall effectiveness of the enterprise management program.

During a downturn organizations may decide to sell off or retire capital equipment that is not optimally utilized. While this might make sense in the short-term, it could be very expensive to buy or lease back the same assets when the economy turns around in the future. Although there may not be immediate cost savings from auditing this area, an audit can help optimize the current, and future capital expenditure budget of the organization.

## **Inventory management**

Many organizations are struggling to sell their finished goods inventories. The retail and auto sectors, in particular, have significant buildup of finished goods and are looking for innovative ways to sell their products and manage working capital.

For organizations in the manufacturing sector, plants may have built up excessive equipment spares and consumables over a period of time. If organizations are manufacturing at multiple locations they may be carrying the same raw materials in more than one location, using up precious working capital in the process.

A thorough review of these areas is important to evaluate innovative ways to manage and move raw materials, spares and finished goods inventories.

## Credit management practices

Prior to the recent economic collapse, the financial services industry was considered to have the most mature credit management practices and processes in place. Their enterprise risk management processes were also considered to be the most advanced and proactive. However, many financial institutions around the world were caught unprepared for the current credit crisis. Now it appears that apart from a lack of good processes, the decisions at a strategic level were also not well thought out. Many financial institutions became overextended, and a small fracture in their receivables hugely impacted their long-term viability.

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. Organizations should be rethinking their credit management practices in this current environment. There is merit in revisiting credit limits for an organization's large customers and counterparties and revising internal processes around their credit assessment. Organizations should also reconsider the nature and extent of the financial information that can be obtained to monitor the financial soundness of their counterparties. Bankruptcies could have a significant impact on recovery of debts or on the normal operation of business in some cases. Internal audit should consider this an important area for review.

## Conclusion

The expectations of audit departments in many organizations are undergoing significant change. Overall, the nature of business risks has altered, particularly for global organizations. Emerging risks, which are difficult to predict from past experience, are now reverberating across entire industries and economies.

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.



## How PwC can help

To maximize the value and effectiveness of the internal audit function, organizations need a comprehensive understanding of the specific objectives, risks and priorities relevant to the organization. PricewaterhouseCoopers' (PwC) Internal Audit team works with clients to assess the effectiveness of their risk management, internal audit and corporate governance processes to help keep up with the changing risks facing their business.

We help our clients address internal audit concerns through the implementation of our Transformational Internal Audit model. The model:

- Ensures that internal audit focuses on areas that enhance shareholder value and consequently are important to stakeholders;
- Identifies cost containment by utilizing PwC process and industry subject matter professionals who have the right depth of knowledge to provide the right input; and
- Creates a more efficient internal audit department by reviewing internal audit activities and benchmarking them with leading practices.

Our internal audit model provides a framework to help internal audit departments add new strategic and operational areas to the audit plan and do more with a cost containment focus in mind. Our approach to working with clients is rooted in a collaborative style that is designed to help organizations implement effective processes and, ultimately, drive value creation.

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