

## Winds of change.

### Control considerations during an economic downturn



#### Background

The credit crunch is affecting more than just the financial services sector. Our recent CFO survey noted: 55% are likely to reduce future hiring and 38% are considering reducing current employee numbers. In addition, 38% plan to reduce capital spending. Most commentators expect businesses to redouble their focus on organisational efficiencies and cost saving opportunities.

As businesses face increased economic pressures and look to cut costs, it can be harder to maintain a strong control environment, as management's attention turns to more immediate operational concerns. In the past, cost cutting exercises may have been undertaken without taking into consideration the control implications, e.g. immediate gains from cost reductions may have more negative long term implications on the control environment.

#### Challenges

How do you maintain a strong control environment in a period of economic uncertainty and instability? How can internal audit help its organisation maintain its focus? How can you ensure that cost effectiveness does not result in a decline in the control environment?

During a period of cost cutting, a manufacturer would not normally cut costs around health and safety measures, as the risk of health and safety incidents still remains constant – or potentially increase if people are working under greater pressure. Similarly, cost cutting measures in any organisation should consider the implications to the control environment and the risk profile of the organisation, and consider what measures are required to compensate accordingly.

#### Example 1

A business changes established and reliable suppliers of important business inputs to new, significantly cheaper suppliers. Potential consequences: new supplier relationships temporarily require increased management bandwidth to monitor and establish good working practice. One or more of the suppliers proves less reliable or of lower quality than required and efficiency and or quality of operations suffers as a consequence

#### Example 2

Process simplification produces headcount and employment cost savings. The simplification reduces the granularity or quality of information used for management decisions, or removes monitoring controls from the business, while introducing risk from loss of retained knowledge from the business.

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Regulators and the public are arguably less forgiving of mistakes and errors during a period of economic downturn and share price is consequently more sensitive to newsflow as a result. In the Deloitte 'Disarming the Value Killers' risk management study, it was identified that roughly one quarter of the companies reviewed took over a year to recover their share prices following a fall in value, a further almost one quarter of companies reviewed had not recovered their share price more than three years after the initial fall in value. During a period of uncertainty and instability, investor perception of 'surprises' and control environment infringements can result in exaggerated responses by the investors and stakeholders.

With 'Turnbull 2' requiring boards to undertake an annual assessment for the purposes of making a public statement on internal control (not just internal financial control), boards and other stakeholders are looking for confidence in the reporting and information provided to them. In a period of economic uncertainty and instability, the additional pressures on the business may mean that maintaining the control environment to these expected levels is a greater challenge. Are you, and the board, confident that information used to drive key decision making is accurate? Changes to the current macroeconomic environment should be reflected in your risk assessment and risk response.

These challenges highlight that maintaining strong organisational governance, including reviewing your controls framework and assurance activities, should continue to be in the forefront of management's concerns. It is important to maintain the appropriate tone at the top, reiterate your existing policies and procedures, and reinforce the importance of internal controls to all levels of management. Internal audit can help to provide senior management with assurance and an independent review of these activities, and be proactive in working with management to identify appropriate responses to managing risk in response to internal and external change.

### Questions to ask the Executive:

#### Governance

During a period of economic uncertainty, it is even more essential for management to be able to respond to changes in its environment on a timely basis. Accordingly, greater emphasis is placed on the accuracy and timeliness of the information that management receives. Are you confident that:

- You have the appropriate oversight mechanisms in place and are you receiving the right information at the right time?

- The right people are preparing the information, are receiving the information and are involved in the decision making?
- You are incentivising your business in a manner which complements your organisational goals and objectives?

#### Risk Management

As the environment in which your business operates is changing, so both the internal and external risks facing you are changing.

- Is your risk management framework flexible, and are you responding to the changes that your organisation faces?
- Have you considered the impact on your business risks and associated risk responses – are you mitigating the right risks for the current environment?
- Are your risk management processes aligned with your performance measurement processes?
- Are operational performance measures tracking your operational risk profile?
- Are potential acquisitions or planned projects still appropriate in the current market?
- Do you rely on third parties for key elements of your operations? If so, are you confident that these third parties will be able to maintain their levels of service and their control environment is consistent with your expectations?



### Internal Controls

Despite increasing use of automated controls, many internal controls are still reliant on people to execute them appropriately. As changes occur within your organisation:

- How do you ensure that management and your employees are familiar with the policies and procedures that affect them?
- How might the economic environment be putting external pressures on your employees, which in turn may affect their attitudes to internal controls or reporting, e.g. personal debt concerns may impact an individual's need to achieve sales targets, which may in turn result in manipulation of data?

### Assurance

At the same time as management is revisiting its risk management responses to the current environment, so internal audit should be revisiting its plan.

- Is your internal audit plan reflective of the current environment?
- Has there been a shift in management's focus, which requires internal audit to refocus its activities?
- Does the internal audit plan reflect management's concerns as identified in its risk assessment process?
- Is internal audit prioritising its plan on the areas that the business needs to know about?
- Does internal audit consider what other forms of assurance management may be receiving when prioritising its activities?
- Are you remembering the basics, and continuing to provide assurance on compliance with policies and procedures?
- Are you supporting management in reinforcing the appropriate tone at the top?

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