

May you live in interesting times: Risk management and assurance in the current economic climate

At a networking evening for Heads of Risk and Internal Audit held on 27 November 2008, co-hosted by Independent Audit and Walker Hamill, the issues relating to internal audit and risk management arising from the current recessionary economic climate were debated. The speaker panel for the evening comprised Dr Colin Johnston (Head of Operational Risk at Barclays Capital, EMEA), Graeme Watt (Head of Internal Audit at Laird Group plc) and Peter Bonisch (Partner, Risk Services at Independent Audit Limited). This paper captures the main issues raised by the speakers and the discussion that followed.

Did you see it coming?

Crash! Bang! Wallop! First, Northern Rock. Then Alliance and Leicester. Soon to follow, RBS, HBOS, Lehman Bros, Merrill Lynch, Glitnir and Fortis and others. One after another, banks found themselves in trouble. Initially seen only as a failure of the banking and financial sector, the woes soon followed in the real economy – in property, retail, manufacturing and the rest of the commercial sector. As the old Chinese curse goes, “may you live in interesting times”.

What lies behind the failures in the financial sector? And what can be learnt? Financial products have become increasingly complex, and the risks taken had increased substantially. But board members and senior managers often failed to understand these products. With complex products like collateralised debt obligations (“CDOs”), perhaps only a handful of people really understood them back to front, and inside out.

The result? Those in the front office had just possibly become too self-confident and careless. They were making substantial profits – some estimates have the financial markets accounting for 30 percent of US corporate profits – but no one, neither board members nor investors, asked the hard questions.



The pressure to conform and match the performance of competing businesses generating high returns also became

a factor – the move into sub-prime debt in banking and, in the commercial sector, pressure to enter sale-and-leaseback transactions to improve returns left businesses lacking the ownership of physical assets to support the business.

Lesson 1: Make sure you understand all aspects of the business and its products. Be prepared to ask the difficult questions and challenge the status quo. Be ready to be unpopular.

Changing risks and refocusing assurance

The immediate impact of the credit crunch has been to lead businesses to ask themselves some fundamental questions relating, in particular, to their funding and cash positions: where was the company’s cash? was it readily accessible? was it clear what funding arrangements were in place or what was needed? and what of the company’s insurance arrangements?

Factors like access to credit were not an issue a few months ago, yet now are threatening many businesses. Just how many organizations’ risk registers saw what was to come? And did companies appreciate the possible impact of a radical change in the economic climate on their businesses?

More practically, has your organization considered the wider risk changes on the business, in areas such as:

- security of key suppliers and their willingness to continue to supply on existing terms
- retention of significant customers, and their ability to continue to meet their obligations
- specific business continuity risks, not just the ‘factory-burning-down’ type scenarios
- treasury risks and interest rate and currency volatility
- changes in business strategy – with growth no longer on the agenda, how does the business need to respond?
- investors expectations and needs, which have shifted substantially in a short space of time.

Lesson 2: Ensure you periodically consider the “what if?” questions. Imagine the unimaginable, and ask the questions that others are not asking. Consider alternative scenarios, and the impact of your business of these events.

More specifically, from an assurance audit perspective, a different approach is needed. Undoubtedly, all Heads of Internal Audit will have reviewed their audit plans for the year. An important step in the review process will have been appropriate engagement with two key stakeholders: the audit committee and executive management.

Reaction from these stakeholders has been variable: some want more of a 'back-to-basics' level of assurance, with internal audit ensuring that day-to-day controls over areas such as cash and inventories are operating well, and the focus of internal audit's work being on undertaking the necessary checks. Other Heads of Internal Audit say that their stakeholders are looking for more value and advice from the audit team. So, where contact with your audit committee chair or some of the executives may have been more occasional than frequent, a change may be required.

Some of the specific areas where a change in the audit plan has been necessary might include:

- a shift in focus toward profit preservation, rather than an assurance focus on risks related to business growth
- a heavy emphasis on fraud and theft, the risk of which increases in difficult economic times
- concentration on working capital and credit controls, and a reassessment of credit risks
- adding value through profit recovery activities – with internal audit helping the business to ensure it is not inadvertently losing revenues through inadequate billing and to strengthen control and management of costs.

Lesson 3: Ensure you engage properly with your audit committee and senior executives and, in particular, understand how, if at all, the risk and controls appetite has changed. Consider how the nature and scope of internal audit's work will need to be different as a result.

The bigger picture

Quite apart from changes to the audit plan, risk and internal functions need to step back and consider the bigger picture. We now all know what's changed, but have we considered the impact of the changes being prolonged?

For example, how does a recessionary China impact the business in contrast to when its economy generated regular double-digit growth? What is the impact of prolonged uncertainty in our markets? (The difference between Treasury bills and 3-month LIBOR is a measure of stress in the credit markets, and spreads have been high and volatile all year – these high spreads are a clear sign of the market's anxiety.)

Areas warranting particular attention going forward are risks relating to change management and people. The very different economic outlook will invariably have an impact on behaviour. With sizeable bonuses that were once a forgone conclusion now at risk, will traders and staff on sales commissions or profit shares try to bend the rules or

massage the numbers? This may be a particular concern where people have over-extended their personal finances, or where reward packages were redesigned to be heavily performance-based with base salaries kept low.

Think more widely about stakeholders too. Not just the audit committee and executive management – but what about investors and credit rating agencies? Have you, as Head of Risk or Head of Internal Audit, considered how investors' expectations have changed and what this means for the company? No doubt someone in your organisation is thinking about this, but are you in tune?

The rating agencies also exert an influence – Standard & Poors, for example, earlier this year announced that they would be taking into account the quality of a company's enterprise risk management systems in determining their ratings. Given your risk and assurance responsibilities, should you be contributing to the dialogue with the rating agencies? Or do you even know who is having this dialogue and how the rating agencies are incorporating this information into their rating decisions?

Undoubtedly, there have been failures in risk management, and it is questionable just how effective companies' enterprise risk management systems have been. There has been inadequate time and effort devoted to *risk oversight* and perhaps too much has been left to audit committees. Clearly, a different approach to risk management is now needed.

Lesson 4: Look afresh at the bigger picture. Understand the expectations of shareholders and rating agencies. Ensure that Internal Audit and Risk are in the loop and involved in the right way, and risk oversight is exercised effectively.

For further information...

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