

Internal audit's role at the start of a recession



These are pivotal times for organisational survival. It is a time for internal audit to be seen, to be heard and to act.

Audit leaders have an important role in supporting the board and senior management as they make critical strategic decisions: providing insight, foresight and assurance.

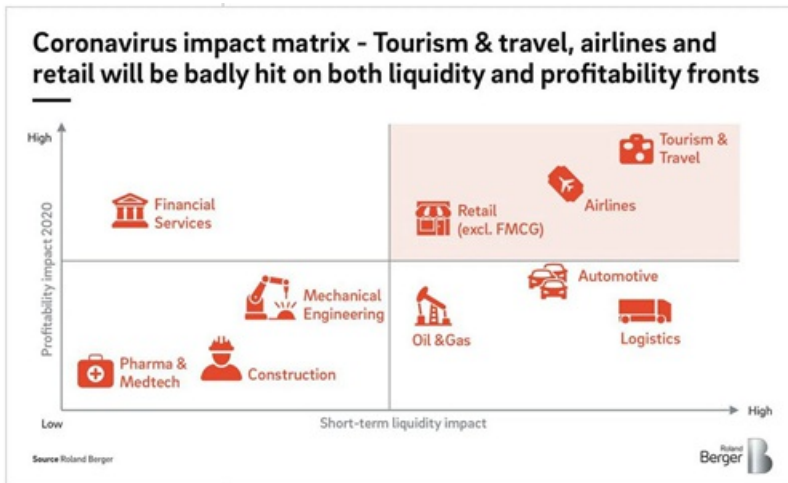
Take a moment to understand how organisations have weathered the storms of recession and what internal audit can do here and now.

Stark predictions

Organisations that survive the turmoil of the COVID-19 crisis may potentially face another devastating and potentially longer-term crisis. On May 13, chancellor Rishi Sunak warned that the country is heading into a “significant recession” as GDP shrank by 2% in Q1 2020 due to the economic impact of COVID-19. The Bank of England estimates that the decline in Q2 could be as high 25%.

Even before the word pandemic became part of our everyday conversation, economists had been debating when the next recession would begin with some suggesting 2020 - 2021. They cited warning signs such as increasing debt, reducing government yields, geopolitical uncertainty, GDP growth in China lower than pre-2010 and negative returns on Standard and Poor's 500. COVID-19 has exacerbated this exponentially.

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Unlike previous recessions, which guide our lessons learnt, the coronavirus pandemic has simultaneously affected all sectors and all countries across the globe. For many the future will be a new normal rather than a return to the recent past. The Bank of England predicts a V-shaped economic recovery albeit over a delayed period of a year, however, as with any forecast other economists have a more sceptical view – the deciding factor could be avoiding a second COVID-19 spike with a return to lockdown measures.

Differentiators of success

The risk of a recession was on the radar of insightful boards prior to the COVID-19 crisis. Recovery, regardless of its shape, will no doubt be influenced by this and compounded by the effects of the pandemic, impact sectors in different ways.

Government support during the first half of 2020 prevented the catastrophic loss of those industries heavily impacted by social distancing measures, particularly retail, hospitality, leisure, tourism and travel, their recoveries remain uncertain.

There are some general lessons from the 2008 financial crisis aftermath that organisations can utilise now. According to [research](#) into the health of 3500 organisations after the financial crisis, the successful ones not only saved their way out of trouble by reducing workforce costs and capital expenditure but also invested their way out by maintaining R&D and CSR activities.

In 2009 resilient organisations had increased their EBITDA by 10%, on average, while their peers within the same industries had lost nearly 15% were the findings of analysis by [Bain](#) and Company. They achieved this by cutting costs fast and hard. It was also noted that they had also managed to reduce their debt rather than extending it.

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Differentiators suggested from other research include:

- maintaining loyalty among high-value customers (central to growth post-recession)
- decentralised organisational structures cope better with change
- leveraging **diverse** employee views and sustaining a positive culture
- aggressive commercial activities
- proactive mergers, acquisitions, and divestments.

Many organisations are much leaner today than they were in 2008.

So, which levers are available to pull today?

Levers to play

All organisations are unique. Identifying the levers that will be most effective is a major challenge for the board; how hard to press and when to apply are key factors.

Audit leaders should be as familiar with the options as their board members to be respected as valued partners fulfilling the 'trusted adviser' role and providing assurance in relation to governance, risk management and internal control.

There are four generic levers to explore.

Balance sheet optimisation

This requires detailed analysis of actuals and assumptions for key elements such as revenue, working capital, dividend payments, tax, debt, and strategic activities such as share buyback/issuance, acquisition and disposals.

Optimisation involves tight management of cash, working capital and capex to maintain liquidity and ideally preserve investment capability.

The obvious first steps include lowering costs, including redundancies, where appropriate, as the government unwinds the furlough process, tightening authorisation procedures for expenditure, and tenaciously chasing outstanding debts.

Organisations will need to evaluate their going concern status with immediate liquidity taking priority over long term viability scenarios.

Some of the typical low hanging fruit for cost reduction include:

- take overdue personnel actions, for example poor performers, those who are known not to be fully utilised, and temporary contractors working on non-core activities
- reduce spending on department management, reducing supervision and basics such as training, overtime and stationery
- gain control of "miscellaneous" spending, in large organisations this can be a black-hole of costs in relation to innovations and projects
- re-propose rejected cost-saving ideas, priorities change and good ideas may just need resurfacing.

Audit leaders need to remain alert to these, particularly as reductions in supervision and controls may have unintended consequences and increase risk to the organisation.

Organisational redesign

Typically aligning structure, people, and processes to strategic goals; for many this is now a constant state of flux via transformation programmes rather than a specific project which this refers to.

At a basic level realigning reporting lines, accountabilities and activities enables redundancies: people, processes and/or controls. Redesign is often a significant change; a light touch approach could also be to ensure policies, authorities and communications safeguard decision-making and positive behaviours.

Unprecedented times call for radical thinking; redesign may also enable some organisations, subject to cost-benefit analysis, to extract themselves out of expensive leases or sell property to address financial constraints. In recessionary times, any effort to redesign must be meaningful; no-one should be rearranging chairs on the decks while the ship is sinking.

Decentralised structures are readily adaptable, as demonstrated by Twitter, announcing that employees would have the option to work permanently from home following the success of remote working during the COVID-19 lockdown. Similarly, Jes Staley, Barclays CEO has said that "there will be a long-term adjustment in how we think about our location strategy - the notion of putting 7,000 people in a building may be a thing of the past."

Portfolio structure

Divestment of non-core assets is a potential revenue stream in addition to reducing distractions. The vulnerability of acquisition targets also presents an opportunity for organisations with financial capacity and/or an aggressive risk appetite. A trend that is predicted to continue through the downturn is for organisations to purchase their way out of inefficient legacy processes such as luxury brand Richemont buying the e-commerce platform YOOX Net-a-Porter rather than developing its own.

Utilise technology to improve productivity

Digital tools can help organisations save cost whilst building future capability. From straightforward solutions such as using cloud storage and enabling virtual communications through to using cloud-based infrastructure services and advanced data analytics such as artificial intelligence.

According to the Institute for Government, the coronavirus crisis forced more change on GP surgeries in March and April than in the last six years with a huge increase in virtual appointments due to necessity. Finding the right balance between face-to-face and virtual is now the priority, as with many organisations the

temporary changes that have been forced upon them may turn into opportunities to improve productivity and/or reduce cost.

Futurist Martin Ford claims that COVID-19 “is going to change consumer preference and really open up new opportunities for automation.” With social distancing predicted to remain in place into 2021, floors are being scrubbed by robots at Walmart stores across America and in South Korea they are being used to measure temperatures and distribute hand sanitiser. Here in the UK, restaurant chain Gaucho’s is considering asking diners to order online when booking and robots for table service.

Immediate actions for audit leaders

Deciding the strategy to take the organisation through a recession is not easy, there are lots of uncertainties, incomplete information, and a huge amount of complexity. Although the accountability for decision-making sits firmly with the board, audit leaders have a duty to provide advice and assurance on the related governance, risk management and internal control processes.

1. Agree internal audit’s role over the coming months with the audit committee. Talk to the chair about the value of internal audit, its charter and purpose. If strategic audits have been ‘out of bounds’ find ways to open the door; demonstrate the role of trusted adviser and assurance partner.
2. Talk to the treasurer (FD or CFO): build a strong, current understanding of the balance sheet. Ask about the finance teams concerns and where assurance is most needed and where it would add greatest value. Utilise external resource if necessary, if no budget exists consider a reciprocal guest auditor arrangement with a peer in another organisation (subject to appropriate confidentiality agreements).
3. Perform a SWOT analysis of the organisation to guide audit planning; how does this compare to the board’s view of the organisation; does it identify any critical risk ‘blind spots’ that need to be surfaced? Industries such as air travel, automotive and tourism will change beyond recognition through a combination of the COVID-19 crisis, the economic recession, and the climate crisis.
4. If not already known, determine the critical activities that the organisation is reliant upon and provide an internal audit opinion on the controls that underpin them. Where data is not available to do this, look at other sources of assurance in the first and second lines and/or perform fast assessments.
5. Validate the information being used by the board to make crucial decisions on the future of the organisation. This will need to be fast, agile assurance as it cannot delay the strategic process.

And always ask questions. The types of questions the board should be asking of itself might also need to be prompted by audit leaders, examples include:

- What are we doing to support the organisation’s short-term viability?
- Do any of the activities being planned to mitigate the recession introduce risk to the longer-term viability (financial, environmental, social and strategic) of the organisation?
- How is the organisation using its capabilities and resources to address societal needs during the COVID-19 crisis, thereby enhancing its reputational and CSR credentials?
- In which ways can the organisation help to protect its stakeholders during the pandemic and through the economic recession?
- How do we maintain the right balance of short-term survival and long-term viability?

It is essential that if asking these and other pertinent questions, audit leaders are ready to provide an

answer if the question is turned on them. Internal audit can be an influential adviser, provoking debate, raising issues and playing devil's advocate where group think is taking hold.

Closing thoughts

It is perhaps an overused phrase that we are living in unprecedented times, yet it is true. As a profession, internal audit is principled about its independence and objectivity however we are all in this together. Our boards and senior executives should welcome the practical, constructive, logical, and insightful perspective that audit leaders can bring to the debate. The time for assurance is now, while decisions are being made that will shape your future and that of the organisation you work in.

"This will require internal audit to continue to be agile, adaptive, and responsive. Our organisations deserve nothing less."

Richard Chambers, CEO and Chairman, IIA Global